Contemporary Issues in International Arbitration and Mediation

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Part I

Investor-State Arbitration
Consider the following two statements:

1. In international investment law, discrimination on the basis of nationality is prohibited. An expropriation that discriminates between investors of different nationalities is illegal. There are rules against arbitrary and discriminatory treatment. Discrimination on the basis of nationality would be a violation of the fair and equitable treatment standard. In addition, nearly all treaties contain national treatment and MFN clauses. Therefore, distinctions on the basis of nationality are prohibited.

2. In international investment law the investor’s nationality is of paramount importance for the enjoyment of rights under treaties. The substantive standards guaranteed in a treaty will only apply to nationals of the States parties to the treaty. In addition, the jurisdiction of an international tribunal is determined, inter alia, by the claimant’s nationality. In particular, if the host State’s consent to jurisdiction is given through a treaty, the offer will only apply to nationals of a State that is a party to the treaty.

Both these statements, contradictory as they may seem, are correct. There is thus a strange paradox about nationality in international investment law. When it comes to access to protection under investment treaties, nationality is extremely important. But when a case reaches the merits, strangely enough, distinctions on the basis of nationality are taboo.

This leads to the question: to what extent can the investor overcome the limitations imposed by its nationality and structure its investment so as to enjoy benefits under an investment treaty?

BITs and other investment treaties contain a variety of provisions concerning the investors’ nationality. The requirements for the nationality of corporations vary from one treaty to another. Some treaties require various forms of economic bonds to the countries concerned.1 Such an economic bond may consist of effective control over the corporation by nationals of the State. Alternatively, it may

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1 See AFT v. Slovak Republic, Award, 5 March 2011, paras. 213-228.
consist of genuine economic activity of the company in the State. But the most commonly used criterion for corporate nationality is just incorporation.

To some extent it is within the investor's disposition whether it meets these various criteria, especially if the criterion of incorporation in a particular country is sufficient to establish nationality. A prudent investor may organize its investment in a way that affords maximum protection under existing treaties. Most often this will be done through the establishment of a company in a State that has favourable treaty relations with the host State provided the relevant treaties accept incorporation as a basis for corporate nationality. That company will then be used as a conduit for the investment. This is done quite frequently through incorporation in The Netherlands because that state has a wide network of treaties that offer favourable standards of protection.

An alternative method is for an investor to transfer its investment or its claim to an existing subsidiary in a country that has favourable treaty relations with the host State.

Some treaties contain so-called denial of benefits clauses. Under such a clause the States reserve the right to deny the benefits of the treaty to a company that does not have an economic connection to the State on whose nationality it relies. The economic connection would consist in control by nationals of the State of nationality or in substantial business activities in that State.2

The nationality of natural persons is usually much more difficult to plan than that of juridical persons. The treaty provisions concerning individuals typically refer to the nationality law of the countries concerned. Typically, it requires time and compliance with often stringent requirements of the respective nationality laws to acquire a new nationality. Therefore, the nationality of natural persons is usually too difficult to manipulate for purposes of gaining access to treaty protection.

In Soufraki v. United Arab Emirates,3 the claimant, an individual, failed in his attempt to assert Italian nationality in order to rely on the BIT between Italy and the United Arab Emirates. The Tribunal found that he did not possess Italian nationality at the relevant time. At the same time, the Tribunal pointed out how Mr. Soufraki could have avoided this unfavourable result through proper nationality planning. The Tribunal said:

The Tribunal…appreciates that, had Mr. Soufraki contracted with the United Arab Emirates through a corporate vehicle incorporated in Italy,

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2 ECT Article 17(1); NAFTA Article 1113; Argentina-United States BIT, Article I(2); United States Model BIT of 2012, Article 17; Austria-Jordan BIT, Article 10.
3 Soufraki v. United Arab Emirates, Award, 7 July 2004.
rather than contracting in his personal capacity, no problem of jurisdiction would now arise.4

This leads to the question of the permissibility and effectiveness of nationality planning. Attitudes vary widely and are reflected in the terminology of commentators. Those disapproving of nationality planning typically speak of treaty shopping and refer to corporations thus established as corporations of convenience. Some will even refer to these practices as abusive. Those who approve of it often speak of corporate structuring.

In principle, there is no reason why a prudent investor should not organize its investment in a way that affords maximum protection under existing treaties. It is neither illegal nor improper for an investor of one nationality to establish a new entity in a jurisdiction perceived to provide a beneficial regulatory and legal environment, including the availability of an investment treaty. The establishment of companies so as to obtain benefits from domestic law and treaties is neither unethical nor illegal and is standard practice in international economic relations. Nationality planning has become as much a standard feature of diligent management as tax planning.

The Tribunal in *HICEE v. Slovakia*5 has pointed out that ‘structured investments’ are

…not unusual, nor is there anything in the least reprehensible about it; structured investments are commonplace. The purpose is to secure advantages from incorporation or operation in a particular jurisdiction;…The advantages anticipated often include the protection of particular bilateral (or other) treaties covering foreign investment.6

Practice confirms that it is permissible and to be expected that investors will structure their investments in order to avail themselves of treaty protection including access to international arbitration.

In a number of cases including *Tokios Tokelės v. Ukraine, Saluka v. Czech Republic* and *Aguas del Tunari v. Bolivia*, the tribunals accepted the investors’ corporate nationality based on the provisions of the respective treaties.

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4 At para. 83.
6 At para. 103.
In *Tokios Tokelės v. Ukraine* the Claimant was a business enterprise established under the law of Lithuania but it was controlled almost entirely by Ukrainian nationals. Article 1(2)(b) of the Lithuania-Ukraine BIT defines “investor” in respect of Lithuania as “any entity established in the territory of the Republic of Lithuania in conformity with its laws and regulations.” Ukraine argued that whilst Tokios Tokelės was lawfully incorporated in Lithuania, it was not a “genuine entity” of Lithuania for the purposes of the Lithuania-Ukraine BIT and the Convention. Ukraine argued that the Tribunal should adopt a “control test”, and look to the company’s ultimate owners which, it said, pointed to Ukrainian, not Lithuanian, nationality. Ukraine argued that the Tribunal ought not to uphold its jurisdiction since the Lithuania-Ukraine BIT and the ICSID Convention did not permit nationals of the host State to submit claims against their own State to international arbitration through a foreign-incorporated entity.

The Tribunal held, by majority, that the Convention leaves the task of choosing the applicable test by which to determine whether a legal person qualifies as a national of a Contracting State to the “reasonable discretion of the Contracting Parties.” The Tribunal underscored the deference it owed to the definition of corporate nationality contained in the BIT. In view of the BIT’s clear definition, the Tribunal held that the legal place of incorporation was the only relevant consideration to determine whether the Tribunal had jurisdiction *racione personae*. Since Tokios Tokelės was a legal entity duly established under the laws of Lithuania, the majority concluded that Tokios Tokelės qualified as a Lithuanian “investor” for the purposes of the BIT and a “national of another Contracting State” for the purposes of the Convention.

The Tribunal also found the absence of a denial of benefits clause significant:

...state parties are capable of excluding from the scope of the agreement entities of the other party that are controlled by nationals of third countries or by nationals of the host country. The Ukraine-Lithuania BIT, by contrast, includes no such “denial of benefits” provision with respect to entities controlled by third-country nationals or by nationals of the denying party. We regard the absence of such a provision as a deliberate choice of the Contracting Parties. In our view, it is not for tribunals to impose limits on the scope of BITs not found in the text, ...

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8 At para. 18.
9 At paras. 21-23.
10 At para. 24.
11 At paras. 25, 26.
12 At paras. 29, 38.
13 At para. 56. Footnote omitted.
In *Saluka v. Czech Republic*\(^{14}\) the Claimant was a legal person incorporated under the laws of the Netherlands. The Respondent objected that Saluka was merely a shell company controlled by its Japanese owners. In accordance with the Czech-Netherlands BIT, the definition of ‘investor’ in Article 1(b)(ii) includes ‘legal persons constituted under the laws of [The Netherlands]’.\(^{15}\) The Tribunal said:

> The Tribunal has some sympathy for the argument that a company which has no real connection with a State party to a BIT, and which is in reality a mere shell company controlled by another company which is not constituted under the laws of that State, should not be entitled to invoke the provisions of that treaty.\(^{16}\)

But it found nevertheless that the Claimant was a Netherlands company. It said:

> The Tribunal cannot in effect impose upon the parties a definition of “investor” other than that which they themselves agreed. That agreed definition required only that the claimant-investor should be constituted under the laws of (in the present case) The Netherlands, and it is not open to the Tribunal to add other requirements which the parties could themselves have added but which they omitted to add.\(^{17}\)

In *Aguas del Tunari v. Bolivia*\(^{18}\) the Claimant was a legal person constituted under Bolivian law. It relied on the definition of ‘national’ in Article 1(b) of the Bolivia-Netherlands BIT which included legal persons incorporated in the host State but controlled by nationals of the other State. Aguas del Tunari argued that it was controlled by Netherlands corporations. Bolivia objected arguing that these Netherlands corporations were, in turn, controlled by a US corporation. The Tribunal found that the controlling Netherlands companies were more than just corporate shells set up to obtain jurisdiction over the dispute before it. Therefore, it found that the BIT’s nationality requirements were fulfilled.\(^ {19}\)

> The Tribunal in *Aguas del Tunari* clearly endorsed the idea of purposeful planning. It stated that it was neither illegal nor uncommon for investors to locate their operations in a jurisdiction that offers a beneficial legal environment in terms of taxation or the availability of a BIT. The Tribunal said:

\(^{14}\) Saluka v. Czech Republic, Partial Award, 17 March 2006.

\(^{15}\) At paras. 1, 73, 183-186, 197.

\(^{16}\) At para. 240.

\(^{17}\) At para. 241.


\(^{19}\) At paras. 206-323.
...it is not uncommon in practice, and—absent a particular limitation—not illegal to locate one's operations in a jurisdiction perceived to provide a beneficial regulatory environment in terms, for examples, of taxation or the substantive law of the jurisdiction, including the availability of a BIT.\(^{20}\)

The language of the definition of national in many BITs evidences that such national routing of investments is entirely in keeping with the purpose of the instruments and the motivations of the state parties.\(^{21}\)

But in a number of other cases nationality planning did not work. *Banro v. DR Congo*\(^{22}\) arose out of an investment agreement concluded between a Canadian company, Banro Resource, and the Democratic Republic of Congo containing an ICSID consent clause. Canada, unlike the United States, was (and is) not a party to the Convention. After a dispute had arisen, Banro Resource transferred the investment to Banro American, its US affiliate. Banro American was not a party to the investment agreement. Nine days after the transfer, Banro American instituted ICSID arbitration. The Tribunal found that Banro Resource was not a “national of another Contracting State” at the time it entered into the contract. There was therefore never a valid agreement to submit a dispute to ICSID arbitration. Applying the principle *nemo plus iuris transferre potest quam ipse habet*, the Tribunal held that Banro Resource could not effectively assign its claim to a US subsidiary that had not entered into an arbitration agreement with the respondent State in order to bypass this fundamental defect of jurisdiction.

Another instance of unsuccessful nationality planning was *Phoenix v. Czech Republic*.\(^{23}\) In that case there was originally a dispute between the Czech State and a Czech investor. Most of the incriminated facts had occurred and the dispute was in full swing when the Czech investor tried to acquire a seemingly convenient nationality by selling the investment to an Israeli company, Phoenix, which had been established especially for that purpose. Shortly after the transfer, the company commenced ICSID arbitration relying on the BIT between Israel and the Czech Republic.

The Tribunal found that it had no jurisdiction *ratione temporis* to consider claims that had arisen prior to the alleged investment by the Israeli company. In addition, the Tribunal found that the claim constituted an abusive attempt to get access to the system of investment protection under the ICSID Convention. The

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\(^{20}\) At para. 330.

\(^{21}\) At para. 332.

\(^{22}\) *Banro v. DR Congo*, Award, 1 September 2000. Only excerpts of the Award have been published: 17 ICSID Review—FILJ 380 (2002).

\(^{23}\) *Phoenix v. Czech Republic*, Award, 15 April 2009.
claimant had made an investment not for the purpose of engaging in economic activity but for the sole purpose of bringing international litigation against the Czech Republic. Since there was no *bona fide* economic transaction, the pursuit of the arbitration was an abuse of the system. It followed that there was no protected investment. The Tribunal said:

The unique goal of the “investment” was to transform a pre-existing domestic dispute into an international dispute subject to ICSID arbitration under a bilateral investment treaty. This kind of transaction is not a *bona fide* transaction and cannot be a protected investment under the ICSID system.\(^\text{24}\)... the Claimant’s initiation and pursuit of this arbitration is an abuse of the system of international ICSID investment arbitration. ... It is the duty of the Tribunal not to protect such an abusive manipulation of the system of international investment protection under the ICSID Convention and the BITs. ... The Tribunal has to ensure that the ICSID mechanism does not protect investments that it was not designed for to protect, because they are in essence domestic investments disguised as international investments for the sole purpose of access to this mechanism.\(^\text{25}\)

Interestingly enough, the *Phoenix* Tribunal did not dismiss nationality planning outright. It approved of the decision in *Tokios Tokelės* and said that international investors can structure “upstream” their investments in a manner that best fits their need for international protection, but cannot modify “downstream” the protection once the acts damaging to the investment have already been committed. In the Tribunal’s words:

International investors can of course structure *upstream* their investments, which meet the requirement of participating in the economy of the host State, in a manner that best fits their need for international protection, in choosing freely the vehicle through which they perform their investment.... But on the other side, an international investor cannot modify *downstream* the protection granted to its investment by the host State, once the acts which the investor considers are causing damages to its investment have already been committed.\(^\text{26}\)

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\(^{24}\) At para. 142.

\(^{25}\) At para. 144.

\(^{26}\) At paras. 94, 95.
In *Cementownia v. Turkey*, the claimant was a Polish company that claimed to have acquired shares of two Turkish companies. The alleged share transfers took place only twelve days before Turkey terminated concession agreements thereby, it was argued, violating its treaty obligations under the ECT. The Tribunal found that the entire share transaction between the Turkish company and the Polish claimant was fabricated and never actually took place. That would have been enough to dismiss the claim. But the Tribunal elaborated on its views about treaty shopping:

This, if true, is unabashedly treaty shopping. As other tribunals have found, treaty shopping *per se* is not in principle to be disapproved of, but in some instances it has been found to be a mere artifice employed to manufacture an international dispute out of a purely domestic dispute. Given the dispute’s history and the temporal aspects of the case (a mere twelve days elapsed between the claimed acquisition of shares in companies already on notice of potential termination of the concessions and the actual termination measures themselves), had the Tribunal found that the share transfers actually did occur on May 30, 2003, it would have held that this case fell within the category of an artifice.

Even if they did occur, the share transfers would not have been *bona fide* transactions, but rather attempts (in the face of government measures dating back some years about to culminate in the concessions’ termination) to fabricate international jurisdiction where none should exist.

The Tribunal, relying on *Phoenix*, added that an investment not for the purpose of engaging in commercial activity but for the sole purpose of gaining access to international jurisdiction was not a bona fide transaction and did not qualify as a protected investment. The Tribunal also referred to “treaty shopping of the wrong kind.”

These cases were rather straightforward and it is difficult to take issue with their outcomes. They all involved last minute or belated attempts to gain access to treaty privileges by investors who did not originally have them. So is the timing of the efforts to obtain the right nationality the answer to the problem?

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28 At para. 156.
29 At para. 117.
30 At paras. 154-157.
A particularly instructive case in this respect is *Mobil v. Venezuela*. In that case, the investments had been made by Exxon Mobil through holding companies in Delaware and the Bahamas. After certain difficulties with the new Venezuelan government had arisen over royalties and income tax, Exxon Mobil restructured its investment by interposing a Netherlands holding company. Mobil informed the Venezuelan government of this step which did not raise any objection. As a consequence of the restructuring, the Delaware and Bahamian companies thereby became 100% owned subsidiaries of the Dutch company.

After Mobil had completed its restructuring, Venezuela took nationalisation measures. Thereupon, Mobil instituted ICSID arbitration relying on the BIT between The Netherlands and Venezuela. The Tribunal found that the restructuring of the investment was not impermissible, in principle, but depended on the particular circumstances. The aim of obtaining access to ICSID arbitration was not *per se* illegitimate:

It thus appears to the Tribunal that the main, if not the sole purpose of the restructuring was to protect Mobil investments from adverse Venezuelan measures in getting access to ICSID arbitration through the Dutch-Venezuela BIT. Such restructuring could be “legitimate corporate planning” as contended by the Claimants or an “abuse of right” as submitted by the Respondents. It depends upon the circumstances in which it happened.

Despite Venezuela’s vigorous protestations, the Tribunal found that this form of corporate structuring was permissible. The Tribunal said:

204. …the aim of the restructuring of their investments in Venezuela through a Dutch holding was to protect those investments against breaches of their rights by the Venezuelan authorities by gaining access to ICSID arbitration through the BIT. The Tribunal considers that this was a perfectly legitimate goal as far as it concerned future disputes.

205. With respect to pre-existing disputes, the situation is different and the Tribunal considers that to restructure investments only in order to

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32 At paras. 200, 201.

33 At paras. 187-192. Under the BIT between The Netherlands and Venezuela not only companies incorporated in The Netherlands but also Companies controlled by Dutch incorporated companies are deemed to be nationals of the Netherlands.

34 At paras. 190, 191.
gain jurisdiction under a BIT for such disputes would constitute, to take the words of the Phoenix Tribunal, “an abusive manipulation of the system of international investment protection under the ICSID Convention and the BITs.”

It appears from these cases, especially from the Mobil v. Venezuela case, that prospective planning within the framework of existing treaties will be accepted by tribunals. Prospective means that the corporate arrangements must be in place before the dispute arose. What appears to be impossible is to create a remedy for existing grievances after a dispute has broken out, by arranging for a desirable nationality.

So it appears that practice has given us a relatively straightforward answer that makes the validity of nationality planning primarily dependent on the time of the restructuring in relation to the dispute. If the restructuring was undertaken early i.e. before the outbreak of the dispute, the newly acquired nationality will be honoured. But a last minute change of nationality in the face of an existing dispute will be rejected. This solution rewards foresight and punishes those who are surprised by events and fail to act until it is too late. This is not inherently unreasonable.

But the solution that has thus evolved has its own pitfalls. The exact time of the outbreak of a dispute is not always easy to determine. Also it is not entirely clear whether the relevant time is the time of the dispute or the time of the events leading to it. If the relevant time is that of the adverse act there may also be a problem where you have a series of acts interfering with the investment. A wise investor will structure its investment from its inception or at any rate as early as possible so as to benefit from treaty relations that offer maximum protection.

The current situation is not entirely satisfactory. As pointed out earlier on, distinctions on the basis of nationality are not particularly logical: they are mandated in some contexts and prohibited in other contexts.

Distinctions on the basis of nationality are also unsavoury from an ethical standpoint. Why should individuals and corporations have widely differing rights depending on the accident of their nationality? Most importantly for our context, distinctions based on nationality are not only arbitrary they are also subject
to manipulation. All it takes is to channel an investment through a company that is incorporated in the right country as long as this is done early enough.

There are essentially two possible ways to deal with this dilemma. But both are not within easy reach, certainly not in the foreseeable future. One would be a widely ratified multilateral agreement on investment that grants substantive and procedural rights to investors from all participating countries. Efforts to draft such a multilateral agreement have been made at least twice but have failed for a variety of reasons. At present, chances for the success of such a project are slimmer than ever. Even if agreement on a text were to be achieved, universal or near universal acceptance is extremely unlikely.

Another theoretical possibility would be to emulate the solution that human rights law has adopted. Human rights are enjoyed regardless of nationality by nationals of any country including nationals of the country that is accused of the violation. Perhaps in the long run, this may be a solution to the problem of nationality in investment law. But we are still a long distance from that and it is entirely unclear whether we will ever get there.

38 See OECD Draft for a Multilateral Agreement on Investment (MAI) dated 22 April 1998, http://www1.oecd.org/daf/mai; In 2004 efforts within the WTO to include investment issues in the Organization’s mandate were terminated: Decision of the WTO General Council of 1 August 2004 on the Doha Agenda Work Program.