

International Centre for  
the Settlement of Investment Disputes  
(ICSID)

June 27, 1990

In the Matter of Arbitration between

ASIAN AGRICULTURAL PRODUCTS LTD.  
(AAPL)

v.

REPUBLIC OF SRI LANKA  
CASE No. ARB/87/3

FINAL AWARD

*President* : Dr. Ahmed Sadek EL-KOSHERI  
*Members of the Tribunal* : Professor Berthold GOLDMAN, and  
: Dr. Samuel K.B. ASANTE  
*Secretary of the Tribunal* : Mr. Bertrand P. MARCHAIS

In Case No. ARB/87/3,

*Between* Asian Agricultural Products Ltd. (AAPL),  
represented by:  
Dr. Heribert Golsong, as Counsel  
[of the law firm of Fulbright & Jaworski]  
And  
The Republic of Sri Lanka  
represented by:  
[Messrs. William Rand, Robert Hornick, Paul Friedland and Evan  
Gray of the law firm of Coudert Brothers, as Counsel; and Messrs.  
M.S Aziz and A. Rohan Perera, as Agents]

THE TRIBUNAL

Composed as above,  
After deliberation,  
Made the following Award:

1. On July 8, 1987, the International Centre for the Settlement of Investment Disputes (hereinafter called "the Centre" or "ICSID") received a Request for Arbitration from Asian Agricultural Products Ltd. (Hereinafter called "AAPL" or "the claimant"), a Hong Kong corporation.

The Request stated that AAPL wished to institute arbitration proceedings against the Democratic Socialist Republic of Sri Lanka (hereinafter called "Sri Lanka" or "the Respondent") under the terms of the ICSID Convention to which Sri Lanka is a contracting Party, and in reliance upon Article 8.(1) of the Agreement between the Government of the United Kingdom of Great Britain and Northern-Ireland and the Government of Sri Lanka for the Promotion and Protection of Investments of February 13, 1980 (hereinafter called "the Bilateral Investment Treaty") which entered into force on December 18, and was extended to Hong Kong by virtue of an Exchange of Notes with effect as of January 14, 1981.

2. Article 8.(1) of the Bilateral Investment Treaty, invoked as expressing Sri Lanka's consent to ICSID Arbitration, reads as follows:

Each contracting Party hereby consents to submit to the International Centre for the Settlement of Investment Disputes (...) for settlement by conciliation or arbitration under the Convention on the settlement of Investment Dispute between States and Nationals of the Other States opened for signature at Washington on 18 March, 1965 any legal disputes arising between that Contracting Party and national or company of the other Contracting Party concerning an investment of the latter in the territory of the former.

3. The Claimant indicated in the Request for Arbitration that a dispute arose directly out of an officially approved investment by AAPL in Sri Lanka that took place in 1983 under the form of participating in the equity capital of SERENDIB SEA-FOODS LTD. (hereinafter called "the Company" or "Serendib") a Sri Lankan public company established for the purpose of undertaking shrimp culture in Sri Lanka.

According to the Claimant, the Company's farm, which was its main producing center, was destroyed on January 28, 1987, during a military operation conducted by the security forces of Sri Lanka against installations reported to be used by local rebels. As a direct consequence of said action, AAPL alleged having suffered a total loss of its investment, and claimed from the Government of Sri Lanka compensation for the damages incurred as a result thereof. The claims submitted on March 9, 1987, remained outstanding without reply for more than the three months period provided for in Article 8.(3) of the Bilateral Investment Treaty to reach an amicable settlement, and hence AAPL became entitled to institute the ICSID arbitration proceedings.

4. On July 9, 1987, the Secretary General of ICSID sent an acknowledgment of the Request to AAPL and transmitted a copy of the Request to Sri Lanka. On July 20, 1987, the Secretary General registered the Request in the Arbitration Register and notified the Parties accordingly.

5. On September 30, 1987, the Centre received a communication from AAPL to the effect that Professor Berthold Goldman has been appointed as member

of the Tribunal in conformity with Rule 5.(1) of the Arbitration Rules. He accepted his appointment as arbitrator on October 8, 1987.

The Republic of Sri Lanka appointed Dr. Samuel K. B. Asante by a letter dated October 20, 1987. He accepted his appointment on October 28, 1987.

Dr. Ahmed S. EL-Kosheri was appointed as the third arbitrator and President of the Tribunal on December 24, 1987, by the Chairman of the Administrative Council of ICSID in consultation with the Parties. He accepted his appointment on January 4, 1988.

Accordingly, the Tribunal became constituted as of January 5, 1988, and the declaration provided for under Arbitration Rule 6 was signed by each arbitrator.

6. At the first session of the Tribunal, held on February 23, 1988 at the Offices of the World Bank in Washington, D.C., the Parties declared that they were satisfied that the Tribunal had been properly constituted in accordance with the provisions of Section 2, Chapter IV of the Convention and of Chapter I of the Arbitration Rules (Minutes of said Session, Item I,(c)).

The Parties and the Tribunal established the framework within which the pleadings have to take place, comprising two consecutive rounds of written submissions followed by oral hearings to be electronically recorded without requiring the production of verbatim transcripts (Items 10-12 of the Minutes).

It was also agreed upon in that First Session that the Arbitration Rules in effect after September 26, 1984, shall apply (Item 2); that the language of the proceeding would be English (Item 8); and that the place of the proceedings will be Washington, D.C. at the seat of the Centre (Item 9).

7. The Claimant's Memorial, submitted on April 13, 1988, focused mainly on the "bases for the claim", consisting of:

- (i) - the unconditional obligation of "full protection and security" provided for in Article 2 of the Bilateral Investment Treaty;
- (ii) - the more specific and clearly defined obligation stated in Article 4(2) of that Treaty requiring adequate compensation of the destruction of the Claimant's property under circumstances not justified by combat action or necessities of the situation; and
- (iii) - finally, the Claimant indicated that the Government's liability extends to cover "damage caused under customary rules of international law on State responsibility" (lines 9 and 10 on page 6 of the Claimant's Memorial).

The remedy required was expressed by the Claimant in terms of evaluating "the market value of the undertaking on the basis of discounted cash flow (DCF) theory", in order to establish the "going concern value" of Serendib Seafoods Ltd on January 28, 1978, the date of the destruction of its property.

8. The Respondent's Counter-Memorial, submitted on June 18, 1988, placed the emphasis on different aspects; mainly to illustrate that the Serendib venture "was a failure from the outset", and its "fitful efforts to restructure was overtaken in

January 1987, by the civil war between Tamil separatists and the Sri Lankan Government". Thus, the large majority of AAPL's claimed damages should be denied since they are based on "the illusion of expected profitability."

Moreover, according to the Respondent's account of the facts, the destruction of Serendib's property was due to intense combat action between the Tamil rebels known as the "Tigers", who were allegedly operating out of Serendib's farm and reported by Governmental sources as having violently resisted the counter-insurgency operation conducted by the Special Task Force (STF), and which aimed to drive the Tiger rebels out of the area,

Equally, with regard to the relevant dispositions of the Bilateral Investment Treaty, the Respondent's Counter-Memorial gave the Treaty an interpretation different from that advanced by the Claimant. Particularly, the expression "full protection and security" used in Article 2 has to be construed as simply incorporating the standard which requires "due diligence" on the part of the States, and does not impose strict liability. As to Article 4.(2), the Government's liability thereunder would not arise except in case the Claimant succeeds in providing the proof that the counter-insurgency actions were not reasonably necessary or that the governmental security forces caused excessive destruction during their combat against the Tamil rebels.

9. The Claimant's Reply to the Respondent's Counter-Memorial was duly submitted on August 18, 1988. The first part of the Reply contained an elaboration of the factual aspects of the case from the Claimant's point of view, especially those related to the events of January 28, 1987. According to Claimant, there was no "battle" at the farm site, but rather "a murderous over-reaction by the STF which led to the destruction and civilian deaths".

Furthermore, no access to the farm was permitted before February 10, 1987, either by the Batticaloa Citizens's Committee for National Harmony or by Serendib's staff, in order that "all evidence of the brutal actions in area could be obliterated".

In the second part of the Reply, the Claimant started by indicating that the Sri Lanka/U.K. Bilateral Investment Treaty "should be considered tantamount to" an agreement between the two Parties as to the applicable rules of law, within the context of Article 42 of the ICSID Convention. Nevertheless, it has to be understood that the Treaty itself is not limited to the explicit statement of certain substantive rules, but renders applicable additional rules incorporated therein, either by reference or by implication. Moreover, the Claimant's Reply states that the "rules of customary international law", as well as the "Law of Sri Lanka as the host country", may be regarded as supplementary "alternative source of applicable law" (p. 29 of the Reply).

With regard to the specific issue of the Standard of Liability under the general pattern followed by Bilateral Investment Treaties, the basic argument developed by the Claimant amounts to an assertion that the traditional "due diligence" criterion applicable under the *minimum standard* of customary international law had been replaced by a new type of "strict or absolute liability not mitigated by concepts of due diligence" (p. 54 of the *Claimant's Reply*).



In case the strict liability argument based on Article 2 and on the most-favoured nation clause contained in the Bilateral Investment Treaty, would not be assisted by the Tribunal, the Claimant presented "as an *alternative submission* only" another argument based on Article 4.(2) (p. 56 of the *Claimant's Reply*), and ultimately on article 4.(1) "which remains the fall-back provision in cases of war destruction" (*Ibid*, p. 57).

Under this alternative argument, the applicability of Article 4.(2) cannot be avoided except in case Sri Lanka would succeed in carrying out its *onus probandi* by providing convincing proof that the destruction of January 28, 1987 was caused "in combat action", and was required by "the necessity of the situation".

At the end of the Claimant's reply, AAPL's submissions were formulated as requesting the Tribunal to:

1. Determine the liability of the Government of Sri Lanka to compensate AAPL for the unlawful requisition and destruction of its investments;
2. Award to AAPL restitution or adequate compensation in the amount of freely transferable U.S. Dollars of not less than \$ 8,067,368 (eight million sixty-seven thousand three hundred sixty-eight) on account of the requisition and destruction of its investment, increased by the additional costs, including all direct and indirect costs of the present proceedings, as well as interest at commercial rates;
3. Order the Respondent to assume the guarantee which AAPL had accepted for the loan by EAB/Deutsche Bank to SSL, or to pay in escrow the additional amount of U.S. \$ 888,000 (eight hundred-eighty thousand), representing the principal of the outstanding loan amount to be paid by AAPL if and when Deutsche Bank prevails in a call on the guarantor for the guarantee subscribed on September 15, 1984;
4. Deny the Counter-claim by the Respondent for costs and attorneys-fees.

10. On October 20, 1988 the Government of Sri Lanka submitted its Rejoinder mainly devoted to emphasizing two issues: (i)—on the one hand, the incorrectness of AAPL's construction of the interrelation between Article 2.(2) and Article 4.(2) of the Sri Lanka/U.K. Bilateral Investment Treaty; and (ii)—on the other hand, the refutation of AAPL's claimed damages.

According to the Respondent's Rejoinder, Article 4.(2) is not an exemption from the rule contained in Article 2.(2), since both articles "share a common standard of liability (that of governmental negligence)", but "the two provisions concern damages arising in distinct situations and caused by distinct parties" (p. 6 of the *Rejoinder*). Moreover, Article 4.(2) could not be considered superseded by operation of Article 3 (the most-favoured-nation clause) as a result of the subsequent conclusion of the Sri Lanka/Switzerland Investment Treaty. In the Respondent's own words, such convention "meets the same problem as AAPL's absolute liability theory; because Article 4 of the Treaty creates potential liability, and does not limit liability, its exclusion from a subsequent treaty could not increase U.K. investor's rights under the Treaty" (p. 10 of the *Rejoinder*).

The Respondent's propositions concerning the claimed damages are composed of three elements:

- (a) - Serendib's desperate financial situation as reflected in the Memorandum of Understanding dated December 22, 1986 could hardly become reversed to evidence future expected profitability;
- (b) - the inclusion of assets and other elements which were never touched by the destruction, such as the hatchery on the west coast;
- (c) - the speculative nature of the projections concerning any possible future profitability.

The Respondent's position on the various legal and factual issues led to the following conclusions:

- (i) - that the STF operation on January 28, 1987, was a legitimate exercise of sovereignty;
- (ii) - that any damage which occurred at the Serendib shrimp farm on that date was either necessary under the circumstances or not caused by the Government;
- (iii) - that AAPL's financial loss due to destruction of assets remains unproven; and
- (iv) - that AAPL suffered *no* loss of any reasonably foreseeable future profits (p. 39 of the *Rejoinder*).

11. The oral phase of the proceedings took place from April 17 to April 20, 1989 at the seat of the Centre in Washington, D.C.

As indicated in the Summary Minutes of the Hearing of the Arbitral Tribunal, oral presentations were made by counsels to both Parties, and counsel to each party was given the opportunity to respond to the presentation made by the other.

The Tribunal heard also an oral presentation from Mr. Deva Rodrigo, advisor to the Claimant, and Mr. Victor Santiapillai, Managing Director of Serendib Seafoods Ltd., appeared before the Tribunal as witness called by AAPL. After giving his evidence, he was examined, and cross-examined by Counsel to each Party, and responded to the questions put to him by the members of the Arbitral Tribunal.

Before declaring the hearing adjourned on April 20, 1989, the Tribunal requested the Parties to submit certain additional documents and information, together with their respective comments thereon.

12. In compliance with the Tribunal's oral order fixing the dates for filing the requested submissions, the first exchange took place on May 22, 1989, and the second exchange on May 29, 1989.

13. The Arbitral Tribunal having met for deliberation in Paris on Monday 26 and Tuesday 27 June 1989, and having considered the various issues pending before it, felt necessary to request further clarifications from both Parties about certain important points deemed not sufficiently pleaded during the previous hearing. A procedural Order was issued consequently on June 27, 1989, inviting both Parties to provide the Arbitral Tribunal with their considered points of view, together with all supporting documents, on the following:

(A) - Within the context of Article 4.1 of the Sri Lanka/United Kingdom Bilateral Agreement of February 13th, 1980, for the Promotion and Protection of Investments, is there any existing precedent or established practice concerning restitution, indemnification, compensation or other settlement allocated to Sri Lanka nationals and companies, or to nationals and companies of any Third State in the circumstances specified in said Article 4.(1)? If so how was the quantum calculated?

(B) - Even if there is no precedent or established practice what are the applicable rules and standards under the Sri Lanka domestic legal system with regard to investment losses suffered by private persons owing to any of the circumstances mentioned in the said Article 4.(1)?

(c) - What are the legal obligations of Sri Lanka under international law with regard to investment losses suffered owing to any of the circumstances mentioned in Article 4.(1) by nationals of companies of Third States, whether these States have or have not concluded Bilateral Investment Agreements with Sri Lanka?

14. In compliance with the Tribunal's Order of June 27, 1989, both Parties submitted their answers to the above-stated questions by September 15, 1989, and Claimant commented on the Memorandum of the Respondent on October 27, 1989.

15. At a later stage, and as a result of consultations undertaken between the members of the Tribunal, a new invitation was addressed on December 26, 1989, to Counsel to both Parties in the following terms:

Taking into consideration that the members of the Tribunal deem appropriate receiving from Counsels of both Parties their reflections and comments about the Decision rendered in July 1989 by the International Court of Justice in the case between the U.S.A. and Italy related to the scope of protection extended to a foreign investor under bilateral treaty;

Therefore, both Counsels are kindly invited to submit within the coming four weeks their comments about the legal reasoning stated in said Decision and the what extent they deem said reasoning relevant in adjudicating the pending Arbitration Case.

Counsel to the Respondent dispatched his comments in a letter dated January 26, 1990, and Counsel to the Claimant expressed his comments in a faxed letter dated January 29, 1990.

16. Subsequent consultations undertaken between the members of the Tribunal indicated that there was no need to convene a new oral hearing, and the Tribunal held its final meeting on March 26-27, 1990.

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17. As a result of said deliberations, the Tribunal is of the opinion that the pending arbitration has to be adjudicated taking into account the following:

### I - Concerning the Applicable Law

18. The present case is the first instance in which the Centre has been seized by an arbitration request exclusively based on a treaty provision and not in implementation of a freely negotiated arbitration agreement directly concluded between the Parties among whom the dispute has arisen.

19. Consequently, the Parties in dispute have had no opportunity to exercise their right to choose in advance the applicable law determining the rules governing the various aspects of their eventual disputes.

In more concrete terms, the prior choice-of-law referred to in the first part of Article 42 of the ICSID Convention could hardly be envisaged in the context of an arbitration case directly instituted in implementation of an international obligation undertaken between two States in favour of their respective nationals investing within the territory of the other Contracting State.

20. Under these special circumstances, the choice-of-law process would normally materialize after the emergence of the dispute, by observing and construing the conduct of the Parties throughout the arbitration proceedings.

Effectively, in the present case, both Parties acted in a manner that demonstrates their mutual agreement to consider the provisions of the Sri Lanka/U.K. Bilateral Investment Treaty as being the primary source of the applicable legal rules.

This basic premise relied upon heavily by the Claimant acquired full acceptance from the Respondent, who, not only based his main arguments on the provisions of the Treaty in question, but also invoked Article 157 of the Constitution of Sri Lanka emphasizing that the Treaty became applicable as part of the Sri Lankan Law.

21. Furthermore, it should be noted that the Bilateral Investment Treaty is not a self-contained closed legal system limited to provide for substantive material rules of direct applicability, but it has to be envisaged within a wider juridical context in which rules from other sources are integrated through implied incorporation methods, or by direct reference to certain supplementary rules, whether of international law character or of domestic law nature. Such extension of the applicable legal system resorts clearly from Article 3.(1), Article 3.(2), and Article 4 of the Sri Lanka/U.K. Bilateral Investment Treaty.

22. In fact, the submissions of both Parties (*supra*, § 7, iii, § 10) clearly demonstrate that they are in agreement about admitting the supplementary role of the recourse—regarding certain issues—to general customary international law, other specific international rules rendered applicable in implementation of the most-favored-nation clause, as well as to Sri Lankan domestic legal rules.

23. In spite of the Claimant's hostility to the general applicability of customary international law rules and his reluctance to admit Sri Lankan domestic law as the basic governing law under the last part of Article 42 of the ICSID Convention covering the absence of choice of law by the Parties, AAPL arrived from a practical point of view to a position similar to that adopted by the Respondent throughout the arbitral pro-

ceedings. This is particularly seen from what has been quoted in § 7, iii and § 9 herein-above.

24. Accordingly, the Tribunal is of the opinion that the “false problem” related to the preliminary determination in principle of the applicable law has no relevance within the context of the present arbitration, since both Parties agreed during their respective pleading to invoke primarily the Sri Lanka/U.K. Bilateral Investment Treaty as *lex specialis*, and to apply, within the limits required, the international or domestic legal relevant rules referred to as a supplementary source by virtue of Articles 3 and 4 of the Treaty itself.

## II – The legal grounds on which the Respondent’s responsibility could be sustained

25. As indicated herein-above, both Parties invoked the Sri Lanka/U.K. Bilateral Investment Treaty as the primary applicable law. However, each Party construed the Treaty’s relevant provisions in a manner which led to basically different conclusions.

### (I). The Claimant’s Case

26. The main point of view relied upon by AAPL to substantiate its submissions can be summarized as follows:

(A) – By providing that the investments of one contracting Party “shall enjoy full protection and security in the territory of the other Contracting Party”, Article 2 of the Treaty went beyond the *minimum standard* of customary international law through the creation of an unconditional obligation to be borne by the host country. According to the Claimant, “the ordinary meaning of the words ‘full protection and security’ points to an acceptance by the host State of strict or absolute liability” (*Reply of Claimant to Respondent’s counter-Memorial, op. cit.*, p. 46);

(B) – Within the “context” of the entire Treaty’s “object and purpose”, and taking into account the “identical or very similar” language used in most of the Bilateral Investment Treaties concluded between Sri Lanka, and Third States, the comparative analysis with the different other patterns followed elsewhere indicates that the term “full protection and security” has to be considered “autonomous in character and independent of any link to customary international law” (*Ibid.*, p. 49);

(C) – By abandoning the “diplomatic protection” theory largely based on the United States’ “Friendship, Commerce and Navigation” (FCN) pattern of indirect protection, the foreign investor “enjoys” under the “Bilateral Investment Treaties” (BIT’s) a different method of direct protection.

According to the Claimant, “the right to protection is vested in the holder of the investment with immediate effect upon the simple coming into force of the treaty”

(*Ibid.*, p. 52). Thus, a deliberate choice is reflected to follow a new pattern in matters of protection different from that which prevailed under traditional International Law.

(D) – In implementation of the most-favoured-nation clause contained in Article 3 of the Sri Lanka/U.K. Bilateral Investment Treaty, and in the light of the fact that the Treaty concluded between Sri Lanka and Switzerland does not provide for a “war clause” or “civil disturbance” exemption from the protection and security standard, the Claimant asserts that: “the standard of treatment under the Swiss Treaty, which is obviously more favourable than the provision of the SL/UK Treaty, applies to British investments. This means that a standard of unmitigated strict liability has to be assured by Sri Lanka in favour of British Investments” (*Ibid.*, P. 56).

27. As an “alternative submission only”, the Claimant envisaged a supplementary argument based on Article 4.(2) of the Sri Lanka/U.K. Bilateral Investment Treaty which could be relied upon in case the Tribunal “unexpectedly” would deem that Article applicable.

The Claimant’s position in this respect was clearly stated at page 57 of his *Reply to the Respondent’s Counter-Memorial*, which reads as follows:

As stated above, Article 4(2) of the SL/UK Treaty provides for an exemption from the strict liability rule of Article 2(2). Article 4(2) provides for restitution and freely transferable compensation if the destruction of property in situation of war or civil disturbances was *not* required by the necessity of the situation. This standard of compensation goes beyond the duty of granting “restitution”, “indemnification”, or “compensation” or “other settlement” provided for by Art 4(1) of the Treaty, which remains the fall-back provision in cases of war destruction.

It is clear from the above quotation that the Claimant invokes Article 4 of the Treaty in its entirety, but considers the present case falling within the scope of the specific rule contained in Article 4.(2), which evidently provides a better type of remedy than due under Article 4.(1).

28. The reasons sustaining that alternative as to the applicability of Article 4.(2) are explained as follows:

(A) – The act complained of was “not caused in combat action”, but amounts to what the Claimant describes as “the wanton destruction of AAPL’s property and the cold-blooded killing of the farm manager and the permanent staff members” which was “clearly not planned pursuant to any combat action” (page 8 of the *Claimant’s Memorial*);

(B) – The property was “requisitioned” by Sri Lankan forces and was “destroyed by those same forces” under circumstances suggesting that the wanton use of force was “not required by the exigencies of the situation” (*Ibid.*, same page 8);

(C) – Moreover, the Claimant ascertains that: “the complete destruction and cold-blooded killings by the Government’s security forces were completely out of proportion to what was necessary to meet the specific exigencies of the situation which actually existed at the SSL facility” (*Ibid.*, p. 9); and

(D) - In reliance upon the language of Article 4.(2), the Claimant is of the opinion that said language: "places the burden on the Respondent to demonstrate that the destruction of Claimant's property was required by the necessity of the situation" (*Ibid.*, p. 11).

Invoking what is considered "a general principle of international judicial and arbitral practice" the Claimant submitted at a later stage that:

the burden of proof shifts from the claimant to the defendant if the former has advanced some evidence which *prima facie* supports his allegation. This is particularly appropriate if the defendant wishes to derive a benefit from an interpretation or rule operating in his favor as does Sri Lanka in this case. It is submitted that rules justifying conduct which would otherwise be unlawful (such as military necessity) fall into the category of norms operating in favor of the defendant for which the defendant carries the *onus probandi* (*Reply to Respondent's Counter-claim*, at p. 58).

29. During the written phase of the procedures, the Claimant deemed sufficient to formulate his claims for "adequate compensation" on the basis of said Article 4.(2) without suggesting what could be the ultimate remedy available if the Tribunal—contrary to his submissions—would arrive to the conclusion that conditions required for the applicability of the paragraph in question are missing in the present case, and accordingly the rules referred to in paragraph (1) of Article 4 constitute the proper legal framework within which the pending issues have to be adjudicated.

The only indications provided for in the Claimant's written pleadings with regard to such alternative are limited to what was previously mentioned in two reported passages:

(i) - the short reference on page 6 of the Claimant's Memorial to the Government's liability "under customary rules of international law on State responsibility" (*supra*, § 7. (iii));

and

(ii) - the closing sentence on page 57 of the Reply to the Respondent's Counter-Memorial containing a precise reference to the remedies "provided for by Article 4.(1) of the Treaty, which remains the fall-back provision in cases of war destruction" (*supra*, § 27 at the end of the quotation).

30. In order to obtain certain necessary clarifications about the Claimant's position a question was put to the Claimant's Counsel by the President of the Tribunal at the Oral Hearing held in Washington D.C. from April 17 to April 20, 1989. According to the transcript of the tape containing Dr. Golsong's Closing Statement on April 20, 1989, the latter responded by saying:

we were told that we had not based our claim on 4(1) which therefore has to be deleted from the discussions. We have in our Memorial and in our Reply generally based our contention on the Bilateral Investment Treaty of the United Kingdom extended to Hong Kong and improved eventually by way of incorporation by reference of most-favoured-nation provisions deriving from other Investment Treaties. And we maintain this position. We have started by saying that 2. para-

graph 2 enshrines an absolute or strict standard of liability and certainly more than due diligence. And that there are some exceptions in the UK Treaty, namely the specific war situation in Article 4 in general, without making a distinction between 4(1) and 4(2). And in any way, if I refer to 4(2), I have implicitly to bring into discussion 4(1). (*Text provided by ICSID's Secretariat, as enclosure to a letter dated April 10, 1990, in response to an earlier request from the President of the Arbitral Tribunal to check the electronically recorded tapes of the hearing.*)

31. At a later stage of the proceedings, the Arbitral Tribunal issued the above-mentioned Order of June 27, 1989 (*supra*, § 130), which invited both Parties to provide the Tribunal with their considered points of view about certain aspects related to Article 4.(1) and the results that could be obtained through its implementation.

By his letter dated September 14, 1989, the Claimant's Counsel provided the Tribunal with answers to the questions put to both Parties without raising any objection to the eventual adjudication of the case under Article 4.(1). Moreover, the last sentence of said letter explicitly emphasized that:

...there can be no doubt that in the present case the provisions of Article 4(1) of the Sri Lanka/UK Agreement are applicable, and being *lex specialis*, supersede any general principle of International Law which otherwise may govern the issues at stake.

#### (II). *The Respondent's Case*

32. In Sri Lanka's Counter-Memorial, the Respondent adopted arguments aimed to contradict the Claimant's initial submissions. The Government's main arguments at that phase of the proceedings can be summarized as follows:

(A) - "The language 'full protection and security' is common in bilateral investment treaties, and it incorporates, rather than overrides, the customary international legal standard of responsibility. This international legal standard requires due diligence on the part of the States and reasonable justification for any destruction of property, but does not impose strict liability" (*Government's Counter-Memorial*, p. 27);

(B) - The "standards for liability under Articles 2.(2) and 4.(2) are essentially identical. In both instances, a requirement of reasonableness is imposed on Government action. Under the international law standard embodied in Article 2.(2), the Government incurs liability if it fails to act with due diligence. Under Article 4.(2), the Government incurs liability if its actions are not reasonably necessary" (*Ibid.*, p. 28);

(C) - "Article 4.(2) sets forth the standard for compensation in the event the Government is found to have violated its obligations under Article 2.(2). That is, if the Government could have prevented the destruction of the farm through due diligence". In case it has been proven that the Government's lack of due diligence caused "unnecessary destruction, then the Government would both have violated its obligation under 2.(2) and owe restitution or compensation under Article 4.(2)" (*Ibid.*, p. 28-29);

(D) - The burden of proof has to be assumed by the Claimant, by proving "that through due diligence, the Government could have prevented Batticaloa from

falling under terrorist control, thus obviating the need for counter-insurgency action. If AAPL fails to prove that the security action itself was avoidable, then its burden is to prove that the Government caused excessive destruction during the operation of January 28, 1987" (*Ibid.*, p. 29);

(E) - "To the extent there was excessive destruction, the Government of Sri Lanka is ready to compensate AAPL for its proportionate ownership". But, it is questionable "whether the Tribunal may determine that there was excessive destruction, without second-guessing tactical decisions made by commanders during the heat of combat" (*ibid.*, p. 41).

(F) - "By investing in an area which it knew contained a vehement, and potentially violent, separatist presence, AAPL assumed the risk that its investment would be caught up in the Sri Lankan civil war" (*Ibid.*, p. 41).

33. The Government's Rejoinder focused essentially on the arguments developed in the Claimant's Reply, by ascertaining that:

(A) - AAPL's alleged "absolute liability theory" based on Article 2.(2) concerns damages arising in situations and caused by parties other than those concerned by Article 4.(2). In essence, according to the Respondent, Article 2.(2) "establishes the general standard of protection owed to foreign investors against damage caused by third parties"; but Article 4.(2) "applies to damages caused by the Government itself" (*Respondent's Rejoinder*, p. 6);

(B) - Contrary to the Claimant's assertion that Article 4.(2) establishes an "exemption" to the strict liability standard of Article 2.(2), Article 4.(2) "creates rather than limits liability" (*Ibid.*, p. 8);

(C) - There are no "authorities" suggesting that "full protection and security" clauses are "among the innovative provisions of modern BITs", and there is "no historical support for AAPL's absolute liability theory" (*Ibid.*, p. 8-9); and

(D) - "The absence of liability-creating provisions analogous to Article 4 of the Treaty in other Sri Lanka BITs, such as the treaty with Switzerland, means only that under those treaties investment losses due to destruction caused by the Government in response to civil strife, whether necessary or not, are covered by the general "fair and equitable treatment" standard found in virtually every BIT, or that investors are left to their traditional remedies under customary international law" (*Ibid.*, p. 10-11).

34. Finally, it has to be noted that throughout the arbitration proceedings, the Government of Sri Lanka maintained that:

- (i) - the destruction was not attributable to the governmental security forces but caused by the rebels;
- (ii) - there was effectively a "combat" between the Government's Special Task Force (STF) and the Tigers insurgents; and
- (iii) - there is no proof that the destruction of the property was "not required by the necessity of the situation".

Therefore, from the Respondent's point of view the liability provided for in Article 4.(2) can not be sustained due to the absence of all three of its *sine qua non* conditions. Hence, the applicability of Article 4.(1) could have been logically envisaged.

Nevertheless, the Government of Sri Lanka refrained from dwelling upon its interpretation of said Article 4.(1), its scope of application, as well as the extent of the responsibility that may emerge thereunder.

The reasons for such silence became perfectly clear during the oral phase of the arbitral proceedings, since Mr. Hornick, Counsel of the Respondent, indicated during his oral argument on April 19, 1989, that there was no need to elaborate upon Article 4.(1), since in his understanding "AAPL is not claiming" thereunder (*Transcript of the electronic taping provided on April 12, 1990 by ICSID Secretariat upon request from the Tribunal's President*).

35. Only at a later stage, and in response to the Tribunal's Order of June 27th, 1989, the Respondent expressed the Government of Sri Lanka's views on the three issues related to the remedies that could be available under Article 4.(1) of the Sri Lanka/U.K. Bilateral Investment Treaty.

36. With regard to the "applicable rules and standards under the Sri Lankan domestic legal system", the letter dated September 13, 1989, addressed by the Respondent's Counsel in response to the Tribunal's Order stated the following:

1. If a Sri Lankan individual or company wished to make a claim against the Sri Lankan Government for any losses suffered owing to the war, etc., it may file an action in a district court in Sri Lanka for compensation. The action will have to be based on a cause of action arising in delict (tort). The law relating to delict is based on Roman Dutch Law which provides a remedy under *lex aquiliana* principles, namely, for intentional or negligent wrongdoing. There is no special legislation or other basis whereby liability is incurred in the absence of fault. Any person making a claim against the Government would have to file an action in the district court. The prescription ordinance of Sri Lanka, which may be availed of by the Government as any other defendant, states (Sections 9):

No action shall be maintainable for any losses, injury or damage, unless the same shall be commenced within two years from the time when the cause of action shall have arisen.

2. It may also be relevant to note that the State (Liability in Delict) Act of 1969 based on the English Crown Liability in Delict Act permits an individual to file an action against the Government in respect of delicts committed by its officers or agents. Under this Act, vicarious liability attaches to the State for the wrongful acts of its servants.

37. Regarding Sri Lanka's legal obligations under international law, the last part of the Respondent's letter dated September 13, 1989 emphasized that:

with regard to investment losses suffered owing to any of the circumstances mentioned in said Article 4.1 by nationals or companies of third States, whether these States have or have not concluded bilateral investment agreements with Sri Lanka, the government refers to Appendix A of its Counter-Memorial (at 7-8) in which it is explained that Government's obligation in such circumstances un-

der customary international law is to exercise due diligence to protect alien individuals or companies from investment losses (references deleted).

Thus, the mere occurrence of investment losses by an alien, such as AAPL, does not render the Government responsible to compensate the alien for the losses. Rather, the Government is obliged to compensate the alien only in the event the alien demonstrates that the Government failed to act reasonably under the circumstances.

### III. *The Tribunal's Findings*

38. From the above-stated summary of the arguments advanced by each of the two Parties to sustain his position, it becomes clear that the only point on which they agree is the applicability of the Sri Lanka/U.K. Bilateral Investment Treaty as the primary source of law. Beyond that preliminary point, the two Parties are in disagreement, since each Party construes the relevant provisions of the Treaty in a manner fundamentally in conflict with the interpretation given by the other Party to the same provisions.

Therefore, the first task of the Tribunal is to rule on the controversies existing in this respect by indicating what constitutes the true construction of the Treaty's relevant provisions in conformity with the sound universally accepted rules of treaty interpretation as established in practice, adequately formulated by *l'Institut de Droit International* in its General Session in 1956, and as codified in Article 31 of the Vienna Convention on the Law of Treaties.

39. The basic rule to be followed by the Tribunal in undertaking its task with regard to the pending controversial interpretation issue has been formulated since 1888 in the Award rendered in the *Van Bokkelen* case (Haiti/USA), where it was stated that:

for the interpretation of treaty language and intention, whenever controversy arises, reference must be made to the law of nations and to international jurisprudence (*Repertory of International Arbitral Jurisprudence*, Volume I: 1794-1918, Edited by; Vincent COUSSIRAT-COUSTÈRE and Pierre Michel EISEMANN, *Nijhoff, Dordrecht/Boston/London*, 1989, § 1015, p. 13).

In essence, the requirement that treaty provisions "must be interpreted according to the Law of Nations, and not according to any municipal code", emerges from the basic premise expressed by Mr. WEBSTER, in the following terms:

When two nations speak to each other, they use the language of nations (Quoted by the Germany/Venezuela Mixed Claims Commission in the *Christem Case*, as reproduced in the *Repertory* referred to herein-above, § 1017, p. 27).

40. The other rules that should guide the Tribunal in adjudicating the interpretation issues raised in the present arbitration case may be formulated as follows:

*Rule (A)* - "The first general maxim of interpretation is that it is not allowed to interpret what has no need of interpretation. When a deed is worded in a clear and precise terms, when its meaning is evident and leads to no absurd conclusion, there can be no reason for refusing to admit the meaning which such deed nat-

urally presents" (passage from VATTEL'S Chapter on Interpretation of Treaties—Book 2, chapter 17, relied upon in 1890 as expressing "universally recognized law" by the U.S.A./Venezuela Mixed Commission in the *Howland case*, *Repertory*, *op. cit.*, § 1016, p. 16), and the Mixed Commission did not hesitate in declaring: "to attempt interpretation of plain words.... would be violative of Vattel's first rule" (*Ibid.*, p. 26). -*cf.* A. Ch. KISS, *Répertoire de la Pratique Française en Matière de Droit International Public*, Tome I, 1962, p. 399, on p. 402 § 810-Text of Prof. GROS's Pleading in the ICJ on July 15-16, 1952 in the *Morocco* case, and § 811-Text of Prof. BASDEVANT's Pleading in of the PICJ on July 5, 1923 in the *Wimbledon* case; S.BASTID, *Les Traités Dans la Vie Internationale*, 1985, p. 129, footnote no. 1—reproducing the text of the Résolution adopted by *l'Institut de Droit International*, Grenada Session, *Annuaire de l'Institut*, vol. 46, 1956, underlining that the rules adopted are only applicable "lorsqu'il y a lieu d'interpréter un traité" -; and I.M. SINCLAIR, "The Principles of Treaty Interpretation and Their Application By the English Courts", *International and Comparative Law Quarterly*, vol. 12, (1963), p. 536—referring to the decisions pronouncing that if the meaning intended to be expressed is clear the Courts are "not at liberty to go further").

*Rule (B)* - "In the interpretation of treaties... we ought not to deviate from the common use of the language unless we have very strong reasons for it (...) words are only designed to express the thoughts; thus the true signification of an expression in common use is the idea which custom has affixed to that expression" (another passage from VATTEL relied upon by the U.S.A./Venezuela Mixed Commission in the *Howland case*, *op.cit.*, p. 16—*cf.* Award of the Mexico/U.S.A. Mixed Commission of 1871 in the *William Barron case*, *Ibid.*, § 1023, p. 30, emphasizing that: "interpretation means finding in good faith that meaning of certain words, if they are doubtful, which those who used the words must have desired to convey, according to the usage of speech (*usus loquendi*)"; ALEXANDER's award of 1899 in the *Treaty of Limits* case between Costa Rica and Nicaragua *Ibid.*, § 1025, p. 31, declaring that: "words are to be taken as far as possible in their first and simplest meanings", "in their natural and obvious sense, according to the general use of the same words", "in the usual sense, and not in any extraordinary or unused acceptation"; S. BASTID, *op.cit.*, p. 129, reproducing the Résolution adopted in 1956 by *l'Institut de droit International* according to which: "L'accord des parties s'étant réalisé sur le texte, il y a lieu de prendre le sens naturel et ordinaire de ce texte comme base d'interprétation"; and I.M. SINCLAIR, *op. cit.*, p. 537, reporting that: "the Court .... is bound to construe them (the words) according to their natural and fair meaning").

*Rule (C)* - In cases where the linguistic interpretation of a given text seems inadequate or the wording thereof is ambiguous, there should be recourse to the integral context of the Treaty in order to provide an interpretation that takes into consideration what is normally called: "le sens général, l'esprit du Traité", or "son écon-

omie générale” (Award rendered in 1914 by the Permanent Court of Arbitration in the *Timor Island* case between the Netherlands and Portugal, *Repertory, op. cit.*, § 1019, p. 28; decision of the Bulgarian/Greek Mixed Arbitration Tribunal rendered in 1927 in the *Sarrapoulos* case, *Repertory, vol. II: 1919-1945*, § 2020, p. 21-22; The 1926 *Paula Mendel* case where the Germany/U.S.A. Mixed Claims Commission disregarded “a literal construction of the language” since it “finds no support in the other provisions of the Treaty as a whole”. Hence, “it cannot stand alone and must fall” *Repertory vol. II, § 2025*, p. 25; and the Decision of the Germany/Venezuela Mixed Claims Commission of 1903 in the *Kummerow* case which stated that: “it is a uniform rule of construction that effect should be given to every clause and sentence of an agreement”, *Repertory, op. cit.*, vol. I, § 1031, p. 38).

*Rule (D)* - In addition to the “integral context”, “object and intent”, “spirit”, “objectives”, “comprehensive construction of the treaty as a whole”, recourse to the rules and principles of international law has to be considered a necessary factor providing guidance within the process of treaty interpretation. (Resolution of *l’Institut de Droit International, op. cit.*, Article 1.(2) which stipulates: “les termes des dispositions du traité doivent être interprétés dans le contexte entier, selon la bonne foi et à la lumière des principes du droit international”; Paragraph 3.(c), of Article 31 of Vienna convention on the Law of Treaties, containing reference to: “all relevant rule of international law applicable in the relations between the parties”, and the Award rendered in 1928 by the France/Mexico Claims Commission in the *Georges Pinson* case, which stated among “les principes généraux d’interprétation”: “Toute convention internationale doit être réputée s’en référer tacitement au droit international commun, pour toutes les questions qu’elle ne résout pas elle-même en termes exprès et d’une façon différente” *Repertory, op. cit.*, vol. II, § 2023, p. 24).

*Rule (E)* - Nothing is better settled, as a canon of interpretation in all systems of law, than that a clause must be so interpreted as to give it a meaning rather than so as to deprive it of meaning (Award of the UK/USA Arbitral Tribunal of 1926 in the *Cayuga Indians* case, *Repertory, vol. II, § 2036*, p. 35-36). This is simply an application of the more wider legal principle of “effectiveness” which requires favouring the interpretation that gives to each treaty provision “effet utile”.

*Rule (F)* - When there is need of interpretation of a treaty it is proper to consider stipulations of earlier or later treaties in relation to subjects similar to those treated in the treaty under consideration” (Award of the Mexico/USA General Claims Commission of 1929 rendered in the *Elton* case, *Repertory, vol. II, § 2033*, p. 35). Thus, establishing the practice followed through comparative law survey of all relevant precedents becomes an extremely useful tool to provide an authoritative interpretation.

41. In the light of the above mentioned canons of interpretation, the relevant provisions of the Sri Lanka/U.K. Bilateral Investment Treaty have to be identified, each provision construed separately, examined within the global context of the Treaty, in order to determine the proper interpretation of each text, as well as its scope of application in relation to the other treaty provisions and with regard to the various general rules and principles of international law not specifically referred to in the Treaty itself.

In more precise terms, all appropriate measures should be undertaken in view of establishing the legal regime created by the Treaty for the protection of those investors covered by the Sri Lanka/U.K. Bilateral Investment Treaty in case their investments suffer destruction owing to activities related to the Government’s counter-insurgency actions.

42. The construction of the Treaty’s comprehensive system governing all aspects related to the extent of the special protection conferred upon the investors in question would permit the evaluation of the Treaty’s effective contribution in this respect; *i.e.* in view of determining with regard to each issue whether the Sri Lanka/U.K. Treaty intended, merely, to consolidate the pre-existing rules of international law, or, on the contrary, it tended to innovate by imposing on the host state a higher standard of international responsibility.

Essentially, said evaluation is required, not as a conceptual doctrinal exercise, but for a practical reason related to the adjudication of the case, since in accordance therewith the following question could be adequately answered: what are the limits within which the classical international law based on the judicial and arbitral precedents could be of relevance in adjudicating the present case?

43. Taking the above-mentioned remarks into consideration, the Tribunal agrees with the Parties in considering that there are four fundamental texts in the Sri Lanka/U.K. Bilateral Investment Treaty that should be carefully considered for the purpose of determining the host State’s responsibility for investment losses suffered as a result of property destruction:

*First:* The general obligation imposed by virtue of Article 2.(2), by which the host State undertook that foreign investments “shall enjoy full protection and security in the territory”, since violation thereof entails a certain degree of international responsibility;

*Second:* The most-favoured-nation provision contained in Article 3, which may be invoked to increase the host State’s liability in case a higher standard of international protection becomes granted to investments pertaining to nationals of a Third State;

*Third:* The special provision of Article 4.(1) which envisages the legal consequences of losses suffered by foreign investments “owing to war or other armed conflict, revolution, a state of national emergency, revolt, insurrection or riot” in the territory of the host State; and

*Fourth:* “without prejudice to” the rules applicable under the previous text (Article 4.(1), the Treaty introduced a more specific rule tailored particularly to cover two

types of “losses”, which are “suffered” in any of the situations enumerated in Article 4.(1). These two categories are:

- (a) requisitioning of their property by its forces or authorities; or
- (b) destruction of their property by its forces or authorities which was not caused in combat action or was not required by the necessity of the situation.

Whenever either case is established, the Treaty provided in the concluding sentence of Article 4.(2) for a certain remedy: “restitution or adequate compensation”, and that the “resulting payments shall be freely transferable”.

44. Accordingly, the treaty envisaged different situations under which protection could be invoked in case of destruction of investments, and different remedies are provided for in order to meet the particularity of each situation.

The various categories of such situations that could be encountered may be classified as follows:

- (i) - Situations in which the foreign investor claims that the destruction of the property was unnecessarily caused by the governmental security forces acting out of combat, and in such case the Treaty provides for a special rule in Article 4.(2), which was tailored particularly to fit the requirements of such serious wrongful action directly attributable to the State organs;
- (ii) - In case the foreign investor fails to establish that the destruction was attributable to the governmental security forces, or in case there was effectively a “combat” during which the property was destroyed under conditions that could hardly permit assessing the unnecessary character of the destruction in a convincing manner, the type of remedy envisaged under Article 4.(2) of the Sri Lanka /U.K. Bilateral Investment Treaty has to be considered excluded. Consequently, the other provisions of the treaty become relevant;
- (iii) - In presence of such situation not possibly governed by Article 4.(2), the search has to be first directed towards investigating the existence of certain rules more favourable to the foreign investor than those provided for under Articles 2.(2) and 4.(1), since the better treatment accorded to investors of the Third State could be extended to apply by virtue of the most-favoured-nation clause stipulated in Article 3 of the Sri Lanka/U.K. Treaty;
- (iv) - In the absence of a more favourable system applicable by virtue of Article 3, the applicable rules become necessarily those governing the liability of the Host State under Article 4.(1) and Article 2.(2), whether taken together or separately as the case may be.

45. The Claimant’s primary submission—as previously explained (*supra*, § 26)—is based on the assumption that the “full protection and security” provision of Article 2.(2) created a “strict liability” which renders the Sri Lankan Government liable for

any destruction of the investment even if caused by persons whose acts are not attributable to the Government and under circumstances beyond the State’s control.

For sustaining said construction introducing a new type of objective absolute responsibility called “without fault”, the Claimant’s main argument relies on the existence in the text of the Treaty of two terms: “enjoy” and “full”, a combination which sustains, according to the Claimant, that the Parties intended to provide the investor with a “guarantee” against all losses suffered due to the destruction of the investment for whatever reason and without any need to establish who was the person that caused said damage. In other words, the Parties substituted the “due diligence” standard of general international law by a new obligation creating an obligation to achieve a result (“obligation de résultat”) providing the foreign investor with a sort of “insurance” against the risk of having his investment destroyed under whatever circumstances.

46. The Tribunal is of the opinion that the Claimant’s construction of Article 2.(2) as explained herein-above cannot be justified under any of the canons of interpretation previously stated (*supra*, § 40).

47. In conformity with Rule (B), the words “shall enjoy full protection and security” have to be construed according to the “common use which custom has affixed” to them, their “*usus loquendi*”, “natural and obvious sense”, and “fair meaning.”

In fact, similar expressions, or even stronger wordings like the “most constant protection”, were utilized since last century in a number of bilateral treaties concluded to encourage the flow of international economic exchanges and to provide the citizens and national companies established on the territory of the other Contracting Party with adequate treatment for them as well as to their property (“*Traité d’Amitié, de Commerce et Navigation*”, concluded between France and Mexico on November 27, 1886—*cf.* A Ch.KISS, *Répertoire de la Pratique Française ...*, *op. cit.*, Tome III, 1965 § 1002, p. 637; The Treaty concluded in 1861 between Italy and Venezuela, the interpretation of which became the central issue in the *Sambiaggio* case adjudicated in 1903 by the Italy/Venezuela Mixed Claims Commission—*U.N. Reports of International Arbitral Awards*, vol. X, p. 512 *ss.*).

48. The arbitral Tribunal is not aware of any case in which the obligation assumed by the host State to provide the nationals of the other Contracting State with “full protection and security” was construed as absolute obligation which guarantees that no damages will be suffered, in the sense that any violation thereof creates automatically a “strict liability” on behalf of the host State.

*Sambiaggio* case seems to be the only reported case in which such argument was voiced, but without success. The Italian Commissioner AGNOLI, referred in his Report to:

The protection and security...which the Venezuelan Government explicitly guarantees by Article 4 of the Treaty of 1861 to Italians residing in Venezuela (*U.N. Reports, op.cit.*, p. 502—underlining added).

The Venezuelan Commissioner ZULOAGA responded by indicating that:



Governments are constituted to *afford* protection, not to *guarantee* it (*Ibid.*, p. 511).

The Umpire RALSTON put an end to the Italian allegation by emphasizing that:

If it had been the contract between Italy and Venezuela, understood and consented by both, that the latter should be held liable for the acts of revolutionists—something in derogation of the general principles of international law—this agreement would naturally have found direct expression in the protocol itself and would not have been left to doubtful interpretation (*Ibid.*, p. 521).

49. In the recent case concerning *Electronica Sicula S.P.A. (ELSI)* between the U.S.A. and Italy adjudicated by a Chamber of the International Court of Justice, the U.S.A. Government invoked Article V.(1) of the Bilateral Treaty which established an obligation to provide “the most constant protection and security”, but without claiming that this obligation constitutes a “guarantee” involving the emergence of a “strict liability” (Section 2—Chapter V of the *U.S.A. Memorial* dated May 15, 1987, where reference is made, on the contrary at page 135 to the : “One well-established aspect of the international standard of treatment... that States must use “due diligence” to prevent wrongful injuries to the person or property of aliens within their territory”).

In its Judgment of July 20, 1989, the ICJ Chamber clearly stated that:

The reference in Article V to the provision of “constant protection and security” cannot be construed as the giving of a warranty that property shall never in any circumstances be occupied or disturbed (*C.I.J., Recueil*, 1989, § 108, p. 65).

Consequently, both the oldest reported arbitral precedent and the latest I.C.J. ruling confirms that the language imposing on the host State an obligation to provide “protection and security” or “full protection and security required by international law” (the other expression included in the same Article V) could not be construed according to the natural and ordinary sense of the words as creating a “strict liability”. The rule remains that:

The State into which an alien has entered ... is not an insurer or a guarantor of his security... It does not, and could hardly be asked to, accept an absolute responsibility for all injuries to foreigners (*Alwyn V. FREEMAN, Responsibility of States for Unlawful Acts of Their Armed Forces*, Sijthoff, Leiden, 1957, p. 14).

This conclusion, arrived at more than three decades ago, still reflects—in the Tribunal’s opinion—the present status of International Law Investment Standards as reflected in “the worldwide BIT network” (*cf.* K.S. GUDGEON, “Valuation of Nationalized Property Under United States and other Bilateral Investment Treaties”. Chapter III, in the *Valuation of Nationalized Property in International Law*, Ed. by Richard B. LILLICH, vol. IV, (1987), p. 120).

50. In the opinion of the present Arbitral Tribunal, the addition of words like “constant” or “full” to strengthen the required standards of “protection and security” could justifiably indicate the Parties’ intention to require within their treaty relationship a standard of “due diligence” higher than the “minimum standard” of general international law. But, the nature of both the obligation and ensuing responsibility remain unchanged, since the added words “constant” or “full” are by themselves not

sufficient to establish that the Parties intended to transform their mutual obligation into a “strict liability”.

51. The Tribunal’s opinion arrived at in applying the established rule, according to which the words contained in a treaty provision have to be given the natural and fair meaning affixed to them by the common usage, is further supported by recourse to the other canons of interpretation.

According to *Rule (C)* (*supra*, § 40), proper interpretation has to take into account the realization of the Treaty’s general spirit and objectives, which is clearly in the present case the encouragement of investments through securing an adequate environment of legal protection. But, in the absence of *travaux préparatoires* in the proper sense, it would be almost impossible to ascertain whether Sri Lanka and the United Kingdom had contemplated during their negotiations the necessity of disregarding the common habitual pattern adopted by the previous treaties, and to establish a “strict liability” in favour of the foreign investor as one of the objectives of their treaty protection. Equally, none among the authors referred to by the Parties claimed in his commentary that the Sri Lanka/U.K. Treaty or similar Bilateral Investment Treaties had the effect of increasing the customary international law standards of protection to the extent of imposing “strict liability” on the host State in cases where the investment suffers losses due to property destruction.

Accordingly, recourse to the spirit of the Treaty and its objectives would not alter the conclusion arrived at by the Tribunal in refusing to consider that the Sri Lanka/U.K. Treaty imposed by Article 2.(2) a “strict liability” in the event of failure to provide “full protection and security”.

52. Moreover, both *Rules (D) and (E)* confirm the Tribunal’s opinion, as Article 2.(2) should not be taken separately out of the Treaty’s global context.

The Claimant’s contention that Article 2.(2) adopted a standard of “strict liability” would lead logically to the inevitable conclusion that Article 4 in its entirety becomes superfluous, in the sense that according to the Claimant’s interpretation the Parties were not serious in adding to their Treaty two provisions which are not susceptible of getting any application in practice. Such an interpretation has to be rejected in application of *Rule (E)* which requires that Article 2.(2) be interpreted in a manner that does not deprive Article 4 from having any meaning or scope of applicability.

Such an unaccepted result could have been easily avoided if the Claimant had not disregarded *Rule (D)* according to which the rules of general international law have to be taken into consideration by necessary implication, and not to be deemed totally excluded as alleged by the Claimant.

In the Tribunal’s opinion the non-reference to international law in Article 2.(2) of the Sri Lanka/U.K. Treaty should not be taken as implying the Parties’ intention to avoid its application under any aspect, including its role as supplementary source providing guidance in the process of interpretation.

The Tribunal's conclusion in this respect, is not only based on *Rule (D)* as previously indicated, but it is supported furthermore by what was expressed by an informed author who stated that:

the U.K. BIT's normally make no international law reference... This drafting device could be argued to cloud reliance on external sources of law and precedent during the life of the treaty, although this is undoubtedly not the intent. (K. Scott GUDGEON, "Valuation of Nationalized Property..." *op.cit.*, at p. 119-120).

53. Finally, it has to be recalled that in reliance upon *Rule (F)* the precedents established by the Arbitral Tribunal in the *Sambiaggio* case (1903) and by the ICJ Chamber in the *Eletronica Sicula* case (1989), both previously referred to (*supra*, § 48-49), are categoric in supporting the Tribunal's refusal to construe the words "full protection and security" as imposing a "strict liability" on the host State for whatever losses suffered due to the destruction of the investment protected under the treaty.

Therefore, and taking into consideration all the reasons stated in the previous paragraphs (*supra*, § 45-52), the Tribunal declares unfounded the Claimant's main plea aiming to consider the Government of Sri Lanka assuming strict liability under Article 2.(2) of the Bilateral Investment Treaty, without any need to prove that the damages suffered were attributable to the State or its agents, and to establish the State's responsibility for not acting with "due diligence".

54. For the same reasons, the Tribunal rejects the Claimant's argument based on the most-favoured-nation clause contained in Article 3 of the Sri Lanka/U.K. Bilateral Investment Treaty.

By invoking the absence in the Sri Lanka/Switzerland Treaty of a text similar to Article 4 providing for a "war clause" or "civil disturbance" exemption from the full protection and security standard, the Claimant based his argument on two implicit assumptions:

- (i) - that the Sri Lanka/Switzerland Treaty provides equally for a "strict liability" standard of protection in case of losses suffered due to property destruction; and
- (ii) - that the rules of general international law are totally excluded and replaced exclusively by the Treaty's "strict liability" standard.

Both assumptions are unfounded, as the Tribunal has no reasons to believe that the Sri Lanka/Switzerland Treaty adopted a "strict liability" standard, and the Tribunal is convinced that, in the absence of a specific rule provided for in the Treaty itself as *lex specialis*, the general international law rules have to assume their role as *lex generalis*.

Accordingly, it is not proven that the Sri Lanka/Switzerland Treaty contains rules more favourable than those provided for under the Sri Lanka/U.K. Treaty, and hence, Article 3 of the latter Treaty cannot be justifiably invoked in the present case.

55. Faced with the task of adjudicating the Claimant's "alternative submission", the Tribunal has to provide an answer to the various arguments raised by both Parties with regard to the interpretation of Article 4, the inter-relation between 4.(1) and 4.(2), their respective scope of application, as well as the burden of proof assumed

by each Party in evidencing the existence or non-existence of the conditions required for the applicability of the rules and standards referred to in both paragraphs of Article 4.

56. In determining the applicability of either paragraph of Article 4, the Tribunal shall be guided by the same rules of interpretation previously prescribed from (A) to (F) (*supra*, § 40).

Nevertheless, in order to handle the legal issues related to evidence, the above-stated canons have to be complemented by taking into consideration the following established international law rules:

*Rule (G)*- "There exists a general principle of law placing the burden of proof upon the claimant" (Bin CHENG, *General Principles of Law as Applied by International Courts and Tribunals*, Grotius Publications, Cambridge, (1987), p. 327, and the supporting authorities referred to therein).

*Rule (H)*- "The term *actor* in the principle *onus probandi actori incumbit* is not to be taken to mean the plaintiff from the procedural standpoint, but the real claimant in view of the issues involved" (*Ibid.*, p. 332). Hence, with regard to "proof of individual allegations advanced by the parties in the course of proceedings, the burden of proof rests upon the party alleging the fact" (*Ibid.*, p. 334; and Durward V. SANDIFER, *Evidence before International Tribunals*, University Press of Virginia, Charlottesville, (1975), p. 127, footnote 101).

*Rule (I)*- "A Party having the burden of proof must not only bring evidence in support of his allegations, but must also convince the Tribunal of their truth, lest they be disregarded for want, or insufficiency, of proof" (CHENG, *op.cit.*, p. 329- 331, with quotations from the supporting authorities).

*Rule (J)*- "The international responsibility of the State is not to be presumed. The party alleging a violation of international law giving rise to international responsibility has the burden of proving the assertion" (*The Tanager Horses* case (1924); the *Corfu Channel* case (1949), and the *Belgium Claims* case (1930) referred to by CHENG, at p. 305-306).

*Rule (K)*- "International tribunals are "not bound to adhere to strict judicial rules of evidence". As a general principle "the probative force of the evidence presented is for the Tribunal to determine" (SANDIFER, *op. cit. pp. 9 and 17; Award of 1896* rendered in the *Fabiani* case between France and Venezuela, *Repertory, op. cit.*, Vol; I, p. 412-413; and the 1903 Award rendered in the *Franqui* case by the Spain/Venezuela Mixed Claims Commission, which considered this rule as expressing "the unanimous conviction of the most conspicuous writers upon international law" and relying *inter alia* on Article 15 of the Rules for Arbitration between Nations adopted in 1875 by *l'Institut de Droit International*, and what

MÉRIGNHAC wrote at p. 269 of his *Traité de l'Arbitrage International—U.N. Reports, op.cit.*, Vol. X, p. 751-753).

*Rule (L)*- In exercising the "free evaluation of evidence" provided for under the previous Rule, the international tribunals "decided the case on the strength of the evidence produced by both parties", and in case a party "adduces some evidence which *prima facie* supports his allegation, the burden of proof shifts to his opponent (SANDIFER, *op. cit.*, pp. 125, 129, 130, 170-173, relying upon the Parker case of 1962 adjudicated by the Mexico/U.S.A. General Claims Commission, *U.N. Reports, op.cit.*, Vol. IV, p. 36-41; the ICJ's *Ambatielos* and *Asylum* cases).

*Rule (M)*- Finally, "In cases where proof of a fact presents extreme difficulty, a tribunal may thus be satisfied with less conclusive proof, i.e., *prima facie* evidence" (CHENG, *op.cit.* p. 323-325, with quotations from the supporting authorities and cited with approval by SANDIFER, at p. 173).

57. In the light of all the legal Rules from (A) to (M) stated herein above (§ 40 and 56), it becomes clear that Article 4.(2) regulated a specific situation by adopting a standard of responsibility representing a certain degree of particularity, and which becomes applicable only in cases characterized by the cumulative existence of three factors:

- (a) - that the destruction of property not only occurred during hostilities, but more precisely such destruction has been proven to be committed by the governmental forces or authorities themselves;
- (b) - that the destruction was not caused in combat action, since the higher standard of liability ("adequate compensation" payable in "freely transferable" currency) is linked with the assumption of unjustified destruction committed out of combat; and
- (c) - that the destruction was not required by the necessity of the situation, as the existence of a combat would not be sufficient *per se* to alleviate the responsibility of the governmental forces and authorities, once it has been proven that the security forces bypassed the reasonable limits by undertaking unnecessary destruction.

58. Moreover, it has to be noted that the foreign investor who invokes the applicability of said Article 4.(2) assumes a heavy burden of proof, since he has, in conformity with *Rules (G) and (J)*, to establish:

- (i) - that the governmental forces and not the rebels caused the destruction;
- (ii) - that this destruction occurred out of "combat";
- (iii) - that there was no "necessity", in the sense that the destruction could have been reasonably avoided due to its unnecessary character under the prevailing circumstances.

59. Exercizing its discretionary power in evaluating the evidence produced by both Parties during the proceedings of the present case in conformity with the above-stated *Rules (K) and (I)*, the Arbitral Tribunal considers that:

- (a) - There is no doubt that the destruction of the premises which existed in Serendib's Farm took place during the hostilities of January 28, 1987, and the loss of the shrimps harvest occurred during the period in which the governmental security forces occupied the Farm's fields;
- (b) - Nevertheless, there is no convincing evidence produced which sufficiently sustains the Claimant's allegation that the firing which caused the property destruction came from the governmental troops, and no reliable evidence was adduced to prove that the shrimps were lost due to acts committed by the security forces;
- (c) - Equally, no convincing evidence was produced which sufficiently sustains the Respondent's allegation that the firing which caused the destruction of the property came from the insurgents resisting the security forces.

60. Therefore, the Arbitral Tribunal finds that the first condition required under Article 4.(2) cannot be considered fulfilled in the present case, due to the lack of convincing evidence proving that the losses were incurred due to acts committed by the governmental forces.

At the same time, the Tribunal cannot proceed in this respect on the basis of *prima facie* evidence adduced in function of *Rules (H) or (M)* since the existence of a legal condition as important as the attributability of the damage should, in the Tribunal's opinion, be proven in a conclusive manner.

61. Regarding the second condition which excluded from the scope of Article 4.(2) the losses suffered "in combat action", it requires first the determination of what is meant by "combat action" and subsequently whether the investment losses were effectively caused in "combat action".

In implementation of the above-stated *Rule (B)* (*supra*, § 40), the term "combat action" has to be understood according to its natural and fair meaning as commonly used under prevailing circumstances, *i.e.* within the context of guerrilla warfare which characterizes the modern civil wars conducted by insurgents.

Rarely, in contemporary history actions undertaken during civil wars would take the classical form of a regular military confrontation between two opposing armed groups on a battle field where the adversaries engage simultaneously in fighting each other on the spot. In most cases, the opponents in current civil war situations would resort to sporadic surprise attacks as far as possible from their home bases, trying to avoid direct military confrontation through retreat to places where pursuit could be extremely difficult.

Hence, a "combat action" undertaken against insurgents could be envisaged comprising vast areas extending over the several square miles covering all the localities

in which the hit and run operations as well as the governmental counter-insurgency activities could take place.

62. In the light of the fore-mentioned remarks, and taking into consideration the evidence submitted by both Parties throughout the arbitration proceedings, the Tribunal is of the opinion that the operation "Day Break" undertaken on January 28, 1987, against the "Tiger" fighters belonging to the movement known as LLTE, in order to regain control of the Manmunai area, qualifies as "combat action".

Accordingly, the losses caused as a result of said "combat action" are not covered by Article 4.(2) of the Sri Lanka/U.K. Bilateral Investment Treaty, since they fall within the explicitly excluded category.

63. The third and final condition provided for in Article 4.(2) relates to the "necessity of the situation", in the sense that the State responsibility under said disposition can only be engaged if it has been proven that the losses incurred were not due to "the necessity of the situation".

The term in question follows a pattern long established in practice, as a number of arbitral precedents refused to allocate compensation for destructions that took place during hostilities on the assumption that these destructions "were compelled by the imperious necessity of war" (cf. the 1903 Award rendered by the Netherlands/Venezuela Mixed Claims Commission in the *Dania Bembelish* case, *Repertory...op.cit.*, vol. I, § 297-280; and the Special *Ad Hoc* Arbitral Tribunal adjudicating the *Hardman* case between the U.K. and the U.S.A.). The doctrinal authorities approved that reasoning mainly justified by the extreme difficulty, described as "next to impossible", of obtaining the reconstruction in front of the arbitral tribunal of all the conditions under which the "combat action" took place with an adequate reporting of all the accompanying circumstances (cf. RALSTON, *The Law and Procedure of International Tribunals*, (1926), p. 391; and C. EAGLETON, *The Responsibility of States in International Law*, (1928), p. 155).

64. In the present case, neither Party was able to provide reliable evidence explaining with precision the conditions under which the destructions and other losses, mainly of the shrimps crop, took place. Under these circumstances, it would be extremely difficult to determine whether the destruction and losses were caused as an inevitable result of the "necessity of the situation", or, on the contrary, were avoidable if the governmental security forces would have been keen to act with due diligence.

Therefore, the Tribunal deems appropriate to rely on the above-stated *Rule (I)*, according to which "the international responsibility of the State is not to be presumed" (*supra*, § 56).

Consequently, all three conditions necessary for the applicability of Article 4.(2) are proven to be non-existent in the present case, and Article 4.(1) becomes the only part of Article 4 providing remedy that could be available for the Claimant to base his claims thereunder.

65. For the applicability of Article 4.(1), the only condition required is the presence of "losses suffered".

These two key words are so clear that they do not call for interpretation in conformity with VATTEL's *Rule (A)* which renders any attempted departure from the plain meaning of the words a violation of international law rules on treaty interpretation.

Undoubtedly, the term "losses suffered" includes all property destruction which materializes due to any type of hostilities enumerated in the text ("owing to war or other armed conflict, revolution, a state of national emergency, revolt, insurrection or riot in the territory").

Equally, the mere fact that such "losses suffered" do exist is by itself sufficient to render the provision of Article 4.(1) applicable, without any need to prove which side was responsible for said destruction, or to question whether the destruction was necessary or not.

In essence, the scope of applicability of Article 4.(1) is not subject to any legal restrictions. Hence, it extends as *lex generalis* to all situations not covered by the special rule of Article 4.(2), including necessarily cases where no proof has been established to determine whether the governmental forces or the insurgents caused the property destruction.

66. The only difficulty encountered under Article 4.(1) does not relate to its interpretation or conditions of applicability, but to the type of remedy provided for thereunder.

Precisely, Article 4.(1) does not include any substantive rules establishing direct solutions; i.e. material rules providing remedies expressed in fixed and definitive terms. Like conflict-of-law rules, Article 4.(1) contains simply an indirect rule whose function is limited to effecting a reference (*renvoi*) towards other sources which indicate the solution to be followed.

According to the undisputed plain language of Article 4.(1), the investor—already enjoying the "full security" under Article 2.(2) of the Sri Lanka/U.K. Treaty—has to be accorded treatment no less favourable than:

- (i) - that which the host State accords to its own nationals and companies; or
- (ii) - that accorded to nationals and companies of any Third State.

Taking into account the absence of restrictions, whether explicit or implied, and the generality of the text, the "no less favourable treatment" granted thereunder covers all possible cases in which the investments suffer losses owing to events identified as including "a state of national emergency, revolt, insurrection, or riot", with regard to remedies enumerated in the text itself: "restitution, indemnification, compensation or other settlement".

67. Consequently, it could be safely ascertained that the Bilateral Investment Treaty, through the above-stated *renvoi* technique, had not left the host State totally immune from any responsibility in case the foreign investor suffers losses due to the destruction of his investment which occurs during a counter-insurgency action undertaken by the governmental security forces.

In implementation of Article 4.(1), the host State could find itself in such a situation bound to bear a certain degree of responsibility to be determined in implementation of the *renvoi* contained in that Article 4.(1).

Once failure to provide "full protection and security" has been proven (under Article 2.(2) of the Sri Lanka/U.K. Treaty or under a similar provision existing in other bilateral Investment Treaties extending the same standard to nationals of a third State), the host State's responsibility is established, and compensation is due according to the general international law rules and standards previously developed with regard to the State's failure to comply with its "due diligence" obligation under the *minumum standard* of customary international law.

68. It should be noted in this respect that in the Government of Sri Lanka's own words, its international responsibility could be engaged "if it fails to act with due diligence" (*Respondent's Counter-Memorial*, at p. 28, second paragraph).

In the sentence starting at the end of the same page and continued on the following page, it was clearly stated that:

If the government's lack of due diligence caused otherwise unnecessary destruction, then the government would ... have violated its obligation under Article 2.(2)....

The reference to the "lack of due diligence" emerges from the Government's basic assumption, according to which:

the language "full protection and security" is common in bilateral investment treaties, and it incorporates rather than overrides, the customary international legal standard of responsibility. This international legal standard requires due diligence on the part of the states, and reasonable justification for any destruction of property (*Respondent's Counter-Memorial*, at p. 27).

69. Hence, any foreign investor, even if his national State has not concluded with Sri Lanka a Bilateral Investment Treaty containing a provision similar to that of Article 2.(2), would be entitled to a protection which requires "due diligence" from the host State, *i.e.* Sri Lanka. Failure to comply with this obligation imposed by customary international law entails the host State's responsibility.

The Letter of September 13, 1989, containing the Government of Sri Lanka's response to the Tribunal's Order dated June 27, 1989, confirmed that:

The Government's obligation in such circumstances under customary international law is to exercise due diligence to protect alien individuals or companies from investment losses (paragraph (c) of said letter, with reference to authorities stating that: "A state on whose territory an insurrection occurs is not responsible for loss or damage sustained by an alien to his person or property unless it can be shown that the government of this state was negligent in the use of, or in the failure to use, the forces at its disposal for the prevention or suppression of the insurrection").

The Respondent's submission as expressed in the Letter's final paragraph reads as follows:

Thus, the mere occurrence of investment losses by an alien, such as AAPL, does not render the Government responsible to compensate the alien for the losses. Rather, the Government is obliged to compensate the alien only in the event the alien demonstrates that the Government failed to act reasonably under the circumstances.

70. Within the context of the latter alternative, the Tribunal has to envisage whether effectively Sri Lanka's responsibility could be sustained under international law which has to be considered applicable by virtue of the *renvoi* provided for in Article 4.(1), combined with the conventional standard of "full protection and security" stipulated in Article 2.(2), as well as in other Bilateral Investment Treaties concluded by Sri Lanka.

71. But, before turning to undertake that task, the Tribunal has to emphasize that the Respondent referred in the september 13, 1989 Letter to another legal ground available by virtue of the *renvoi* contained in Article 4.(1), which is the State's responsibility under the rules of the domestic legal system.

As indicated in paragraph (B) of said letter, previously quoted in its entirety (*supra*, § 36), the Sri Lankan Law provides, for the person who suffered losses owing to armed hostilities, "a remedy under *lex aquilian* principles, namely, for intentional or negligent wrongdoing".

Nevertheless, the Tribunal deems appropriate, for procedural considerations, not to delve into the domestic law responsibility, since the Sri Lankan Law was not fully pleaded during the present arbitration proceedings.

### III—The Legal and Factual Considerations on which the Respondent's Responsibility is Established

72. It is a generally accepted rule of International Law, clearly stated in international arbitral awards and in the writings of the doctrinal authorities, that :

- (i) - A State on whose territory an insurrection occurs is not responsible for loss or damage sustained by foreign investors unless it can be shown that the Government of that state failed to provide the standard of protection required, either by treaty, or under general customary law, as the case may be; and
- (ii) - Failure to provide the standard of protection required entails the state's international responsibility for losses suffered, regardless of whether the damages occurred during an insurgents' offensive act or resulting from governmental counter-insurgency activities.

73. The long established arbitral case-law was adequately expressed by Max HUBER, the *Rapporteur* in the *Spanish Zone of Morocco* claims (1923), in the following terms:

The principle of non-responsibility in no way excludes the duty to exercise a certain degree of vigilance. If a state is not responsible for the revolutionary events

themselves, it may nevertheless be responsible, for what its authorities do or not to do to ward the consequence, within the limits of possibility. (Translation from the French original text reported by CHENG, in his *general principles...*, *op. cit.*, at p. 229).

Furthermore, the famous arbitrator indicated that the "degree of vigilance" required in proving the necessary protection and security would differ according to the circumstances.

In the absence of any higher standard provided for by Treaty, the general international law standard was stated to reflect the "degree of security reasonably expected". Max HUBER indicated in this respect:

Du moment que la vigilance exercée tombe manifestement au-dessous de ce niveau par rapport aux ressortissants d'un Etat étranger déterminé, ce dernier est en droit de se considérer comme lésé dans des intérêts qui doivent jouir de la protection du droit international (*Rapport, U.N. Recueil des Sentences Arbitrales*, vol. II, p. 634; and in *Repertory...*, *op. cit.*, p. 426).

In implementation of said standard of vigilance "qu'au point de vue du droit international l'Etat est tenu de garantir", HUBER arrived in his award rendered on May 1, 1925 (*Britanic Property* case between Spain and the U.K.) to hold Spain responsible for: "manque de diligence dans la prévention des actes dommageables" (*U.N. Recueil des Sentences...*, *op. cit.*, p. 645), and in the *Melillea-Ziat, Ben Kiran* case he went as far as to declare the authorities responsible for: "négligence qui friserait la complicité" (*Ibid.*, p. 731).

74. Another reputed arbitrator and author, RALSTON acting as Umpire in the *Sambiggo* case between Italy and Venezuela, did not hesitate to declare:

The umpire .... accepts the rule that if in any case of reclamation submitted to him it is alleged and proved that Venezuelan authorities failed to exercise due diligence to prevent damages from being inflicted by revolutionists, that country should be held responsible (*U.N. Recueil des Sentences Arbitrales*, Vol. X, p.534).

75. On various other occasions, the State Responsibility had been admitted for failure to provide the required protection, as witnessed by the following examples:

- In the 1903 *Kummerow* case, the Germany/Venezuela Mixed Claims Commission declared:

substantially all the authorities on international law agree that a nation is responsible for acts of revolutionists under certain conditions such as lack of diligence, or negligence in failing to prevent such acts, when possible, or as far as possible to punish the wrongdoer and make reparation for the injuring (*Repertory, op. cit.*, Vol I, p. 37);

- In Max HUBER's Report of 1925 on "the Individual Claims" (*Spanish Zone of Morocco* cases), he treated the failure to provide the necessary protection and security as an omission or inaction, and considered that:

l'on est fondé à envisager cette inaction comme un manquement à une obligation internationale (*Repertory*, vol. II, p. 430);

- In the 1926 *Home Insurance Company* case, the Mexico/USA General Claim Commission emphasized the importance of the "duty to protect", which required undertaking all "means reasonably necessary to accomplish that end" (*Ibid.*, p. 433).

- In three successive years (1927, 1928, and 1929), the Mexico/USA General Claims Commission declared that the Mexican Government is to be responsible for what could be characterized as "lack of protection" in case this has been proven (the *David Richards* case (1927), the *Oriental Navigation Co.* case (1928), and the *F.M. Smith* case (1929), *Repertory*, vol. II, p. 435-437).

- In the *Victor A. Ermerins* case (1929), the Presiding Commissioner, Dr. SIND-BALLE, in response to the claim that the Mexican authorities failed "to afford protection to the interest of Ermerins", arrived at the conclusion that in the circumstances of that case:

a crime of this nature could not have taken place, if the authorities of the town had properly fulfilled their duty to afford protection to the property of Ermerins (*U.N. reports of International Arbitral Awards*, vol. IV, p. 476-477);

- In both the *Chapman* case and the *Mrs. Mead* case, adjudicated in 1930 by Mexico/USA General Claims Commission, in spite of the insufficiency of the records submitted, the Commission, relied on sworn affidavits and non-official reports introduced as evidence in order "to sustain the charge of lack of protection" (*U.N. Reports, op. cit.*, Vol. IV, p. 639 and p. 656-657);

In the *Dexter Balwin* case (1933), the Panama/USA General Claims commission, condemned the local authorities's failure "to afford protection" (*Repertory*, vol. II, p. 442);

- In the 1937 two cases concerning *Mr. Braumann* and *Frances Healey* against the Republic of Turkey, the Government was declared responsible according to NIELSON's ruling on the basis that "reasonable care to prevent injuries" was not afforded (*Ibid.*, p. 443-444).

76. In the light of all the above-mentioned arbitral precedents, it would be appropriate to consider that adequate protection afforded by the host State authorities constitutes a primary obligation, the failure to comply with which creates international responsibility. Furthermore, "there is an extensive and consistent state practice supporting the duty to exercise due diligence" (BROWNLIE, *System of the Law of Nations, State Responsibility—Part I*, Oxford, 1986, p. 162).

As a doctrinal authority, relied upon by both Parties during the various stages of their respective pleadings in the present case, Professor BROWNLIE stated categorically that:

There is general agreement among writers that the rule of non-responsibility cannot apply where the government concerned has failed to show due diligence (*Principles of Public International Law*, Third Edition, Oxford, 1979, p. 453).

After reviewing all categories of precedents, including more recent international judicial case-law, the learned Oxford University Professor arrived, not only to confirm that international responsibility arises from the mere "failure to exercise due diligence"

in providing the required protection, but also to note “a sliding scale of liability related to the standard of due diligence” (*State Responsibility, op. cit.* p. 162 and p. 168).

In addition, special attention has to be given to the following passages of BROWNLIE’s writings which seem to be of particular relevance to the present case:

- “Unreasonable acts of violence by police officers ... also give rise to responsibility” (*Principles, op. cit.*, p. 447);
- “Substantial negligence to take reasonable precautionary and preventive action” is deemed sufficient ground to create “responsibility for damage to foreign public and private property in the area” (*Ibid.*, p. 452);
- In commenting the ICJ Judgment rendered in the *Cofu* case (1949), the fact that “nothing was attempted to prevent the disaster” was qualified as “grave omission” which involved the international responsibility of Albania (*State Responsibility, op. cit.*, p. 154);
- With regard to the ICJ Judgment rendered in the *Hostages* case (1980), Professor BROWNLIE emphasizes Iran’s failure “to take appropriate steps to ensure the protection” required under the “full protection and security” provision of the Iran/U.S.A. Amity, Navigation and Commerce Treaty (*Ibid.*, p. 157).

77. A number of other contemporary international law authorities noticed the “sliding scale”, from the old “subjective” criteria that takes into consideration the relatively limited existing possibilities of local authorities in a given context, towards an “objective” standard of vigilance in assessing the required degree of protection and security with regard to what should be legitimately expected to be secured for foreign investors by a reasonably well organized modern State.

As expressed by Professor FREEMAN, in his 1957 Lectures at the Hague Academy of International Law:

The “due diligence” is nothing more nor less than the reasonable measures of prevention which a well-administered government could be expected to exercise under similar circumstances (*Responsibility of States...*, *op. cit.*, p. 15-16).

According to modern doctrine, the violation of international law entailing the State’s responsibility has to be considered constituted by “the mere lack or want of diligence”, without any need to establish malice or negligence (*cf.* C.F. AMERASINGHE, *State Responsibility for Injuries to Aliens*, Oxford, (1967), p. 281-282; F.V. GARCIA-AMADOR, *The Changing Law of International Claims*, vol. I, (1987), p. 115,118; M. BEDJAOUI, “Responsibility of States: Fault and Strict Liability”, *Encyclopedia of Public International Law*, vol. 10, (1987), p. 359; and K. ZEMANEK, “Responsibility of States: General Principles”, *Ibid.*, p. 365).

78. In the light of the above-stated international law precedents and authorities, the arbitral Tribunal has to review the evidence submitted by both Parties in the present case in order to establish the proven facts, and to determine whether these facts sustain the Claimant’s allegation that the Respondent Government failed to comply with its obligation under the Sri Lanka/U.K. Bilateral Investment Treaty (particularly the standard provided for in Article 2.(2)), as well as by virtue of the rules governing

State responsibility under general international law (which becomes necessarily applicable by virtue of the *renvoi* contained in Article 4.(1) of the Treaty)).

79. The Claimant’s case on the facts surrounding the events of January 28, 1987, as initially submitted can be summarized as follows:

- (a) - “During the later part of 1986 and into 1987, the Government of Sri Lanka was faced with grave difficulties because of terrorist activities, including terrorist activities in that part of the country which is near Serendib Seafoods, Ltd. farm” (*Claimant’s Memorial*, P. 7);
- (b) - The management of Serendib company had been closely cooperating “with the security authorities in the region”, and “was ready and willing to cooperate with the Government” (*Ibid.*, p. 8-9);
- (c) - The destruction and killing which took place on January 28, 1987 “was caused by special security forces”, under circumstances which “strongly suggest that this incident was a wanton use of force not required by the exigencies of the situation and not planned pursuant to any combat action” (*ibid.*, p. 8);
- (d) - The burning of Serendib’s “office structure, repair shed, store and dormitory”, the opening of the sluice gates to the grow-out ponds, thus destroying the shrimp crop, as well as the execution of “21 staff members of Serendib Staff”, was not needed since “less destructive action—short of wholesale destruction and murder—could surely have been taken by the Sri Lankan special security forces” (*Ibid.*, p. 9 and 10).

In order to substantiate the Claimant’s version of the January 28th, 1987 events, a number of sworn affidavits were submitted with the Claimant’s Memorial, all emanating from the former Serendib employees or relatives of dead former employees, together with copies of two letters addressed by Serendib’s Managing Director to the President of the Republic on February 2, and February 9, 1987 (Exhibits form (F) to (P)).

80. In the Claimant’s Reply to Respondent’s Counter-Memorial, special additional emphasis was put on reiterating that “the destruction and the killings on January 28, 1987 were caused by the STF”, and the following supplemental points were particularly stressed:

- “the Serendib farm was not a terrorist facility”;
- “the STF did not meet with violent resistance from the farm on January 28, 1987”;
- “extensive combat action did not occur at the farm between terrorists and the STF”; and
- “that Respondent has admitted its liability by offering compensation payments to families of the staff members killed by the STF” (*Claimant’s Reply*, p. 72).

Among the documents attached to Claimant’s Reply to the Respondent’s Counter-Memorial, only one Exhibit related to the factual aspects of the events that took place on January 28, 1987, and during the following days was submitted as

"Exhibit 00". The document in question contains a letter addressed to the Managing Director of Serendib Company by the Batticaloa District Citizen's Committee about the results of the visit of the farm that took place on February 10, 1987.

81. Furthermore, the only person who gave testimony in front of the Tribunal during the oral phase of the arbitration proceedings was the Managing Director of Serendib Company, Mr. Victor Santiapillai, whose two letters to the President of the Republic were submitted as evidence by the Claimant according to what has been previously indicated (Claimant's Exhibits (M) and (P)).

Mr. Santiapillai was examined by the Claimant's Counsel and cross-examined by the Respondent's Counsel.

82. The Respondent's case provided a different version of the facts, which can be summarized as follows:

- (a) - "The Government of Sri Lanka was seeking ways to prevent the spread of terrorism and the erosion of Government control in the towns surrounding the shrimp farm" (*Government's Counter-Memorial*, p. 3);
- (b) - "that the Serendib farm was, in the months preceding the operation (of January 28, 1987), used by Tiger rebels as a base of operations and support" (*Ibid.*, p. 4);
- (c) - "That the farm's management cooperated with the Tigers (*Ibid.*, p. 4)
- (d) - "That operating out of the farm (and the surrounding area) the Tigers violently resisted the Special Task Force raid", and "intense combat action occurred at the farm between the Tigers and the special Task Force during the raid" (*Ibid.*, p. 4);
- (e) - "Any destruction of the farm which occurred was caused directly by terrorist action (in particular, mortar fire), and not by the Special Task force" (*ibid.*, p. 41).

83. During the first exchange of the written pleadings, the Respondent's case on the facts concerning the events of January 28, 1987 relied exclusively on three Exhibits submitted with the Counter-Memorial, which contain:

- (i) - Document containing the Report of Assistant Superintendent Nimal Lewke, dated February 2, 1987, and addressed to his superior, Superintendent Karunasena, Commander of the Special Task Force (Exhibit No. 34);
- (ii) - Document dated February 1, 1987, by virtue of which the Operation's Commander Superintendent Karunasena addressed his Report to his superior, Superintendent Sumith Silva, the Coordinating Officer of Batticaloa (Exhibit No. 35); and
- (iii) - Three internal correspondence within the General Intelligence & Security Department of the Ministry of Defense, dated successively February 3, 1987, February 9, 1987, and March 18, 1987, all related to the fate of Serendib's prawns which were in the farm ponds and disappeared after the farm's destruction on January 28, 1987 (Exhibit No. 36).

84. The text of the Respondent's Rejoinder contained no new elaboration on the facts, but its enclosures comprised two additional Exhibits related to the events of January 28, 1987, which are:

- (i) - A sworn affidavit dated October 17, 1988 (Exhibit No. 38) emanating from the same Mr. Karunasena, the author of the report previously submitted as Exhibit No. 35; and
- (ii) - A sworn affidavit dated also October 17, 1988 (Exhibit No. 39), emanating from Mr. Sumith Silva, the area Coordinating Officer to whom Mr. Karunasena's Report has been previously submitted.

85. Exercising its recognized prerogatives with regard to the evaluation of the entire evidence submitted by both Parties taken as a whole, and after careful consideration of all arguments raised during the proceedings related to the factual aspects of the case, the Arbitral Tribunal came to the following conclusions:

- (A) - Both Parties are in agreement about one fact; that the infiltration by the rebels of the area in which Serendib's farm was located took such magnitude that the entire district had been for several months before January 1987 practically out of the Government's control.

Though such admitted situation would have raised logically the question of whether there was during that period failure from the Government's part to provide "full protection and security" according to the objective standard suggested to be applicable, said question remains theoretical since there were no claimed "losses suffered" due to the lack of governmental protection throughout that period.

- (B) - The Respondent never contested the evidence given by Mr. Santiapillai, neither during the written phase of the proceedings, nor when he gave his testimony at the Oral Hearing, about what he expressed in his letter of February 2, 1987, addressed the Sri Lankan President of the Republic by stating:

we maintained very cordial relationship with the senior officers of the security forces in Batticaloa, repeatedly told them that, if they had the slightest reservation about any of our Batticaloa staff they should let us know quietly and we would take action directly to get such persons out of the company.

More importantly, Mr. Santiapillai, indicated that:

On last visit to Batticaloa, (he) met Sumith de Silva, Coordinating Officer for the area, on January 17, 1987, (and) introduced (to him) the new Farm Manager (Mr. Karunargy), who was appointed on 1 January 1987 Farm Manager, after having worked for the Company since its inception.

He added, that during that visit to Mr. Sumith de Silva on January 17, 1987, the latter:

assured me ... that he had no such reservation.

In his Affidavit prepared and sworn in October 1988; *i.e.* after Mr. Santiapillai's letter was produced as evidence by the Claimant in the present case, the same Mr. Sumith de Silva did not contest that the meeting in question took place at the



indicated date (just 10 days before the January 28, 1987 operation), he did not contradict the substance of the reported discussion, and he did not deny the existence of "cordial relationship" as manifested by making "enquiries from government officials" before recruiting staff and readiness to dismiss whoever the authorities have "the slightest reservation" about him.

In the light of said uncontested evidence, the Tribunal is of the opinion that reasonably the Government should have at least tried to use such peaceful available high level channel of communication in order to get any suspect elements excluded from the farm's staff. This would have been essential to minimize the risks of killings and destruction when planning to undertake a vast military counter-insurgency operation in that area for regaining lost control.

The Tribunal notes in this respect that the failure to resort to such precautionary measures acquires more significance when taking into consideration that such measures fall within the normal exercise of governmental inherent powers—as a public authority—entitled to order undesirable persons out from security sensitive areas. The failure became particularly serious when the highest executive officer of the Company reconfirmed just ten days before his willingness to comply with any governmental requests in this respect.

Accordingly, the Tribunal considers that the Respondent through said inaction and omission violated its due diligence obligation which requires undertaking all possible measures that could be reasonably expected to prevent the eventual occurrence of killings and property destructions.

- (c)- There are no reasons to doubt the Respondent's submission regarding the long planned character of the January 28, 1987 operation given the code-name "Day Break" which obtained prior high level clearance. But the Tribunal does not consider the military reports prepared at a later date conclusive evidence with regard to the alleged heavy firing coming "from the direction of the Prawn Farm", or that "the enemy hold up in the Farm" and resisted the security forces during a period over two hours.

The reports of the two officers are contradicted on these specific points by the information contained in the affidavits sworn by Mr. Kirupakara, the casual worker at Serendib farm (Exhibit F), and by Mr. Selbatnamby, the tractor driver at Serendib farm. Both provide more detailed account as eye-witnesses about what effectively happened on the spot with extreme rapidity between 7.45 in the morning, when gunfire came "in the direction of the office" causing the employees to "rush into the Farm office for shelter", and 8.00, when "three officers attached to the STF entered the office". The taking-over of the Farm by the security forces faced no resistance according to these two eye-witnesses, and there were no destructions at that time, as witnessed by the fact that the tractor driver returned later in the day to the Farm with four members of the security forces to take certain equipments from the Farm Office, which implies that it remained non-destroyed till then.

Moreover, it has to be noted that of the officers' reports raise certain issue of credibility with regard to their chronological order, since unexpectedly the commander of the operation, Mr. Karunasena who was observing from a helicopter reported to his superior the Area Coordinating Officer Sumith de Silva on February 1, 1987, before receiving any report from his assistant Mr. Lewke who effectively conducted on the ground the operation of taking over the farm facilities (the latter's report is dated February 2, 1987).

Therefore, the Respondent's version of the events has to be considered lacking convincing evidence with regard to the allegation that the farm became a "terrorist facility" which "violently resisted the Special Task Force" through an "intense combat action" that "occurred at the Farm".

Apparently, the officers' version of the events, which are not substantiated with any credible evidence, and which are contradicted by the Affidavits submitted by eye-witnesses, were intended to cover up their inability to prevent the destruction of the farm.

- (d) - Neither Party succeeded in providing the Tribunal with convincing evidence about: (i)—the circumstances under which the destruction of the premises took place after they came under the control of the governmental forces; (ii)—who are the persons responsible for the effective destruction of the farm premises; (iii)—how was the destruction committed; and (iv)—how the subsequent acts causing the loss of the prawns in ponds took place.

The Respondent could have at least provided the results of investigations conducted in this respect by the competent Sri Lankan authorities, particularly since all the events in question took place during the two weeks period when the farm was under the exclusive control of the security forces.

In final analysis, no conclusive evidence exists sustaining the Claimant's allegation that the special security forces were themselves the actors of said destruction causing the losses suffered.

At the same time no conclusive evidence sustains the Respondent's allegation that the destruction were "caused directly by the terrorist action".

Hence, the adjudication of the State's responsibility has to be undertaken by determining whether the governmental forces were capable, under the prevailing circumstances, to provide adequate protection that could have prevented the destructions from taking place totally or partially.

In this respect, it has been already indicated that the governmental authorities should have undertaken important precautionary measures to get peacefully all suspected persons out of Serendib's farm before launching the attack, either through voluntary cooperation with the Management of the company or by ordering the Company to expel the suspected persons.

The reports of Messrs. Lewke, Karumasena, and Silva, as well as the sworn affidavits of the last two senior officers, provide certain indications that the governmental authorities failed to undertake such measures because they were

considering as suspected guerrilla supporters the entire Management of Serendib Company, starting from the newly appointed farm manager Mr. Karunargy, up to the American Manager, Mr. Bruce Cyr. Even Mr. Santiapillai the Managing Director was accused of "complicity with LLTE as far as the management of the Prawn Farm is concerned" (Paragraph 8, of the Report of the Commandant/STF dated March 18, 1987, *Respondent's Exhibit No. 37*, which referred to "evidence" against the Managing Director to that effect).

If this had been effectively the case, in the opinion of the Tribunal, the legitimate expected course of action against those suspected persons would have been either to institute judicial investigations against them to prove their culpability or innocence, or to undertake the necessary measures in order to get them off the Company's farm. But, as previously explained, nothing of the sort took place. On the contrary, only ten days before the January 28, 1987, operation no complaints were voiced against any of them, including the newly appointed farm manager Mr. Karunargy, during the meeting of Mr. Santiapillai with the Area Coordinating Officer Mr. Sumith de Silva. The mere fact that Mr. Karunargy had been the first person who lost his life during the first hours of the operation "Day Break", under the circumstances described by Mr. Kirupakara in his Affidavit (*Claimant's Exhibit F*) and Mr. Selbathnamny in his Affidavit (*Claimant's Exhibit G*), casts serious doubts about the ability of the security forces which took control over Serendib's farm to provide the required standard of protection in preventing human losses, or a *fortiori* of property destruction, which is by far a less imperative objective.

Therefore, and faced with the impossibility of obtaining conclusive evidence about what effectively caused the destruction of the farm premises during the period in which the entire area was out of bounds under the exclusive control of the governmental security force, the Tribunal considers the State's responsibility established in conformity with the previously stated international law rules of evidence (especially *Rules (L) and (M)*, *supra* § 56).

86. For all the legal and factual considerations contained in the present section of the award, the Tribunal came to the conclusion that the Respondent's responsibility is established under international law.

#### IV—The Legal Consequences of the Respondent's International Responsibility

##### (A)—Quantum of the compensation

87. Both Parties are in agreement that whenever the State's responsibility is established, due to failure of its authorities to provide foreign investors with the full protection and security required under the relevant international law rules and standards, the interested party becomes entitled to claim the type of remedy deemed appropriate,

which takes in the present case the form of monetary compensation (*Respondent's Counter-Memorial*, p. 28–29, p. 39, p. 40, p. 42 ss; and *Government's Rejoinder*, p. 11 ss).

88. Both Parties are equally in agreement about the principle, according to which, in case of property destruction, the amount of the compensation due has to be calculated in a manner that adequately reflects the full value of the investment lost as a result of said destruction and the damages incurred as a result thereof.

The basic rule long established in this respect was clearly formulated by Max Huber in the 1925 *Melilla-Ziat, Ben Kim* case in the following words:

Le dommage éventuellement remboursable ne pourrait être que le dommage direct, à savoir la valeur de marchandises détruites ou disparues (*U.N. Reports of International Arbitration Awards*, vol. II, p. 732).

Thus, the task of the Tribunal in the present case has to focus on the determination of the "value" of the Claimant's right which suffered losses due to the destruction that took place on January 28, 1987, and throughout the following days during which Serendib's farm remained under governmental temporary occupation (unjustifiably characterized by the Claimant as *de facto* "requisition", since it has not been proven that the Government used the farm to promote its own military interests and to benefit thereof).

89. Disagreement among the two Parties to the present arbitration emerges only with regard to the following two major points:

- (i) - Which elements have to be taken into consideration in calculating the Claimant's property rights to be compensated; and
- (ii) - What quantum reflects the full value of the elements constituting the Claimant's property right to be compensated.

90. With regard to the first point, the elements enumerated in the Claimant's Memorial included the following:

- (A) - 50% of the physical direct losses sustained by Serendib Company on January 28, 1987, which comprise:
  - (1) - loss of revenue from stocks of shrimp existing by then in the ponds;
  - (2) - value of farm structure and equipment destroyed, damaged or missing;
  - (3) - loss of investment in technical staff training at the farm;
  - (4) - compensation payable to dependents of dead staff members;
  - (5) - pond rehabilitation to resume operations.
- (B) - The "going concern value" of the Claimant's 50% share-holding percentage in Serendib Company on January 28, 1987.
- (C) - 50% of the projected lost profits for a reasonable period of 18 months (*Claimant's Memorial*, p. 14–16).

91. According to the final form submitted by the end of the oral hearing on April 19, 1989, expressing the Claimant's conclusions, the Tribunal was requested to award AAPL compensation that includes the following elements:

- (A) - 48.2% of the value of assets destroyed, comprising

- (1) - physical assets;
  - (2) - financial assets;
  - (3) - intangible assets.
- (B) - 48.2% of Serendib's net projected future earnings.

92. The Respondent's Counter-Memorial, emphasized the following important aspects:

- (i) - AAPL's Claims is "largely based on the illusion of expected profitability" (*Government's Counter-Memorial*, p. 42);
- (ii) - AAPL's claim "is based on blatant double (or triple) counting. AAPL claims entitlement not only to its share of "going concern value" of Serendib, but also to indemnification for physical losses and lost prospective profits. Yet AAPL cannot be entitled to both, because any measurement of the "going concern value" of Serendib on January 28, 1987, includes a valuation of the net book value of both Serendib's assets and its future profitability" (*Ibid.*, p. 43);
- (iii) - "In the event the Tribunal finds the Government liable to AAPL for damage sustained by Serendib, the Tribunal must chose *either* to undertake a going concern valuation *or* to determine damages for "physical loss" and lost prospective profits, but cannot logically award both" (*Ibid.*, p. 43).

93. During the course of the proceedings, the Respondent added another basic objection according to which the percentage of AAPL's share-holding in Serendib is neither 50% as initially claimed, nor 48.2% as subsequently admitted, but a far lesser percentage, since the "preference shares" of the Export Development Board should be taken into consideration as an integral part of Serendib's equity capital.

94. The Parties were invited by the Tribunal to express their considered opinions and conclusions on that issue, by virtue of the Order of April 20, 1989, rendered at the end of the oral hearing, and lengthy exchanges took place in this respect on May 22, and May 29, 1989 as previously indicated (*supra*, § 1.2).

95. In deciding on the issues under consideration which are subject to disagreement among the Parties, the Tribunal has primarily to indicate that AAPL is entitled in the present arbitration case to claim compensation under the Sri Lanka/U.K. Bilateral Investment Treaty, on the legal grounds previously described in Part II of this award due to the fact that the Claimant's "investments" in Sri Lanka "suffered losses" owing to events falling under one or more of the circumstances enumerated by Article 4.(1) of the Treaty ("revolution, state of national emergence, revolt, insurrection", etc....).

The undisputed "investments" effected since 1985 by AAPL in Sri Lanka are in the form of acquiring shares in Serendib Company, which has been incorporated in Sri Lanka under the domestic Companies Law.

Accordingly, the Treaty protection provides no direct coverage with regard to Serendib's physical assets as such ("farm structures and equipment", "shrimp stock in

ponds", cost of "training the technical staff", etc.), or to the intangible assets of Serendib if any ("good will", "future profitability", etc...). The scope of the international law protection granted to the foreign investor in the present case is limited to a single item: the value of his share-holding in the joint-venture entity (Serendib Company).

96. In the absence of a stock market at which the price for Serendib's shares were quoted on January 27, 1987 (the day preceding the events which led to the destruction of the value of AAPL's investment in Serendib's capital), the evaluation of the shares owned by AAPL in Serendib has to be established by the alternative method of determining what was the reasonable price a willing purchaser would have offered to AAPL to acquire its share holding in Serendib.

97. Certainly, all the physical assets of Serendib, as well as its intangible assets, have to be taken into consideration in establishing the reasonable value of what the potential purchaser could have been willing to offer on January 27, 1987 for acquiring AAPL's shares in Serendib. But the reasonable price should have reflected also Serendib's global liability at that date; *i.e.* the aggregate amount of the current debts, loans, interests, etc... due to Serendib's creditors.

98. Consequently, the Tribunal is of the opinion that the determination of the percentage of AAPL's share-holding in Serendib's capital is a false problem, since the relevant factor is to establish a comprehensive balance sheet which reflects the result of assessing the global assets of Serendib in comparison with all the outstanding indebtedness thereof at the relevant time.

For the purpose of evaluating the market price of AAPL's shares on January 27, 1987, the result would be ultimately the same whether or not the "preference shares" of Sri Lanka's Export Development Board technically qualify under the domestic companies law as part of Serendib's capital. Assuming that the correct legal interpretation of the Sri Lankan Law would lead to include among Serendib's capital assets the value of the "preference shares" issued in favour of the Export Development Board as a security for the cash money funds already supplied to the Company, Serendib's capital assets would have on one hand, to be considered increased. But on the other hand, the global amount of the Development Board's disbursements together with the accruing interests due on January 27, 1987, should be taken into consideration in reflecting Serendib's global indebtedness.

In other words, in case the "preference shares" of Export Development Board decrease AAPL's percentage of share-holding in Serendib's equity capital, this would not ultimately affect the value of AAPL's share-holding.

In the language of figures, a 48% ordinary share-holding is an equity capital amounting to 21,464,241 Sri Lankan Rupees (*S-L.Rs*) equals 37% share-holding in an entity having a total capital of *S-L.Rs* 28,184,241 (*i.e.* by adding the value of the preferences shares).

At the other side of the equation, assuming 48% of loan liabilities totalling *S-L.Rs* 70,024,000, is the same as acquiring 37% of the global indebtedness amounting to *S-L.Rs* 76,744,000.

99. Taking into consideration the above stated preliminary remarks of general character, the Tribunal is faced with no legal objections in allocating to the Claimant compensation for the damages which were effectively incurred due to the destruction of a substantial part of Serendib's physical assets, thus rendering the legal entity in which AAPL invested out of business since January 28, 1987. In essence, Serendib ceased as of that date to be a "going concern" capable of realizing profits, thus causing AAPL's investment therein to become a total loss.

100. In the light of all the elements of evidence provided by both Parties, including the evaluation Report of *Coopers & Lybrand*, the additional explanation pertaining thereto (filed by AAPL as *Exhibit BB*), the Respondent's objections raised in the *Government's Rejoinder* (p. 17ss), as well as those other issues raised during the Oral Hearing, particularly in cross-examination of the Claimant's advisor Mr. Deva Rodrigo which led to revised evaluation figures submitted by the Claimant before the end of the Oral hearing, the Tribunal considers that the fair evaluation exclusively based on Serendib's tangible assets leads to value AAPL's investment in that company at a total amount of 460,000 U.S. Dollars.

101. Nevertheless, the major part of the Claimant's pleas were directed towards obtaining 5,703,667 U.S. dollars as compensation for a variety of other claimed damages, which include intangible assets, mainly "goodwill", and loss of future profits.

The admissibility of such claims raised serious legal objections from the Respondent, which are expressed in the following two quotations:

- (a) - "International arbitral tribunals are bound to project future on the basis of the past, Serendib's history offers no sound basis for projecting any future profitability" (*Counter-Memorial of the Government*, p. 49);
- (b) - "The loss of crops to be harvested in the future has usually been considered to be too speculative and indefinite to be included as a proper element of damage under international law" (*Ibid.*, p. 50).

102. In the Tribunal's view, it is clearly understood that the evaluation of the "going concern" which is Serendib Company in the present case, has for unique objective the determination of what could be the reasonable market value of the Company's shares under the circumstances prevailing on January 27, 1987. Hence, as a general rule all elements related to subsequent developments should not be taken as such into consideration, and *lucrum cessans* in the proper sense could not be allocated in the present case for which the precedents concerning unlawful expropriation claims or liability for unilateral termination of a State contract are of no relevance.

The only pertinent question in the present case would be to establish whether Serendib have had by then developed a "good will" and a standard of "profitability" that renders a prospective purchaser prepared to pay a certain premium over the value of the tangible assets for the benefit of the Company's "intangible" assets.

Consequently, the projection of future profits in function of the "Discounted Cash Flow Method" (DCF) has to be envisaged simply as a tool to assess the level of

Serendib's future profitability under all relevant circumstances prevailing at the beginning of 1987.

103. In this respect, it would be appropriate to ascertain that "goodwill" requires the prior presence on the market for at least two or three years, which is the minimum period needed in order to establish continuing business connections, and during that period substantial expenses are incurred in supporting the management efforts devoted to create and develop the marketing network of the company's products, particularly in cases like the present one where the Company relies exclusively on one product (shrimps) exportable to a single market (Japan).

The possible existence of a valuable "goodwill" becomes even more difficult to sustain with regard to a company, not only newly formed and with no records of profits, but also incurring losses and under-capitalized.

A reasonable prospective purchaser would, under these circumstances, be at least doubtful about the ability of the Company's balance sheet to cease being in the red, in the sense that the future earnings become effectively sufficient to off-set the past losses as well as to service the loans which exceed in their magnitude the Company's capital assets.

104. Furthermore, according to a well established rule of international law, the assessment of prospective profits requires the proof that:

"they were reasonably anticipated; and that the profits anticipated were probable and not merely possible" (Marjorie M. WHITEMAN, *Damages in International Law*, vol. II, (1937), p. 1837, with reference to extensive supporting precedents disallowing "uncertain" or "speculative" future profits, p. 1836-1849; The 1902 Award rendered in *EL Triunfo* case (EL Salvador/U.S.A.), *Repertory, op.cit.*, vol. I, § 1350, p. 324; The 1903 Award rendered by the Italy/Venezuela Mixed Commission in the *Poggidi* case, *Ibid.* § 1358, p. 328-329; Ignaz SEIDEL-HOHENVELDOERN, "L'Evaluation des Dommages dans les Arbitrages Transnationaux", *Annuaire Français de Droit International*, vol. XXXIII, (1987), p. 17 ss. with ample reference to the numerous decisions rendered by the Iran/USA Claims Tribunal to that effect, and interestingly the Author's reference to the DCF calculations provided by the Expert Accountants of the Parties which contain "élément de conjecture" looking: "guère moins spéculatifs et tout aussi obscurs que les prophéties de Nostradamus" P. 24).

105. The Claimant itself, in the *Reply to the Respondent's Counter-Memorial* (p. 64-68), reproduced a long quotation from the Award rendered on July 14, 1987, by the Chamber presided by the late Michel VIRALLY, in the case *AMOCO International Finance Corporation v. Iran*, which after clearly distinguishing the *lucrum cessans* from the "future prospects" of profitability that constitutes an element to be taken into consideration in evaluating the "going concern", find necessary to emphasize the need to prove that:

the undertaking was a "going concern" which had demonstrated a certain ability to earn revenues and was, therefore to be considered as keeping such ability for the future ( § 203 of the Award as quoted on p. 67 of the *Claimant's Reply*).

The fact that Serendib exported for the first time two shipments to Japan during the same month of January 1987 when its farm was destroyed, does not sufficiently demonstrate in the Tribunal's opinion "a certain ability to earn revenues" in a manner that would justify considering Serendib—by exporting for the first time in its short life—able to keep itself commercially viable as a source of reliable supply on the Japanese market.

106. In the light of the above-stated considerations, and taking into account all the evidence introduced by both Parties with regard to the existence or non-existence of "intangible assets" capable of being evaluated for the purpose of establishing the total appropriate value of Serendib on January 27, 1987, the Tribunal comes to the conclusion that neither the "goodwill" nor the "future profitability" of Serendib could be reasonably established with a sufficient degree of certainty.

107. Without putting into doubt the binding force of the rules requiring that the intangible assets including "goodwill" and "future profitability" of an enterprise have to be reflected in the evaluation of a "going concern", the Tribunal's opinion is established on considering the assumptions upon which the Claimant's projection were based in the present case insufficient in evidencing that Serendib was effectively by January 27, 1987, a "going concern" that acquired a valuable "goodwill" and enjoying a proven "future profitability", particularly in the light of the fact that Serendib had no previous record in conducting business for even one year of production.

108. Therefore, all the amounts of claimed compensation for "intangible assets", as well as for "future earnings" are rejected.

(B)—*The issue of AAPL's Guarantee to the European Asian Bank*

109. Evidently, the present Arbitral Tribunal does not have jurisdiction to adjudicate any controversy or dispute related to the interpretation of AAPL's Guarantee given for the benefit of Serendib in AAPL's capacity as share-holder in Serendib Company, in order to determine whether said Guarantee came to an end or is still operative and capable of creating potential liability on AAPL.

110. Nevertheless, the Tribunal takes into consideration that AAPL as Claimant in the present Arbitration has considered its investment in Serendib a total loss, and submitted in its final conclusions dated April 19, 1989, that:

... AAPL is willing to give up its shares of Serendib Seafoods Ltd, should the Respondent pay adequate compensation.

The Tribunal equally notes that the Respondent Government did not raise any objection, with regard to said offer.

111. Accordingly, the Tribunal deems appropriate to invite the two Parties to envisage, upon reception of the amounts becoming due to the Claimant by virtue of the present Award, to conclude an agreement according to which AAPL undertakes all the necessary steps in order to transfer free of charge all its shares in Serendib

Company to the Government of Sri Lanka or to any other entity the Government may nominate, with the understanding that said transfer of title on the shares entails in exchange the passing of any potential liability under the European Asian Bank Guarantee from AAPL to the new owner of the shares.

(C)—*The allocation Of Interest*

112. The Claimant requested interest at the rate of 10% per annum as of the date of the losses incurred (January 28, 1987), and the Respondent did not raise any objection with regard to, either the principle of entitlement to interests in case the Government's responsibility is sustained by the Tribunal, or to the suggested rate of 10% per annum.

113. In accordance with a long established rule of international law expressed since 1872 by the Arbitral Tribunal which adjudicated the *Alabama* case between the U.K. and U.S.A., "it is just and reasonable to allow interest at a reasonable rate" (*Reportory, op.cit.*, vol. I, § 1382, p. 343).

In implementation of the above-stated rule, and in view of the Parties' attitude indicated herein-above, the present Tribunal deems appropriate to allocate interest on the amount of U.S. \$460,000 granted to the Claimant as previously stipulated (§ 100), at the rate of 10% per annum.

114. The only pending issue in this respect relates to the date from which that interest starts accruing.

The survey of the literature reveals that, in spite of the persisting controversies with regard to cases involving moratory interests, the case-law elaborated by international arbitral tribunals strongly suggests that in assessing the liability due for losses incurred the interest becomes an integral part of the compensation itself, and should run consequently from the date when the State's international responsibility became engaged (*cf. R. LILLICH, "Interest in the Law of International Claims", Essays in Honor of Vade Saario and Toivo Sainio, (1983), P. 55-56.*

115. Therefore, and taking into account that Article 8.(3) of the Sri Lanka/U.K. Bilateral Investment Treaty provides that the foreign investor becomes entitled to file a recourse in front of the Centre only in case agreement with the Host State "cannot be reached within three months", and since the claimant in the present case effectively submitted his Request of Arbitration on the 8th of July, 1987, the Tribunal rules that the 10% per annum rate of interest adopted starts accruing as of July 9th, 1987, and continues to run as a part of the compensation allocated to the Claimant up to the date of the payment of the sum awarded.

*(D)—Costs*

116. In implementation of Article 61.(2) of ICSID Convention, the Tribunal exercises the discretionary power accorded thereto in the following manner:

- (i) - in assessing the fees and expenses incurred by the Claimant in preparation and presentation of its case, all the amounts figuring in AAPL's final Statement of May 7, 1990 under *Items 1, 4, 5 and 6* in the Section entitled "Statement of expenditure incurred by AAPL and its officers" have to be excluded, since they are not proven necessary "in connection with the proceedings", and the rest which is totalling U.S. \$164,917.20 (One Hundred, Sixty Four Thousands, Nine hundred Seventeen, and Twenty Cents) has to be shared on the basis of two thirds by the Claimant and one third by the Respondent;
- (ii) - the Respondent has to bear all the fees and expenses incurred in preparation and presentation of its case;
- (iii) - the costs of the arbitration, including the arbitrators' fees and the administrative charges of the Centre, have to be shared on the basis of 40% by the Claimant and 60% by the Respondent.

For the above-stated reasons:

**THE TRIBUNAL DECIDES AS FOLLOWS:**

1. The Republic of Sri Lanka shall pay to Asian Agricultural Products Ltd., the sum of U.S. Dollars FOUR HUNDRED AND SIXTY THOUSAND (U.S. \$ 460,000) with interest on this amount at the rate of ten percent (10%) per annum from July 9, 1987 to the date of effective payment.

2. The Two Parties are invited to envisage adopting a solution that would permit, upon reception of the payment due under the preceding paragraph, to conclude an agreement according to which Asian Agricultural Products Ltd. undertakes all the steps required in order to transfer free of charge all its shares in Serendib SEA-FOODS LTD. to the Government of Sri Lanka or any other entity the Government may nominate, provided that in exchange the new owner of the shares assumes any potential liability under the European Asian Bank Guarantee previously granted by AAPL as shareholder to the benefit of Serendib Company.

3. All other submissions of the Parties are rejected.

4. The Republic of Sri Lanka shall bear the amount of U.S. \$54,972.40 (Fifty Four Thousands Nine Hundred Seventy Two, and Forty Cents) which represents one third of the relevant fees and expenses incurred by Asian Agricultural Products Ltd. for the preparation and presentation of its case.

5. The Republic of Sri Lanka shall bear the fees and expenses it incurred for the preparation and presentation of its case.

6. The Republic of Sri Lanka shall bear sixty percent (60%) of the arbitrators' fees and expenses and the charges of use of the facilities of the Centre, and the remaining forty percent (40%) shall be borne by Asian Agricultural Products Ltd.

*Ahmed S. EL-KOSHERI*

*Berthold GOLDMAN*

Signed by both arbitrators forming the majority of the Arbitral Tribunal on 21 June 1990, after taking notice of Dr. ASANTE's Dissenting Opinion dated 15 June 1990.

OXFORD PUBLIC INTERNATIONAL LAW

## Oxford Reports on International Law

### **Wena Hotels Limited v Egypt, Award, ICSID Case No ARB/98/4, (2004) 6 ICSID Rep 89, (2002) 41 ILM 896, IIC 273 (2000), 8th December 2000, International Centre for Settlement of Investment Disputes [ICSID]**

**Date:** 08 December 2000

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**Citation(s):** ICSID Case No ARB/98/4 (Official Case No)

(2004) 6 ICSID Rep 89 (Other Reference)

(2002) 41 ILM 896 (Other Reference)

IIC 273 (2000) (OUP reference)

**Product:** Oxford Reports on International Law [ORIL]

**Module:** International Investment Claims [IIC]

**Parties:** Wena Hotels Ltd  
Egypt

**Judges/Arbitrators:** Monroe Leigh (President); Ibrahim Fadlallah (Claimant appointment); Don Wallace Jr (Respondent Appointment)

**Counsel for Party One:** Emmanuel Gaillard (Shearman & Sterling); John Savage (Shearman & Sterling); Peter Griffin (Shearman & Sterling)

**Counsel for Party Two:** Eric A Schwartz (Freshfields Bruckhaus Deringer); Simon B Stebbings (Freshfields Bruckhaus Deringer); Counselor Osama Ahmed Mahmoud (Egyptian State Lawsuits Authority); Counselor Hussein Mostafa Fathi (Egyptian State Lawsuits Authority)

**Procedural Stage:** Award

**Previous Procedural Stage(s):**

Decision on jurisdiction; *Wena Hotels Ltd v Egypt*, ICSID Case No ARB/98/4; IIC 272 (1999); 41 ILM 881 (2002), 25 May 1999

**Subsequent Development(s):**

Decision on the application by Egypt for annulment of the award; *Wena Hotels Ltd v Egypt*, ICSID Case No ARB/98/4; IIC 274 (2002); 41 ILM 933 (2002), 28 January 2002

Decision on the application by Wena Hotels Ltd for interpretation of the award; *Wena Hotels Ltd v Egypt*, ICSID Case No ARB/98/4; IIC 275 (2005), 20 October 2005

**Arbitral Rules:** Convention on the Settlement of Investment Disputes Between States and Nationals of Other States (18 March 1965) 575 UNTS 159, entered into force 14 October 1966

**Governing Law:** Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Arab Republic of Egypt for the Promotion and Protection of Investments (UK/Egypt) (11 June 1975), entered into force 24 February 1976 ('Egypt-UK BIT'); International law; Law of Egypt

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**Subject(s):**

Expropriation of contract rights — Prompt, adequate and effective compensation (Hull Formula) — Foreign Direct Investment — Measure — Fair and equitable treatment standard — Full protection and security — State entities and attribution — Choice of law — Customary international law — Host state law — Treaty provisions — Corruption claim — Treaty claim — Costs and expenses — Damages, sunk costs — Discounted cash flow (DCF), anticipated future profits — Interest, compound/simple — Interest, rate of — Valuation

**Core Issue(s):**

Whether Egypt violated its obligations to provide Wena fair and equitable treatment, full protection and security and its obligation not to expropriate Wena's investment absent prompt, adequate and effective compensation.

What law was applicable to the arbitration and whether a municipal statute of limitation applied to the Egypt-UK BIT claims.

What the appropriate method was for calculating damages for expropriation.

**Oxford Reports on International Investment Claims is edited by:**

Ian Laird, Crowell & Moring LLP, Washington, DC

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## **Facts**

**F1** On 11 June 1975 the United Kingdom and Egypt entered into an Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Arab Republic of Egypt for the Promotion and Protection of Investments (UK/Egypt) (11 June 1975), entered into force 24 February 1976 ('Egypt-UK BIT') whereby Egypt and the UK promised to create favourable conditions for nationals or companies of the other contracting party to invest in its territory.

**F2** On 8 August 1989, Wena Hotels Ltd, an English company ('Wena'), entered into a Lease and Development Agreement with the Egyptian Hotels Company ('EHC'), a company wholly owned by the Egyptian government. Pursuant to the Lease and Development Agreement, Wena was to operate and manage the Luxor Hotel in Luxor, Egypt for a period of 21 years and six months. The agreement also required Wena to upgrade and expand the hotel facilities. On 28 January 1990, Wena entered into a similar agreement with EHC to operate and manage the Nile Hotel in Cairo, Egypt—together, the 'Lease Agreements'.

**F3** On 1 October 1989, Wena entered into a related agreement with both EHC and the Egyptian Ministry of Tourism whereby Wena agreed to train Egyptian nationals in hotel management in the UK.

**F4** On 20 August 1989, Wena entered into a consultancy agreement with Mr Kandil, the Chairman of EHC. Under the terms of the consultancy agreement, Mr Kandil was to advise and assist Wena in relation to the opportunities available for the development of other hotel business opportunities in Egypt. Between 18 August 1989 and 30 January 1990, Wena made a total of £52,000 in payments to Mr Kandil. On 26 March 1991 Wena initiated a lawsuit against Mr Kandil for allegedly breaching the consultancy agreement.

**F5** Shortly after entering into the Lease Agreements, disputes arose between EHC and Wena concerning their respective obligations under these agreements. Wena claimed that the condition of the two hotels was far below the standard stipulated in the Lease Agreements and withheld part of the rent due. In response, EHC claimed that Wena failed to pay the rent due under the Lease Agreements and therefore liquidated the performance security posted by Wena.

**F6** On 3 May 1990, Wena instituted arbitration proceedings in Egypt against EHC arising out of the disputes over the Luxor Hotel. In an award dated 14 November 1990 an *ad hoc* Tribunal ordered EHC to make repairs to the Luxor Hotel and ordered Wena to fulfil its rental obligations. Wena applied to the local courts to have the award set aside.

**F7** On 27 March 1991, EHC's Board of Directors met to discuss the course of action to be taken in relation to Wena's withholding of rent. The decision was taken to terminate the leases on both hotels and this course of action was confirmed by a resolution of the Chairman of the Board of EHC on 30 March 1991. EHC attempted to inform Wena of its decision but there was no evidence that this information was received by Wena prior to 1 April 1991.

**F8** On 1 April 1991, EHC staff attacked both the Luxor and Nile hotels and forcefully took possession of both hotels from Wena. From 1 April 1991 through to 25 February 1992, the Nile Hotel remained in the control of EHC. The Luxor Hotel remained in EHC's control until 21 April 1992. During this time, Wena made efforts to regain control of the hotels by seeking assistance from officials in the United States and UK as well as Egyptian officials.

**F9** Egypt, through its Minister of Tourism, Fouad Sultan, acknowledged that the seizure of the Luxor and Nile hotels was illegal and wrong. However, Egypt did not take any action to return possession of the hotels to Wena, to punish EHC or its officials, or to withdraw the hotels licenses so that EHC could not operate the hotels.

**F10** On the 16 January 1992 the Chief prosecutor of Egypt ruled that attacks against the Nile Hotel were illegal and that Wena was entitled to repossess the hotel. However, it was not until 25 February 1992 the Nile Hotel was actually returned to Wena's control. The Nile Hotel was handed over to Wena with all the furniture and fixtures removed. Two days before the Nile Hotel was returned to Wena, the Ministry of Tourism cancelled the operating license of the Nile Hotel for alleged safety violations. Wena never operated the Nile Hotel again and it was placed in judicial receivership in 1997.

**F11** On 21 April 1992, the Chief Prosecutor of Egypt ruled that attacks against the Luxor Hotel were also illegal and ordered that the hotel should be returned to Wena. On 28 April Wena re-entered the Hotel. However, the Ministry of Tourism denied Wena a permanent operating licence for the hotel instead only granting it a series of temporary licenses.

**F12** Wena subsequently sought compensation from Egypt as a result of its loss of possession of both hotels. However, Egypt denied the requests.

**F13** On 10 July 1998, Wena filed a request for arbitration with the International Centre for Settlement of Investment Disputes ('ICSID'). Wena sought the following relief: A declaration that Egypt breached its obligations to Wena pursuant to the Egypt-UK BIT by illegally expropriating Wena's investments and failing to accord Wena's investments fair and equitable treatment and full protection and security; An order that Egypt pay damages in an amount no less than USD \$62,820,000; And an order that Egypt pay Wena's costs associated with the arbitration.

**F14** Egypt originally raised four objections to the jurisdiction of the Tribunal. Egypt claimed that: Wena, although incorporated in the UK, should be treated as an Egyptian company by virtue of its ownership; Wena had made no investment in Egypt as required by Article 25 of the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States (18 March 1965) 575 UNTS 159, entered into force 14 October 1966 ('ICSID Convention'); There was no legal dispute between the parties as required by Article 25 of the ICSID Convention; And Wena's consent to arbitration was insufficient and the Request for Arbitration was premature because Wena failed to comply with the three month waiting period required by the Egypt-UK BIT.

**F15** Egypt withdrew two of its four objections at the hearing on jurisdiction. In its decision dated 29 June 1999 (Decision on jurisdiction; *Wena Hotels Ltd v Egypt*, ICSID Case No ARB/98/4; IIC 272 (1999); 41 ILM 881 (2002), 25 May 1999), the Tribunal concluded that Egypt's two remaining jurisdictional objections should be denied and jurisdiction should be exercised over the dispute.

**F16** Egypt did not dispute that the repossession by EHC of the Luxor and Nile hotels and EHC's eviction of Wena from the hotels on 1 April 1991 was wrong. However, Egypt denied liability for the claims asserted by Wena by raising two affirmative defences. First, Egypt asserted that Wena's claims in relation to the seizure of the hotels were time barred by virtue of Article 172(i) of the Egyptian Civil Code (Egypt) ('Civil Code').

**F17** Second, Egypt alleged that Wena had sought to improperly influence the Chairman of the EHC, Mr Kandil with respect to the award of the Lease Agreements by illegally granting him the consultancy agreement. Egypt asserted that Wena's actions amounted to corruption and that Wena could now not claim compensation for the loss of its interests in the Lease Agreements because the Lease Agreements had been obtained improperly.

## **Held**

**H1** Whilst there was no clear evidence that Egypt—other than EHC officials—had participated in the seizures of the two hotels, there was substantial evidence that Egypt was aware of EHC's intentions and took no action to prevent the seizure of the hotels.

**H2** Once the seizures had taken place, neither the police nor the Ministry of Tourism did anything

to restore possession of the hotels to Wena. Further, Egypt never imposed sanctions on EHC or its senior officials, suggesting that Egypt adopted the actions of EHC. As a result, Egypt breached Article 2(2) of the Egypt-UK BIT by failing to accord Wena's investments fair and equitable treatment and full protection and security. (paragraph 84)

**H3** An expropriation may have taken place if the state allowed a *de facto* possessor to remain in possession of the property which had been seized. (paragraph 97) Further, it was well established that expropriation was not limited to tangible property rights. Contract rights were entitled to protection under international law and the taking of such rights may have involved an obligation to compensate. (paragraph 98)

**H4** Whether or not it authorized or participated in the actual seizures of the hotels, Egypt had deprived Wena of its 'fundamental rights of ownership' by allowing EHC to forcibly seize the hotels and to possess them illegally for nearly a year. Thus, Egypt's actions amounted to an expropriation of Wena's investment without prompt, adequate and effective compensation in violation of Article 5 of the Egypt-UK BIT and international law. (paragraphs 99–101)

**H5** Municipal statutes of limitation did not necessarily bind a claim for violation of an international treaty. (paragraph 106) Further, Article 42(1) of the ICSID Convention did not require an ICSID Tribunal to apply municipal statutes of limitation. Rather, Article 42(1) provided that a Tribunal should have applied the domestic law of the host state 'and such rules of international law as may be applicable.'

**H6** Tribunals should have applied rules of international law to ensure the precedence of international law norms where the rules of the applicable domestic law were in collision with such norms. The strict application of statute of limitation found in the Civil Code would have collided with the general international principle that municipal statutes of limitation did not bind claims before international tribunals. Therefore, the statute of limitation in the Civil Code did not apply and Wena's claims were not time barred. (paragraph 107)

**H7** With respect to the allegations of corruption, Egypt had not discharged its burden of proving any misconduct by Wena. The Egyptian Government was aware of the consultancy agreement and had not prosecuted Mr Kandil. Therefore, Egypt should not have been shielded from liability on the basis that the Lease Agreements were illegal under Egyptian law. (paragraph 116) Further, Egypt failed to refute the evidence put forth by Wena which indicated that the consultancy agreement was legitimate. (paragraph 117)

**H8** Wena's claims for lost profits and lost opportunities using a discounted cash flow analysis were inappropriate in this case. There was an insufficient base of evidence to establish any profit or to predict growth of the investment made by Wena. (paragraphs 123, 124) Rather, the proper calculation of Wena's damages was the market value of the investment immediately prior to expropriation. (paragraph 125)

**H9** Wena was entitled to damages in the amount of USD \$20,600,986.43. In addition, Wena was entitled to interest at 9% compounded quarterly, plus its lawyers' fees and expenses incurred in relation to addressing the merits of the proceeding. (paragraphs 127–130)

Date of Report: 10 December 2007

**Reporter(s):** Jeffrey M Sullivan

## **Analysis**

**A1** It should first be noted that Professor Don Wallace Jr was appointed as arbitrator by Egypt following the resignation, due to medical emergency, of Professor Michael F Hoellering. Professor Hoellering was appointed by Egypt following the resignation of Professor Hamez Ahmed Haddad.

Professor Haddad was the original appointee of Egypt and sat as part of the Tribunal that issued the Decision on Jurisdiction. Professor Haddad resigned from the Tribunal due to his appointment as the Minister of Justice of Jordan.

**A2** The Tribunal's substantive decisions with respect to Egypt's violation of the Egypt-UK BIT were relatively straightforward. The Tribunal found that there was clear evidence that Egypt had wrongfully seized the Nile and Luxor hotels on 1 April 1991. These seizures amounted to a violation of the fair and equitable treatment and full protection and security provisions of the BIT. The seizures also constituted a violation of the prohibition on illegal expropriation found in the BIT.

**A3** Whilst the substantive rulings of the Tribunal with respect to violations of the Egypt-UK BIT appeared relatively uncontroversial, this decision was notable with respect to its ruling on the law applicable to the dispute. Article 42(1) of the ICSID Convention provided that, absent agreement of the parties, ICSID tribunals should have applied the law of the state party to the dispute 'and such other rules of international law as may be applicable'.

**A4** In this decision, the Tribunal held that whilst the Egypt-UK BIT was the 'primary source' of applicable law, the Tribunal would, pursuant to Article 42(1), also apply Egyptian law and international law. The Tribunal also held that where Egyptian law conflicted with established international law norms, the international law norms should have prevailed. The Tribunal's view that international law performed a corrective function with respect to the host state's law was nearly identical to the views set out by the ad hoc Committees in *Klöckner Industrie-Anlagen GmbH and ors v Cameroon*, Decision on annulment, Case No ARB/81/2, 3 May 1985 and *Amco Asia Corporation and ors v Indonesia*, Decision on annulment, ICSID Case No ARB/81/1; (1993) I ICSID Rep 509, 1986.

Date of Analysis: 10 December 2007

Analysis by: Jeffrey M Sullivan

### ***Instruments cited in the full text of this decision:***

#### *International*

Convention on the Settlement of Investment Disputes Between States and Nationals of Other States (18 March 1965) 575 UNTS 159, entered into force 14 October 1966, Article 42(1)

Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Arab Republic of Egypt for the Promotion and Protection of Investments (UK/Egypt) (11 June 1975), entered into force 24 February 1976, Articles 2(2), 5

#### *Domestic*

Egyptian Civil Code (Egypt), Article 172(i)

### ***Cases cited in the full text of this decision:***

#### *International Centre for Settlement of Investment Disputes*

*Klöckner Industrie-Anlagen GmbH and ors v Cameroon*, Decision on annulment, Case No ARB/81/2, 3 May 1985

*Amco Asia Corporation and ors v Indonesia*, ICSID Case No ARB/81/1; (1993) I ICSID Rep 509, 1986

*Southern Pacific Properties (Middle East) Ltd v Egypt*, Award, ICSID Case No ARB/84/3, 1993

*American Manufacturing & Trading Inc v Zaire*, Award and separate opinion, ICSID Case No

ARB/93/1; IIC 14 (1997); 36 ILM 1531; 5 ICSID Rep 14; 12 Intl Arbitration Rep no 4, April 1997, p A1, 21 February 1997

*Metalclad Corporation v Mexico*, Award, ICSID Case No ARB(AF)/97/1; IIC 161 (2000), (2001) 16 ICSID Rev—FILJ 168; (2001) 40 ILM 36; (2001) 26 Ybk Com Arb 99 (excerpts); (2002) 119 ILR 618; (2002) 5 ICSID Rep 212; [French translation of English and Spanish originals] (2002) 129 Journal du Droit International Clunet 233 (excerpts), 30 August 2000

*Ad hoc*

*Craig v Ministry of Energy of Iran*, 3 Iran-US CTR 280, 1984

*Tippets and ors v TAMS-AFFA Consulting Engineers of Iran*, Award, Award No ITL 141-7-2, 1984

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## **Decision - full text**

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## **Certificate**

I hereby certify that the attached is an additional true copy of the Award of the Arbitral Tribunal rendered in the above case, and of its accompanying Statement by Professor Don Wallace, Jr.

Certified copies of the Award and of its accompanying Statement were first dispatched to the parties on December 8, 2000. The Award, is therefore deemed to have been rendered on December 8, 2000, in accordance with Article 49(1) of the Convention on the Settlement of Investment Disputes between States and Nationals of Other States.

/s/

Ko-Yung Tung

Secretary-General

Washington, D.C., December 19, 2000

## **I. The Proceedings**

**1.** The present arbitration was initiated on July 10, 1998, when Claimant, Wena Hotels Limited (“Wena”),<sup>1</sup> filed a request for arbitration with the Secretary-General of the International Centre for Settlement of Investment Disputes (“ICSID”). The request was filed against Respondent, the Arab Republic of Egypt (“Egypt”), and asserted that “[a]s a result of Egypt's expropriation of and failure to protect Wena's investment in Egypt, Wena has suffered enormous losses leading to the almost total collapse of its business.”<sup>2</sup> Wena requested the following relief:

(a) a declaration that Egypt has breached its obligations to Wena by expropriating Wena's investments without providing prompt, adequate and effective compensation, and by failing to accord Wena's investments in Egypt fair and equitable treatment and full protection and security;

(b) an order that Egypt pay Wena damages in respect of the loss it has suffered through Egypt's conduct described above, in an amount to be quantified precisely during this proceeding but, in any event, no less than USD 62,820,000; and

(c) an order that Egypt pay Wena's costs occasioned by this arbitration, including the arbitrators' fees and administrative costs fixed by ICSID, the expenses of the arbitrators, the fees and expenses of any experts, and the legal costs incurred by the parties (including fees of counsel).<sup>3</sup>

The Acting Secretary-General registered the request for arbitration on July 31, 1998.

**2.** In accordance with Article 37(2)(a) of the Convention on the Settlement of Investment Disputes between States and nationals of Other States (“the ICSID Convention”), the parties agreed that the Tribunal was to consist of three arbitrators, one appointed by each party and the third, presiding, arbitrator, appointed by agreement of the parties or, in the absence of such agreement, by agreement of the two party-appointed arbitrators. Wena appointed Professor Ibrahim Fadlallah, a national of Lebanon, as an arbitrator. Egypt then appointed Hamzeh Ahmed Haddad, a national of Jordan, as an arbitrator. In accordance with Article 38 of the ICSID Convention, the Chairman of ICSID's Administrative Council was requested by Wena to appoint the third, presiding, arbitrator. The Center informed the parties that the Secretary-General of ICSID was planning to recommend Mr. Monroe Leigh, a United States national, for the Chairman's appointment. Having received no objection from either party, the Center informed the parties that the Chairman of the ICSID's Administrative Council had appointed Mr. Leigh as the arbitrator to be the President of the Arbitral Tribunal. Having received from each arbitrator the acceptance of his appointment, the Center informed the parties that the Tribunal was deemed to be constituted and the proceedings to have begun on December 18, 1998. The parties subsequently agreed that the Tribunal had been properly constituted under the provisions of the ICSID Convention.

**3.** The Tribunal held its first session, at the Permanent Court of Arbitration in The Hague, on

February 11, 1999. During this first session, Egypt objected to the request for arbitration filed by Wena and expressed reservations as to the Tribunal's jurisdiction to hear the request.

**4.** The Tribunal, pursuant to Article 41(2) of the ICSID Convention, granted the parties an opportunity to brief the jurisdictional objections. The parties filed four sets of papers (including accompanying documentary annexes) with the Tribunal:

- (1) Respondent's Memorial on its Objections to Jurisdiction (submitted on March 4, 1999);
- (2) Claimant's Response to Respondent's Objections on Jurisdiction (submitted on March 25, 1999);
- (3) Respondent's Reply on Jurisdiction (submitted on April 8, 1999); and
- (4) Claimant's Rejoinder on Jurisdiction (submitted on April 22, 1999).

In its briefing, Egypt raised four objections to jurisdiction. First, Egypt asserted that it had “not agreed to arbitrate with the Claimant as it is, by virtue of ownership, to be treated as an Egyptian company.”<sup>4</sup> Second, Egypt argued that “[t]he Claimant has made no investment in Egypt.”<sup>5</sup> Third, Egypt claimed that “[t]here is no legal dispute between the Claimant and the Respondent.”<sup>6</sup> Finally, Egypt contended that “[t]he Claimant's consent to arbitration in the Request for Arbitration is insufficient and its Request premature.”<sup>7</sup>

**5.** The Tribunal heard oral argument on Respondent's objections to jurisdiction during a second session, at the offices of the World Bank in Paris, on May 25, 1999. During the session, Egypt withdrew two of its four objections. First, it noted that the “the papers that we have now been supplied as part of [Wena's briefing] do indicate at least a *prima facie* case that the Claimant has made an investment, that money was spent in the development and renovation of the hotels and that the money was paid for by the Claimant, rather than any other party.”<sup>8</sup> Thus, “for the purpose of establishing jurisdiction only, the Respondent is willing to accept that an investment has been made.”<sup>9</sup>

**6.** Second, Respondent also withdrew its procedural objections to Claimant's request for arbitration. As Egypt appropriately observed, even if the Tribunal had endorsed its objections, the alleged defects could have been easily rectified. Noting that “it is not our wish to raise argument simply for the purpose of being difficult or to delay,” Egypt advised “that as far as that particular objection is concerned, we are prepared to forgo it.”<sup>10</sup>

**7.** In its Decision on Jurisdiction dated June 29, 1999, the Tribunal concluded that Respondent's two remaining jurisdictional objections should be denied and that jurisdiction should be exercised over the dispute. Specifically, the Tribunal: (1) declined to adopt Egypt's contention that Wena should be treated as an Egyptian company for purposes of the Agreement for the Promotion and Protection of Investments between Egypt and the United Kingdom (“IPPA”),<sup>11</sup> and (2) found, without prejudice to the merits of the case, that Wena had at least alleged a *prima facie* legal dispute with Egypt.<sup>12</sup> The Tribunal proceeded to set a briefing schedule on the merits and proposed dates for oral argument.

**8.** On August 14, 1999, Professor Hamzeh Ahmed Haddad resigned from the Tribunal — apologizing that, as a result of his new duties as Minister of Justice for Jordan, he would no longer be able to continue as a member of the Tribunal. The Tribunal was reconstituted on September 14, 1999 with the appointment by Egypt of Mr. Michael F. Hoellering as the replacement for Professor Haddad.

**9.** The parties filed four sets of papers (each including voluminous accompanying documentary annexes) with the Tribunal addressing the merits of the case:



- (1) Claimant's Memorial on the Merits (submitted on July 26, 1999);
- (2) Respondent's Memorial on the Merits (submitted on September 6, 1999);
- (3) Claimant's Reply on the Merits (submitted on September 27, 1999); and
- (4) Respondent's Rejoinder on the Merits (submitted on October 18, 1999).

**10.** Regrettably, the session on the merits — which had been scheduled for November 15–18, 1999 — had to be postponed by the sudden hospitalization of Mr. Hoellering for a medical emergency. On November 15, 1999, Mr. Hoellering resigned from the Tribunal — apologizing for the inconvenience “this unexpected turn of events” had caused.

**11.** The Tribunal was reconstituted on December 9, 1999, with the appointment by Egypt of Professor Don Wallace, Jr. as the replacement for Mr. Hoellering. The Tribunal subsequently fixed a new schedule for oral argument on the merits.

**12.** The Tribunal heard witnesses and oral argument on the merits during its third session, at the offices of the World Bank in Paris, on April 25–29, 2000.<sup>13</sup> In lieu of closing argument, the Tribunal permitted the parties to file post-hearing briefs. The Tribunal also requested that the parties submit proposed findings of fact, chronologies of events and statements of their attorney's fees and costs. In accordance with this schedule, the parties filed a final round of papers with the Tribunal:

- (1) Claimant's Post-Hearing Brief (submitted on May 30, 2000);
- (2) Respondent's Post-Hearing Memorial (submitted on May 30, 2000);
- (3) Claimant's Post-Hearing Reply (submitted on June 15, 2000); and
- (4) Respondent's Post-Hearing Rebuttal Memorial (submitted on June 15, 2000).

**13.** On July 13, 2000, the Tribunal issued a Procedural Order concerning the introduction of certain documents into the proceeding subsequent to the hearing. As part of this Order, the Tribunal admitted into the record, without prejudice to their probative value, nine documents submitted by Wena with its Post-Hearing Reply brief<sup>14</sup> and a memorandum dated January 19, 1997 on the El-Nile Hotel prepared by Arthur Andersen & Co., which the Tribunal had received from the U.S. Agency for International Development.<sup>15</sup>

**14.** On November 1, 2000, the Secretary of the Tribunal issued a letter, advising the parties of the closure of the proceedings, pursuant to Arbitration Rule 38(1).

## **II. The Facts**

**15.** This dispute arose out of long-term agreements to lease and develop two hotels located in Luxor and Cairo, Egypt. Having received voluminous submissions from the two parties and heard five days of oral testimony, the Tribunal hereby makes the following findings of fact:

### **A. U.K.-Egypt Agreement for the Promotion and Protection of Investments**

**16.** On June 11, 1975, the United Kingdom and the Arab Republic of Egypt entered into an Agreement for the Promotion and Protection of Investments (“IPPA”).<sup>16</sup> Under Article 2(1) of the IPPA, Egypt and the United Kingdom promised to “encourage and create favorable conditions for nationals or companies of other Contracting Party to invest capital in its territory.” They also guaranteed that “[i]nvestments of nationals or companies of either Contracting Party shall at all times be accorded fair and equitable treatment and shall enjoy full protection and security in the territory of the other Contracting Party.”<sup>17</sup> Finally, Egypt and the United Kingdom agreed that “[i]nvestments of nationals or companies of either Contracting Party shall not be nationalised,

expropriated or subjected to measures having effect equivalent to nationalisation or expropriation ... in the territory of the other Contracting Party except for a public purpose related to the internal needs of the Party and against prompt, adequate and effective compensation.”<sup>18</sup> As discussed in the Tribunal's previous Decision on Jurisdiction, Wena is a British company for purposes of the IPPA.<sup>19</sup>

### **B. Luxor and Nile Hotel Agreements**

**17.** On August 8, 1989, Wena and the Egyptian Hotels Company (“EHC”), “a company of the Egyptian Public Sector affiliated to the General Public Sector Authority for Tourism”<sup>20</sup> entered into a 21 year, 6 month “Lease and Development Agreement” for the Luxor Hotel in Luxor, Egypt.<sup>21</sup> Pursuant to the agreement, Wena was to “operate and manage the ‘Hotel’ exclusively for [its] account through the original or extended period of the ‘Lease,’ to develop and raise the operating efficiency and standard of the ‘Hotel’ to an upgraded four star hotel according to the specification of the Egyptian Ministry of Tourism or upgratly [sic] it to a five star hotel if [Wena] so elects....”<sup>22</sup> The agreement provided that EHC would not interfere “in the management and or/operation of the ‘Hotel’ or interfere with the enjoyment of the lease” by Wena and that disputes between the parties would be resolved through arbitration.<sup>23</sup> The lease was awarded to Wena in a competitive bid, after Wena agreed to pay a higher rent than another potential investor.<sup>24</sup>

**18.** On January 28, 1990, Wena and EHC entered into an almost identical, 25-year agreement for the El Nile Hotel in Cairo, Egypt.<sup>25</sup> Wena also entered into an October 1, 1989 Training Agreement with EHC and Egyptian Ministry of Tourism “to train in the United Kingdom ... Egyptian nationals in the skills of hotel management....”<sup>26</sup>

### **C. Events Leading up to the April 1, 1991 Seizures**

**19.** Shortly after entering into the agreements, disputes arose between EHC and Wena concerning their respective obligations. Wena claims that it “found the condition of the Hotels to be far below that stipulated in the lease [and] withheld part of the rent, as the lease permitted.”<sup>27</sup> In turn, Egypt claims that Wena “failed to pay rent due to EHC... and EHC in turn liquidated the performance security posted by Claimant.”<sup>28</sup> In the view which the Tribunal takes of this case it is not necessary at this time to determine the truth of these conflicting allegations. It is sufficient for this proceeding simply to acknowledge, as both parties agree, that there were serious disagreements between Wena and EHC about their respective obligations under the leases.

**20.** On May 3, 1990, Wena instituted arbitration proceedings in Egypt against EHC concerning their disputes over the Luxor Hotel. In an award dated November 14, 1990, the *ad hoc* arbitral tribunal ordered EHC to make repairs to the Luxor Hotel and ordered Wena to pay its outstanding rental obligations.<sup>29</sup> Wena subsequently brought an action in the South Cairo Court to have the arbitration set aside.<sup>30</sup>

**21.** At about the same time, “toward the end of 1990,” according to Wena's parliamentary consultant, Mr. Humfrey Malins, M.P., “rumour, I think, must have reached Mr. Faragy because he told me that there were rumours that there would be violence and the hotels would be violently seized back.”<sup>31</sup> As a result, in December 1990, Mr. Malins traveled to Egypt to meet with the Egyptian Minister of Tourism, Minister Fouad Sultan, and the Egyptian Minister of the Interior, Minister Halim Moussa.<sup>32</sup> Mr. Malins recounted that “[b]oth Ministers gave me their separate, absolute assurances ... that no violence could or would take place.”<sup>33</sup>

**22.** Nevertheless, disagreements between Wena and EHC continued. On February 11, 1991, Mr. Nael El-Faragy, Wena's founder, wrote to Minister Sultan, seeking his intervention to resolve these on-going disputes as well as to offset financial difficulties caused by the Gulf War.<sup>34</sup> In his letter, Mr Faragy mentions that EHC had threatened to repossess the hotels through force:

*officials from the Egyptian Hotels Company threatened to storm the hotels and expel us, and this was after our Company had spent the sums previously outlined. The matter reached a point where [sic] the Chairman of the Board of Directors of the Egyptian Hotels Company issued a decision for his company to take possession of the Luxor Hotel without a legal ruling or any other measure [to support his decision].*<sup>35</sup>

**23.** In response to Mr. Farargy's request, on February 26, 1991, Minister Sultan convened a meeting in his offices to "discuss the differences between the Egyptian Hotels Company and Wena...."<sup>36</sup> The attendees at the meeting included the Minister, representatives of EHC (including EHC's Chairman, Mr. Kamal Kandil), and Wena's lawyer (Mr. Ahmad Al Khawaga). During the meeting, Minister Sultan declared that "[t]he Ministry took no pleasure from any misunderstandings with investors; however, at the same time it could not accept any excesses in respect of any of the Government's rights."<sup>37</sup> The Minister proposed a series of compromises between the parties. Wena, however, subsequently did not accept the Minister's proposals.<sup>38</sup>

**24.** On March 21, 1991, Mr. Kandil wrote to Minister Sultan, noting that Wena had refused to accept the Minister's proposals.<sup>39</sup> Mr. Kandil proposed to Minister Sultan:

that the following steps be taken:

(One) the Letter of Guarantee for the Nile Hotel be seized and the sum deducted from their debt;

(Two) the contractual relationship for the two hotels be terminated;

(Three) *the two hotels be taken and the license withdrawn;*

(Four) list all development work at the two hotels and deduct it from their debt; and,

(Five) in the event that the company is still in debt following these measures, proceedings should be taken to seize [the outstanding money] in the United Kingdom.<sup>40</sup>

Alternatively, Mr. Kandil suggested that Minister Sultan establish a 10-day grace period for Wena to "pay its debts," with the understanding, however, that "[i]n the event that the payment is not made, the license for the two hotels would be withdrawn and the Egyptian Hotels Company would take the measures that it view appropriate to preserve its rights."<sup>41</sup> Mr. Kandil closed the letter by advising Minister Sultan: "*We leave the matter to you.*"<sup>42</sup>

**25.** Marginalia on this March 21, 1991 letter (in Minister Sultan's handwriting), indicate that Minister Sultan telephoned the British Ambassador to Egypt, asking the Ambassador to ascertain Wena's response to the proposed compromises from the February 26, 1991 meeting.<sup>43</sup>

**26.** Contemporaneously, on March 25, 1991, Mr. Malins wrote to Minister Sultan asking for another meeting in mid-April or May to discuss the continued disputes between Wena and EHC.<sup>44</sup> Mr. Malins concluded his letter by requesting an understanding from the Minister that no actions would be taken until that meeting could occur: "please confirm what must surely be [sic] right, mainly that all matters be 'absolutely frozen,' with no detrimental action of whatever nature being taken pending our meeting...."<sup>45</sup>

**27.** Minister Sultan personally did not reply to Mr. Malins' letter. Instead, although the letter had been sent to Minister Sultan and not EHC, on March 31, 1991, Mr. Kandil responded to Mr. Malins, referencing "your fax dated 25th March 1991, concerning your request for a meeting, — in your capacity as the parliament advisor for Wena Ltd...."<sup>46</sup> Mr. Kandil mentioned the February 26, 1991 meeting and Wena's refusal to accept the proposed compromises. Mr. Kandil ended his letter by threatening that "the owning company will take all necessary measures to protect its rights which is considered a state ownership."<sup>47</sup>

## **D. Seizures of the Nile and Luxor Hotels (April 1, 1991)**

### **1. Decision to Seize the Hotels**

**28.** On March 27, 1991, EHC's Board of Directors met "to consider what action should be taken."<sup>48</sup> According to Mr. Munir Abdul Al-Aziz Gaballah Shalabi, of the Legal Affairs Division at EHC, the Board decided "to present Wena with an ultimatum to implement" the proposed compromises from the February 26, 1991 meeting with Minister Sultan.<sup>49</sup> He further explained that "Wena having failed to meet the deadline, it was decided that EHC would take possession of the Nile Hotel."<sup>50</sup> Similarly, Mr. Yusseri Mahmud Hamid Hajjaj, EHC's Manager for the Upper Egypt Hotels Division at EHC, stated that "[faced] with [Wena's] breaches of contract, the board of directors of EHC had no choice but to issue its decision of March 27, 1991 to take over the Luxor Hotel and to place it under its own management with effect from April 1, 1991."<sup>51</sup>

**29.** The decision to seize the hotels was "confirmed by a resolution of the Chairman of the Board No. 215 of 1991, dated March 30, 1991."<sup>52</sup> Although this resolution is mentioned by Mr. Munir in his witness statement and is referenced in at least two contemporaneous documents,<sup>53</sup> a copy of this resolution was not provided to the Tribunal.

**30.** EHC purported to notify Wena of its decision to terminate both the Nile and Luxor Leases and to reclaim the Hotels in a letter from Mr. Kandil to Mr. Farargy dated March 30, 1991.<sup>54</sup> In the letter, Mr. Kandil stated that:

the board of Directors of the [Egyptian Hotels] Company had decided:

- a — to terminate the two hotels Contracts.
- b — to receive the hotels and operate them *with knowledge of the owning company* starting form April 1,1991.
- c — to complain to the courts and to the Public Prosecutor in order to recover [our] company's dues which amount to millions of Egyptian pounds and that are considered as public funds, either by legal or diplomatic ... *means including freezing of your accounts receivable.*
- d — to warn security services to be aware of your arrival from abroad in order to present you to courts *to decide what you owe and to collect it.* <sup>55</sup>

However, there is no evidence that this letter was received before the seizures on April 1, 1991.<sup>56</sup> Of the two copies of the March 30, 1991 letter provided to the Tribunal, one was sent by registered mail to Wena's Gatwick Hotel in England and does not appear to have been received until April 5, 1991.<sup>57</sup> The second copy bears a fax legend indicating that the letter had been faxed by EHC and received by Wena on April 14, 1991.<sup>58</sup> Although Mr. Munir testified that the second copy had been faxed to Wena's offices in England on March 30, 1991, no fax cover sheet or confirmation sheet has been submitted to support this claim.<sup>59</sup>

**31.** In an Administrative Decision Number 216, dated March 31, 1991 and signed by Mr. Kandil, two EHC officials —Messrs. Fakhri Hamid Al-Batuti and Atif Abd Al-Al —were authorized to act on behalf of EHC "in respect of the Nile Hotel."<sup>60</sup> Mr. Yusseri was given the same authority concerning the Luxor Hotel.<sup>61</sup> EHC planned to evict Wena simultaneously from both hotels during the early evening on April 1, 1991 when they expected no resistance because "all the senior people of Wena would be taking the Ramadan breakfast at home...."<sup>62</sup>

**32.** Egypt does not dispute "that the repossession by EHC of the Luxor and Nile Hotels and EHC's eviction of the Claimant from the Hotels on April 1, 1991 was wrong."<sup>63</sup>

## 2. Seizure of the Nile Hotel

**33.** On April 1, 1991, at approximately 6:15 p.m., Mr. Simon Webster and Ms. Angela Jelcic, Wena's foreign managers, left the Nile Hotel to have dinner at the nearby Nile Hilton Hotel.<sup>64</sup> Short thereafter, several buses owned by EHC arrived at the Nile Hotel.<sup>65</sup>

**34.** According to a statement made that evening to the Kasr El-Nile Police by Mr. Muhammad Abdul Hameed Wakid, an attorney for Wena Hotels, "about one hundred and fifty persons, some of whom were carrying sticks and cudgels, assaulted the hotel against us immediately after Ramadan breakfast."<sup>66</sup> When he "tried to enquire of them who they were they stated that they had come to seize the hotel according to instructions from the Chairman of the Board of Directors of their company to do so."<sup>67</sup> According to Mr. Wakid, "[t]hey seized all the keys of the offices and safes in which the company's funds and hotel receipts from the guests are deposited [and] seized the hotel in full and they threatened any person who resisted them and attacked them...."<sup>68</sup>

**35.** Similarly, Mr. Tamim Foda, Wena's resident manager at the Nile Hotel, stated in a subsequent police deposition:

At about 6:30 p.m., when it was time to take the fast breaking meal, I was reviewing some documents concerning my work ... I have been surprised by violent knocking on the door and its breaking, shouting in the hall of the hotel and I saw three persons bursting into my office. They attacked me, slapping my face and breaking my eye-glasses. They took possession of my office by force and everything inside it. ... I was prevented from getting in touch with anybody outside the hotel and they told me that all the telephones were cut. ... I was entrusted to three persons holding rods and cudgels who took me out of the hotel by force and while I was going out I saw more than one hundred men inside the hotel, holding rods and cudgels, some of them were taking out a number of cartons, belongings and implements of the hotel to vehicles parking in front of the door of the hotel. I waited outside the hotel until arrival of the police when I was taken inside for inspection under guard of the police.<sup>69</sup>

**36.** Mr. Mostafa Ahmed Osman, Financial Manager for Wena, who was "taking my fast breaking meal at the restaurant on the ninth floor," reported being "surprised by strange and suspicious persons [who] took me downstairs by force holding my arms to the administrative offices on the mezzanine... "<sup>70</sup> According to Mr. Osman, one of the EHC employees "threatened me, saying that he holds a licensed weapon and that he is ready to use it if I resist. He informed me that all communications inside and outside the hotel have been cut."<sup>71</sup>

**37.** A guest of the hotel restaurant, Mr. Sherif Ibrahim Mohamed Khalifa, who "was with my wife to take the fast breaking meal at the hotel as it is our favorite place," witnessed similar scenes.<sup>72</sup> In his statement to the police, Mr. Khalifa said that he "heard shoutings, sounds of breaking and crushing at the hotel."<sup>73</sup> When he went downstairs from the restaurant, he "found many [sic] person in the lobby, a state of absolute disorder, holding rods and some of them taking out carton cases and other things that I do not know, to vehicles parking in front of the hotel. These vehicles were bearing the badge of the Egyptian Hotels Co."<sup>74</sup> Afraid of "being attacked[,] I rushed out of the hotel with my wife."<sup>75</sup>

**38.** Another guest of the restaurant, Mr. Mohamed Sabry Ismail Emam, stated that he "heard shoutings and sounds of breaking coming from the side of the kitchen and somebody announcing in a loud voice that all the employees of the WENA HOTELS LTD have to go downstairs."<sup>76</sup> When he "tried to go downstairs escaping from this situation, one of the a/m took me downstairs and told me to go out quietly as the hotel had been seized by the Egyptian Hotels Co." and he noted several people "carrying carton cases and taking them to buses parking in front of the hotel, bearing the badge of the Egyptian Hotels Co."<sup>77</sup>

**39.** A *Daily Telegraph* article describing the seizure reported that "[o]ne British tourist said he was

punched and gouged by 'semi-military types' who ordered him out of bed at 2 a.m."<sup>78</sup> The article also quoted a "British visitor" as saying:

The new managers said we could stay, but I did not feel safe. They told me they were repossessing the hotel on government orders because of an argument between Wena managers and the authorities.<sup>79</sup>

**40.** Mr. Hany Mohamed Hassan Mohamed Wahba, a security guard at the Nile Hotel, also stated in a subsequent deposition to the police:

While I was at the main entrance of the hotel, I saw a bus bearing the badge of the Egyptian Hotels Co. and numerous persons going into the hotel. They caught me and I was subject to personal searching. They were holding rods and cudgels and requested the key of the main door of the hotel. When I told them that I do not keep it and tried to inquire about the matter, as they were numerous, they tried to attack me and my colleagues.<sup>80</sup>

Mr. Wahba stated that he was taken "to the rear gate by force threatening me with the rods and cudgels."<sup>81</sup> As he was taken, Mr. Wahba "saw the guests of the hotel rushing out in a state of fear and terror caused by their bursting into the hotel in this savage way."<sup>82</sup> Mr. Wahba also reported seeing "a group of the a/m persons going upstairs and another group cutting the telephone wires, a third group burst into the reception and broke the cupboards containing the guests' registers."<sup>83</sup> Eventually, when he was released, Mr. Wahba "proceeded with a number of the employees of the WENA HOTELS LTD who were thrown out with me, to the Tourist Police where we informed verbally about the event. Then the Policeman came to the hotel."<sup>84</sup>

**41.** At approximately 8:45 p.m., Ms. Jelcic returned to the Nile hotel. She testified that she had just returned to her room when a group of men broke in, grabbed her and removed her from the hotel.<sup>85</sup> According to Ms. Jelcic, the men "had like Navy blue pants, dark pants, which is kind of unusual because they do not normally, you know, dress alike, so that gave me the illusion as if they were some sort of organization..."<sup>86</sup> Ms. Jelcic testified that she and other Wena employees (including Mr. Webster) then stood outside the hotel, looking into the lobby where she says she noticed "about four gentlemen or so that were standing in the lobby, towards the back of the lobby, and they were radically different from the other people that were in the lobby.... [t]hey were very well groomed, very well dressed..."<sup>87</sup> According to Ms. Jelcic, some of the Egyptian Wena staff "told me that they were Ministry of Tourism officials."<sup>88</sup> However, Ms. Jelcic admitted that she "personally did not recognize them, no, but my staff, obviously the staff that were there saw the people come into the hotel on previous occasions, so I had no reason to doubt them."<sup>89</sup> Mr. Webster also testified that, although he did not personally recognize any officials from the Ministry of Tourism, two of his Egyptian staff "said to me that there were officials from the Ministry of Tourism in the lobby at the time."<sup>90</sup>

**42.** Further evidence of their contemporaneous impression that the Ministry of Tourism was involved in the seizure of the Nile Hotel is reflected in the police statements that Ms. Jelcic and Mr. Webster made to the Kasr El-Nile police. Ms. Jelcic's statement, for example, begins "I would like to make a complaint, charge and case against the Egyptian Hotels Company and the Ministry of Tourism of Egypt."<sup>91</sup> Similarly, Mr. Webster's statement, which is titled "Against the Egyptian Hotels Company/Ministry of Tourism," concludes "[w]e therefore place and hold the Egyptian Hotel Company and Ministry of Tourism responsible for items as listed below and not returned immediately."<sup>92</sup>

**43.** However, in his testimony, Minister Sultan adamantly rejected the suggestion that Ministry officials might have been present during the seizure: "I am sure that none of them have been there. I am sure of that, and, please, those who are accusing the Ministry should have come up with physical evidence showing representatives of the Ministry were there."<sup>93</sup> Mr. Munir also testified that "[t]here was no official of the Ministry of Tourism" present during the seizure.<sup>94</sup>

**44.** According to Ms. Jelcic and Mr. Webster, Wena staff went to both the nearby Kasr El-Nile police station and the Tourist police station seeking assistance.<sup>95</sup> Although both Ms. Jelcic and Mr. Webster testified that—with the exception of one, lone policeman who arrived two to three hours later—both police forces refused to assist Wena,<sup>96</sup> there is evidence that officers from Kasr El-Nile police did begin an investigation at around 11:00 p.m.<sup>97</sup>

**45.** The report by the Kasr El-Nile Police records that they were “informed by the Director of the Security Department in the El“Nile Hotel,” perhaps Mr. Wahba, “that the Management of the Egyptian Hotels Corporation had previously sent a number of its employees to seize the hotel in full....”<sup>98</sup> According to the report, four officers from the Kasr El-Nile police station went to investigate. When they arrived, they met with officials from EHC, who “presented to us a photocopy of the administrative order number 216 dated 31/3/1991 stamped and signed by Mr. Muhammad Kamal Qindeel, Chairman of the Board of Directors of the Egyptian Hotels Corporation.”<sup>99</sup> During their investigation that evening, the Kasr El-Nile Police reported that “damage was noticed which resulted from the use of force to locks in the rooms of the secretaries, the resident manager and the administrative business and the room for [reception?] customers and the buffet and the room of the lawyer to the Wena Company who is resident in the hotel.”<sup>100</sup>

**46.** As previously indicated, at approximately 1:00 a.m., Ms. Jelcic, Mr. Webster, and several other Wena employees went to the nearby Kasr El-Nile police station to file a complaint.<sup>101</sup> According to Ms. Jelcic and Mr. Webster, the police at first refused to let them make a statement, and then only would allow them to submit statements dealing with the loss of personal items, not the illegality of EHC's seizure.<sup>102</sup> Several other employees also prepared statements, reporting the loss of money, jewelry, watches, and other personal items.<sup>103</sup>

### **3. Seizure of the Luxor Hotel**

**47.** Also on April 1, 1991, at approximately 7:00 p.m., several EHC employees, led by Mr. Yusseri, took possession of the Luxor Hotel.<sup>104</sup>

**48.** According to a subsequent statement to the Luxor police by Mr. Bahia El Din Abdel Hadi El Wakeel, a security guard at the Luxor Hotel, “more than 100 people from the EHC seized the Wena Hotel by force in spite myself and others responsible for the security and guards in the hotel presence at the time.”<sup>105</sup> Mr. Wakeel also stated that “EHC forced their entry through by force ... which caused panic, fear, and hysteria for the guests and employees.”<sup>106</sup> Two other guards, Messrs. Ismael Ahmed Hefni and Ahmed Hamza Mostafa, made short statements, agreeing with Mr. Wakeel's description of events.<sup>107</sup>

**49.** Mr. Muhammad Nagib Al-Sayyid, Wena's General manager of the Luxor Hotel, also filed a police statement, asserting that, at approximately 7:00 p.m., EHC personnel entered his office, seized the hotel's papers and ordered him to leave the hotel.<sup>108</sup> Mr. Nagib reported the incident to the Luxor Tourist Police, who accompanied Mr. Nagib back to the hotel and subsequently opened an investigation into the seizure.<sup>109</sup>

**50.** These contemporaneous descriptions comport with the subsequent report by the Advocate General at the Office of the Assistant Attorney General for Upper Egypt, which concluded that EHC “broke into the Hotel ... entered by force into the management office, broke open the doors and Offices of the Hotels Ltd. [and] forced the personnel they found there to quit the Hotel.”<sup>110</sup>

### ***E. Events Following the Seizures of the Nile and Luxor Hotels***

**51.** Minister Sultan testified that he first learned of the seizures by reading the newspaper the next morning.<sup>111</sup> Minister Sultan stated that he “requested one of my associates to investigate the issue and we found that he [Mr. Kandil] is mistaken by taking the law into his hands....”<sup>112</sup> Minister Sultan also testified that “we most probably discussed that with the Prime Minister....”<sup>113</sup>

**52.** Minister Sultan repeatedly stated that he “was furious”<sup>114</sup> at EHC's decision to seize the hotels, that EHC's actions were “wrong,”<sup>115</sup> and that “[i]f I had the slightest idea about that incident, I would have immediately stopped it because during that time I was also involved in the SPP dispute....”<sup>116</sup> However, Minister Sultan also admitted that he did not take any action to return Wena to the hotels, to punish EHC or its officials, or to withdraw the hotels licenses so that EHC could not operate the hotels.<sup>117</sup> Minister Sultan explained that by reinstating Wena “I would be taking again of siding [sic] with someone, whereas the dispute should be settled through arbitration or a court.”<sup>118</sup>

**53.** From April 1, 1991 through February 25, 1992, the Nile Hotel remained in the control of EHC. The Luxor Hotel remained in EHC's control until April 21, 1992. During this time, Wena made several efforts to recover possession of the hotels — including seeking the assistance of officials in the United States and United Kingdom.<sup>119</sup> For example, on July 9, 1991, Mr. Faragy wrote to the Egyptian Ambassador to the United Kingdom, complaining about the apparent collapse of negotiations between Wena and a representative of the Egyptian government.<sup>120</sup> Apparently, also during this time, the Civil Defense Authority (which is responsible for fire safety) issued at least two reports — on May 22, 1991 and November 12, 1991 — about unsafe conditions at the Nile Hotel.<sup>121</sup>

**54.** On January 16, 1992, the Chief Prosecutor of Egypt ruled that the seizure of the Nile Hotel was illegal and that Wena was entitled to repossess the hotel.<sup>122</sup> However, the Nile Hotel was not immediately returned to Wena. On February 21, 1992, Mr. Webster wrote to the British Embassy in Cairo, complaining of Minister Sultan's “uncooperative stance” and the delays that Wena was experiencing in recovering the hotels: “if he [Minister Sultan] wishes to press settlement of account, then we too will press for settlement of monies outstanding to Wena.”<sup>123</sup> Mr. Webster concluded his letter by saying that “[w]e are of the impression that the Minister is either poorly informed or part of the entire scheme.”<sup>124</sup>

**55.** On February 25, 1992, the Nile Hotel was returned to Wena's control.<sup>125</sup> Just two days before the hotel was returned, on February 23, 1992, the Ministry of Tourism withdrew the Nile Hotel's operating license because of fire safety violations and “the hotel was closed down.”<sup>126</sup> According to Mr. Munir, these safety violations had pre-dated EHC's seizure of the hotel in April 1991.<sup>127</sup> In a contemporaneous report to the Kasr El-Nile police, an EHC official confirmed that on February 23, 1992, just before returning the Nile Hotel to Wena, EHC had issued “decree no. 148/92 to stop operations” in response to orders from the Ministries of Interior and Tourism.<sup>128</sup>

**56.** According to the witnesses produced by Wena, upon returning to control of the Nile Hotel, they found the hotel vandalized.<sup>129</sup> Although Mr. Munir denied that any such vandalism occurred, he confirmed that EHC had removed and auctioned much of the hotel's fixtures and furniture.<sup>130</sup> According to Wena's management, it never operated the Nile Hotel again.<sup>131</sup>

**57.** On April 21, 1992, the Chief Prosecutor of Egypt ruled that EHC's seizure of the Luxor Hotel was illegal and ordered that the hotel should be returned to Wena.<sup>132</sup> On April 28, 1992, Wena reentered the hotel.<sup>133</sup> According to Wena's witnesses, the Luxor Hotel had also been damaged, although not nearly as badly as the Nile Hotel.<sup>134</sup> The Ministry of Tourism denied Wena a permanent operating license for the Luxor Hotel; instead, it granted only a series of temporary licenses because of alleged defects in the drainage system and the fire safety system, which Wena complains prohibited it from properly operating the hotel.<sup>135</sup>

**58.** After the return of the hotels, Wena sought compensation from Egypt.<sup>136</sup> On November 11, 1992, Mr. Malins wrote to the Honorable Lee Hamilton, a senior member of the U.S. House of Representatives, complaining that “the Minister of Tourism, Dr. Fouad Sultan, will not consider our requests” and that “it is clear that subsequent to any perceived movement, Dr. Sultan personally intervenes to obstruct a solution.”<sup>137</sup>

**59.** On April 10, 1993, the Kasr El-Nile court convicted several representatives of EHC —including



Messrs. Kandil and Munir—under Article 369/1 of the Egyptian Criminal Code (dispossession by violence), holding that unlawful force was used to expel Wena from the Nile Hotel.<sup>138</sup> These convictions were subsequently upheld by the Southern Cairo Court of Appeal, on January 16, 1994.<sup>139</sup> According to Mr. Munir, the decision is currently under appeal to the Court of Cassation.<sup>140</sup> Neither Mr. Kandil nor Mr. Munir was sentenced to serve any jail time; both were fined only 200 Egyptian pounds, which Mr. Munir stated that he had not paid.<sup>141</sup> Since then, Mr. Munir has been promoted to become the Head of the Legal Affairs division at EHC and is expecting a further promotion.<sup>142</sup> According to Ms. Jelcic, Mr. Kandil is currently an advisor to a senior member of the Egyptian parliament.<sup>143</sup>

**60.** On December 2, 1993, Wena initiated arbitration in Egypt against EHC for breaching the Nile Hotel lease.<sup>144</sup> Similar arbitration was initiated by Wena against EHC for breaching the Luxor Hotel lease on January 12, 1994.<sup>145</sup>

**61.** On April 10, 1994, an arbitration award of EGP 1.5 million for damages from the invasion of the Nile Hotel was issued in favor of Wena. However, the award also required Wena to surrender the Nile Hotel to EHC's control.<sup>146</sup> On June 21, 1995, Wena was evicted from the Nile Hotel.<sup>147</sup> Nearly two years later, on June 9, 1997, Wena received the damages awarded by the Nile Hotel arbitration, less, fees—a total of EGP 1,477,498.30.<sup>148</sup>

**62.** The Luxor Hotel arbitration also found in favor of Wena, awarding the company, in a September 29, 1994 decision, EGP 9.06 million for damages from the seizure.<sup>149</sup> The award subsequently was nullified by the Cairo Appeal Court on December 20, 1995, on the basis, among other things, that the arbitrator appointed by EHC had not signed the final decision.<sup>150</sup> On August 14, 1997, Wena was evicted from the Luxor Hotel and, according to Mr. Yusseri, the hotel was turned over to a court-appointed receiver requested by EHC.<sup>151</sup>

## **F. Harassment**

**63.** Wena has also alleged “a campaign of continual harassment” by Egypt since the seizure of the two hotels, including the following allegations: “in 1991 the Minister of Tourism made defamatory statement about Wena that were reproduced in the media; in 1992 Egypt revoked the Nile Hotel's operating license without reason; in 1995 Egypt imposed an enormous, but fictitious, tax demand on Wena; in 1996 Egypt removed the Luxor Hotel's police book, effectively rendering it unable to accept guests; and, last but not least, in 1997 Egypt imposed a three-year prison sentence and a LE 200,000 bail bond on the Managing Director of Wena based on trumped-up charges.”<sup>152</sup>

**64.** The Tribunal has received some limited testimony and other evidence on these various allegations. However, because it finds, as discussed in section III, *infra*, that Egypt's actions concerning the April 1, 1991 seizures of the two hotels are sufficient to determine liability, the Tribunal does not find it necessary to make a finding on the veracity of these additional allegations.

## **G. Relationship between EHC and Egypt**

**65.** From 1983 through September 1991, EHC was a “public sector” company, wholly owned by the Egyptian Government, and operating in accordance with law Number 97 of 1983 governing Public Sector Companies and Organizations.<sup>153</sup> In September 1991, Egypt enacted the Public Business Sector Companies Law, which reorganized the “314 State owned economic companies,” pooling them into “16 (reduced later to 12) State owned holding companies supervised by the Minister for [the] public Sector.”<sup>154</sup> However, at the time of the seizures of the Nile and Luxor Hotels, EHC was governed by Law Number 97 of 1983.

**66.** As explained by Minister Sultan during his testimony, under Law Number 97 of 1983, the sole shareholder of EHC was Egypt.<sup>155</sup> EHC's shareholder assembly was chaired by the Minister of

Tourism and would be attended by several other government officials.<sup>156</sup> The Minister of Tourism also was responsible for the appointment of at least one half of the Board of Directors of EHC, and furthermore nominated EHC's Chairman.<sup>157</sup> Indeed, in May 1989, Mr. Kamal Kandil was appointed, at the nomination of Minister Sultan, Chairman and CEO of EHC by Egyptian Prime Minister's Decree Number 539 of 1989.<sup>158</sup> According to Mr. Munir's statement "EHC's Directors were also appointed by the Ministry of Tourism and Civil Aviation."<sup>159</sup>

**67.** Of considerable relevance to this proceeding, the Minister of Tourism was also empowered to dismiss the Chairman and the members of the Board of EHC if "it appears that the continued presence of these persons would affect the proper functioning of the company."<sup>160</sup>

**68.** Until at least the passage of the September 1991 Public Business Sector Companies Law, "EHC operated within broad policy guidelines laid down by the Egyptian Government."<sup>161</sup> As Minister Sultan explained during a parliamentary debate on July 14, 1992, at the time of the seizures, "the tourism sector with its companies" was "[s]ubordinated to the Minister of Tourism."<sup>162</sup> In a letter from February 1992, the Ministry of Tourism contrasted the relationship between EHC and the Egyptian Government before and after the passage of the September 1991 law, by explaining:

After the issuance of the new law of the Business Sector and after its implementation starting from Oct. 1991, the Egyptian Hotels Company has full autonomy in all of its business dealings without intervention from the Ministry.<sup>163</sup>

**69.** The documents also reflect that EHC and the Ministry of Tourism considered EHC's money to be "public money" or "public funds,"<sup>164</sup> and EHC's rights to be "a state ownership."<sup>165</sup> Indeed, during the February 26, 1991 meeting chaired by Minister Sultan, the Minister is recorded as saying that "[t]he Ministry took no pleasure from any misunderstandings with investors; however, at the same time it could not accept any excesses in respect of *any of the Government's rights*."<sup>166</sup> Similarly, in his April 1, 1991 statement to the Luxor police, Mr. Atitu Sirri Atitu, "Manager of the Legal Department at Egyptian Hotels Company for hotels in the Luxor area," explained that "the Egyptian Hotels Company, *as a Government company*, was compelled to preserve the *public money* by the means it viewed in as being in accordance with the *public interest*."<sup>167</sup>

#### **H. Consultancy Agreement between Wena Hotels Ltd. and Mr. Kamal Kandil**

**70.** Egypt has contended that the "claimant improperly sought to influence the Chairman of EHC with respect to the award of the leases."<sup>168</sup> Both parties agree that, on or about August 20, 1989, Wena Hotels Ltd. entered into a consultancy agreement with Mr. Kamal Kandil.<sup>169</sup> The second paragraph of the agreement provides that Mr. Kandil's duties "shall be to give advice and assistance to the company as to the opportunities available to the company for developing its hotel business in Egypt."<sup>170</sup>

**71.** On March 26, 1991, Wena (through its attorneys, Tuck & Mann) issued a Writ of Summons in England against Mr. Kandil, alleging that, under the agreement, Wena had made five payments to Mr. Kandil between August 18, 1989 and January 30, 1990.<sup>171</sup> The total of these payments, which Wena sought to reclaim, was GB£ 52,000.

**72.** On August 19, 1991, Mr. Kandil responded to this Writ in a letter written to the Senior Master of the Royal Court of Justice.<sup>172</sup> In his letter, Mr. Kandil objected to Wena's writ, claiming that "there was no Contract between the Claimant Company and myself," that there was only "a Draft Contract which is not a Contract because it was neither signed nor sealed between the Parties," and that "the signature which appears is not mine."<sup>173</sup> Mr. Kandil asserted that the "subject of the above-mentioned Draft Contract was to develop new hotels in Egypt, these hotels being the Ramses Village project in Abou Simbal and a Conference Center in Aswan City...."<sup>174</sup> Mr. Kandil also stated that "[i]n the Draft Contract I did not act in my quality of Chairman of the Egyptian Hotels Company nor did the Draft Contract concern either the Nile Hotel or the Luxor Hotel, instead I acted as Tourist

Consultant for the Aswan Government and Chairman of the Board of Directors of Misr Aswan Tourist Co.”<sup>175</sup>

**73.** As corroborating evidence of Mr. Kandil's statements, Wena has submitted two letters it sent to the Governor of Aswan in December 1989 and January 1990 (including one letter on which Mr. Kandil was copied), concerning the Abou Simbal and Aswan City developments.<sup>176</sup>

**74.** Mr. Farargy testified that the Egyptian government was aware of the consultancy agreement and that Mr. Kandil “offered his help and assistance officially above board with their knowledge.”<sup>177</sup> According to Minister Sultan, however, he was not personally aware that “Mr. Kandil was an agent to Farargy” and that when he did learn about it, “I passed that to the prosecutor requesting a full fledged investigation....”<sup>178</sup> Both parties agree, however, that “the investigation appears ... to have been closed”<sup>179</sup> and that “Mr. Kandil was never prosecuted in Egypt in connection with the Consultancy Agreement.”<sup>180</sup> Unfortunately, other than this consensus that Mr. Kandil was never prosecuted, the Tribunal has been presented with no evidence of any investigation the Egyptian government might have undertaken in this matter.

### **III. Liability**

**75.** In its Memorial on the Merits, Wena claims that “Egypt violated the IPPA, Egyptian law and international law by expropriating Wena's investments without compensation.”<sup>181</sup> Wena also argues that “Egypt violated the IPPA and other international norms by failing to protect and secure Wena's investments.”<sup>182</sup>

**76.** Egypt denies Wena's claims, asserting that it has neither “violated the IPPA's prohibition on expropriation without compensation”<sup>183</sup> nor “breached any obligation under international law to protect and secure the claimant's investment.”<sup>184</sup> In addition to its objections to the substance of Wena's claims, Egypt has also raised two affirmative defenses. First, Egypt asserts that “Claimant's claims in respect of the seizure of the hotels and acts of vandalism are time barred.”<sup>185</sup> Second, Egypt contends that “Claimant improperly sought to influence the Chairman of EHC [Mr. Kamal Kandil] with respect to the award of the leases that are the subject of this arbitration” and, therefore, as a result of this alleged corruption, “Claimant cannot now properly appear before an international tribunal, constituted in accordance with the IPPA, and claim compensation for the alleged loss of leasehold interests that were improperly obtained in the first place.”<sup>186</sup> The Tribunal has carefully considered all of these claims. The Tribunal devoted particular attention to the allegations of corruption raised by Egypt.

**77.** Despite the able representation of Egypt's counsel, the Tribunal concludes that Egypt did violate its obligations under the IPPA by failing to provide Wena's investments in Egypt “fair and equitable treatment” and “full protection and security”<sup>187</sup> and by failing to provide Wena with “prompt, adequate and effective compensation” following the expropriation of its investments.<sup>188</sup> The Tribunal also finds that Wena's claims are not time barred. Finally, although Egypt has raised serious allegations of misconduct and corruption, the Tribunal finds that Egypt (which bears the burden of proving such an affirmative defense) has failed to prove its allegations. The Tribunal's rationale is discussed in more detail below.

#### **A. Law Applicable to this Arbitration**

**78.** Before Disposing of the merits of this case, the Tribunal must consider the applicable law governing its deliberations. As both parties agree, “this case all turns on an alleged violation by the Arab Republic of Egypt of the agreement for the promotion and protection of investments that was entered into in 1976 between the United Kingdom and the Arab Republic of Egypt.”<sup>189</sup> Thus, the Tribunal, like the parties (in both their submissions and oral advocacy), considers the IPPA to be the primary source of applicable law for this arbitration.

**79.** However, the IPPA is a fairly terse agreement of only seven pages containing thirteen articles. The parties in their arguments have not treated it as containing all the rules of law applicable to their dispute, and this is also the view of the Tribunal. In particular, Egypt has relied on Egyptian law, namely, the Egyptian Civil Code to raise its first defense — that Wena's claims are time barred. In its response to that defense, Wena has taken the position that both Egyptian law and international law are applicable to the dispute.<sup>190</sup> Under Article 42(1) of the ICSID Convention:

The Tribunal shall decide a dispute in accordance with such rules of law as may be agreed upon by the parties. In the absence of such agreement, the Tribunal shall apply the law of the Contracting State party to the dispute (including its rules on the conflicts of laws) and such rules of international law as may be applicable.

The Tribunal finds that, beyond the provisions of the IPPA, there is no special agreement between the parties on the rules of law applicable to the dispute. Rather, the pleadings of both parties indicate that, aside from the provisions of the IPPA, the Tribunal should apply both Egyptian law (*i.e.*, “the law of the Contracting State party to the dispute”) and “such rules of international law as may be applicable.” The Tribunal notes that the provisions of the IPPA would in any event be the first rules of law to be applied by the Tribunal, both on the basis of the agreement of the parties and as mandated by Egyptian law as well as international law.

## **B. The Issue of Egypt's Substantive Liability**

### **1. Summary of Wena's Claims**

**80.** As noted already, Wena raises two claims against Egypt. First, it contends that Egypt's actions constitute an unlawful expropriation without “prompt, adequate and effective” compensation in violation of Article 5 of the IPPA, as well as Egyptian law and other international law.<sup>191</sup> Second, Wena argues that Egypt violated Article 2(2) of the IPPA, and other international norms, by failing to accord Wena's investments “fair and equitable treatment” and “full protection and security.”<sup>192</sup>

**81.** Egypt disputes both allegations, contending, *inter alia*, “that the Claimant has no legitimate grievance against the Respondent, who neither authorized nor participated in the repossession of the Luxor and Nile Hotels on April 1, 1991 or most of the subsequent events of which the Claimant complains.”<sup>193</sup>

**82.** The Tribunal disagrees. There is substantial evidence that, even if Egyptian officials other than officials, of EHC did not participate in the seizures of the hotels on April 1, 1991, 1) Egypt was aware of EHC's intentions to seize the hotels and did nothing to prevent those seizures; 2) the police, although responding to the seizures, did nothing to protect Wena's investments; 3) for almost one year, Egypt (despite its control over EHC both before and after April 1, 1991) did nothing to restore the hotels to Wena; 4) Egypt failed to prevent damage to the hotels before their return to Wena; 5) Egypt failed to impose any substantial sanctions on EHC (or its senior officials responsible for the seizures), suggesting its approval of EHC's actions; and 6) Egypt refused to compensate Wena for the losses it suffered.

**83.** The Tribunal shall consider each of Wena's claims, beginning with its assertion that Egypt violated its obligations under Article 2(2) of the IPPA to provide “full protection and security” to Wena's investments.

### **2. Article 2(2) of the IPPA: “Fair and Equitable Treatment” and “Full Protection and Security”**

**84.** The Tribunal agrees with Wena that Egypt violated its obligation under Article 2(2) of the IPPA to accord Wena's investment “fair and equitable treatment” and “full protection and security.” Although it is not clear that Egyptian officials other than officials of EHC directly participated in the April 1, 1991 seizures, there is substantial evidence that Egypt was aware of EHC's intentions to

seize the hotels and took no actions to prevent EHC from doing so. Moreover, once the seizures occurred, both the police and the Ministry of Tourism took no immediate action to restore the hotels promptly to Wena's control. Finally, Egypt never imposed substantial sanctions on EHC or its senior officials, suggesting Egypt's approval of EHC's actions.

Article 2(2) of the IPPA provides:

Investments of nationals or companies of either Contracting Party shall at all time be accorded fair and equitable treatment and shall enjoy full protection and security in the territory of the other Contracting Party. Each Contracting Party shall ensure that the management, maintenance, use, enjoyment or disposal of investments in its territory of nationals or companies of the other Contracting Party is not in any way impaired by unreasonable or discriminatory measures. Each Contracting Party shall observe any obligation it may have entered into with regard to investments of nationals or companies of the other Contracting party.<sup>194</sup>

In interpreting a similar provision from the bilateral investment treaty between Zaïre and the United States, another ICSID panel has recently held that “the obligation incumbent on [the host state] is an obligation of vigilance, in the sense that [the host state] shall take all measures necessary to ensure the full enjoyment of protection and security of its [sic] investments and should not be permitted to invoke its own legislation to detract from any such obligation.”<sup>195</sup> Of course, as still another ICSID panel has observed, a host state's promise to accord foreign investment such protection is not an “absolute obligation which guarantees that no damages will be suffered, in the sense that any violation thereof creates automatically a ‘strict liability’ on behalf of the host State.”<sup>196</sup> A host state “is not an insurer or guarantor... [i]t does not, and could hardly be asked to, accept an absolute responsibility for all injuries to foreigners.”<sup>197</sup> Here, however, there is no question that Egypt violated its obligation to accord Wena's investments “fair and equitable treatment” and “full protection and security.”

**85.** Even if Egypt did not instigate or participate in the seizure of the two hotels, as Wena claims,<sup>198</sup> there is sufficient evidence to find that Egypt was aware of EHC's intentions and took no actions to prevent the seizures or to immediately restore Wena's control over the hotels. As discussed in section II.C, *supra*, in December 1990, Wena's parliamentary consultant, Mr. Malins, traveled to Egypt expressly to meet with minister Sultan and the Egyptian Minister of the Interior to express Wena's concerns about such a seizure.<sup>199</sup> Mr. Malins recounted that “[b]oth Ministers gave me their separate, absolute assurances ... that no violence could or would take place.”<sup>200</sup> In February 1991, Wena wrote to Minister Sultan, mentioning that EHC was again threatening to repossess the hotels through force:

*officials from the Egyptian Hotels Company threatened to storm the hotels and expel us, and this was after our Company had spent the sums previously outlined. The Matter reached a point where the Chairman of the Board of Directors of the Egyptian Hotels Company issued a decision for his company to take possession of the Luxor Hotel without a legal ruling or any other measure [to support his decision].*<sup>201</sup>

**86.** Then, on March 21, 1991 (only eleven days before the seizures), Mr. Kandil wrote to Minister Sultan, proposing that, among other things, “the two hotels be taken and the license withdrawn.”<sup>202</sup> Mr. Kandil closed the letter by advising Minister Sultan: “We leave the matter to you.”<sup>203</sup> Marginalia, in Minister Sultan's handwriting, confirm that the Minister received and reviewed the letter.<sup>204</sup>

**87.** Finally, on March 25, 1991 (only six days before the seizure), Mr. Malins wrote to Minister Sultan asking for another meeting and requesting an understanding from the Minister that no actions would be taken until that meeting could occur: “please confirm what must surely be [sic] right, mainly that all matters be ‘absolutely frozen,’ with no detrimental action of whatever nature

being taken pending our meeting..."<sup>205</sup> As evidence of the close coordination between the Ministry of Tourism and EHC, Mr. Kandil (and not Minister Sultan) responded to this letter on March 31, 1991 (the day immediately before the seizures).<sup>206</sup> Mr. Kandil ended his letter by threatening that "the owning company will take all necessary measures to protect its rights which is considered a state ownership."<sup>207</sup>

**88.** Despite all these warnings, Egypt took no action to protect Wena's investment. Minister Sultan sought to defend Egypt's failure to prevent the seizure by explaining he was not aware that EHC planned to illegally seize the hotels,<sup>208</sup> and that "[i]f I had the slightest idea about that incident, I would have immediately stopped it..."<sup>209</sup> Even if the Tribunal were to accept this explanation for Egypt's failure to act *before* the seizures, it does not justify the fact that neither the police nor the Ministry of Tourism took any immediate action to protect Wena's investments *after* EHC had illegally seized the hotels.

**89.** For example, despite the convincing evidence that a large number of people forcibly seized the Nile Hotel at approximately 7:00 p.m.,<sup>210</sup> it is undisputed that the Kasr El-Nile police (located only a few minutes away) did not begin an investigation until four hours later and it is not evident that the Ministry of Tourism police (also located nearby) ever responded to Wena's request for assistance.<sup>211</sup> Moreover, even after the Kasr El-Nile police began their investigation, they took no steps to remove EHC and restore Wena to control of the hotel. The Luxor police, although more prompt in their response, also declined to expel EHC and restore the Luxor hotel to Wena.<sup>212</sup>

**90.** The Ministry of Tourism also failed to take any immediate action to protect Wena's investments. Although he testified that he "was furious"<sup>213</sup> at EHC's decision to seize the hotels and that EHC's actions were "wrong,"<sup>214</sup> Minister Sultan also acknowledged that he did not take any action to return the hotels to Wena, to punish EHC or its officials, or to withdraw the hotel's licenses so that EHC could not operate the hotels.<sup>215</sup> Under Law Number 97 of 1983 governing Public Sector Companies and Organizations, Minister Sultan was empowered to dismiss the Chairman and the members of the Board of EHC if "it appears that the continued presence of these persons would affect the proper functioning of the company."<sup>216</sup> Also, given its power as the sole shareholder in EHC,<sup>217</sup> with several of its senior officials participating in and one of them chairing EHC's shareholder assembly,<sup>218</sup> and with "EHC operat[ing] within broad policy guidelines laid down by the Egyptian Government,"<sup>219</sup> Egypt could have directed EHC to return the hotels to Wena's control and make reparations.

**91.** Instead, neither hotel was restored to Wena until nearly a year later, after decisions by the Chief Prosecutor of Egypt,<sup>220</sup> which Wena asserts were only obtained as a result of diplomatic pressure on Egypt.<sup>221</sup> Even after the Chief Prosecutor's first decision (concerning the Nile Hotel) was issued on January 16, 1992, in which he found the seizures "illegal," the Ministry of Tourism delayed returning control of the Nile Hotel to Wena. For example, on February 21, 1992, Mr. Webster wrote to the British Embassy in Cairo, complaining of Minister Sultan's "uncooperative stance" and the delays that Wena was experiencing in recovering the hotels: "if he [Minister Sultan] wishes to press settlement of account, then we too will press for settlement of monies outstanding to Wena."<sup>222</sup> Mr. Webster concluded his letter by saying that "[w]e are of the impression that the Minister is either poorly informed or part of the entire scheme."<sup>223</sup>

**92.** Moreover, neither hotel was returned to Wena in the same operating condition that it had been in before the seizures. According to Wena's witnesses, both hotels had been vandalized.<sup>224</sup> Although Mr. Munir denied that any such vandalism occurred, he confirmed that EHC had removed and auctioned much of the Nile Hotel's fixtures and furniture.<sup>225</sup> Furthermore, neither hotel had a permanent operating license. In fact, just two days before the Nile Hotel was returned to Wena, the Ministry of Tourism withdrew that hotel's operating license because of alleged fire safety violations.<sup>226</sup> Although, as Mr. Munir noted, these safety violations had pre-dated EHC's seizure of the hotel in April 1991,<sup>227</sup> it is noteworthy that the Ministry of Tourism allowed EHC to operate the

Nile Hotel from April 1991 through February 1992, despite these violations, and revoked the license only on February 23, 1992, just prior to restoring the hotel to Wena's control.

**93.** Egypt also refused to compensate Wena for the losses it had experienced.<sup>228</sup> On November 11, 1992, Mr. Malins wrote to the Honorable Lee Hamilton, a senior member of the U.S. House of Representatives, complaining that “the Minister of Tourism, Dr. Fouad Sultan, will not consider our requests” and that “it is clear that subsequent to any perceived movement, Dr. Sultan personally intervenes to obstruct a solution.”<sup>229</sup>

**94.** Finally, neither EHC nor its senior officials were seriously punished for their actions in forcibly expelling Wena and illegally possessing the hotels for approximately a year. Although several representatives of EHC — including Messrs. Kandil and Munir — were convicted for their actions, neither Mr. Kandil nor Mr. Munir was sentenced to serve any jail time. Instead, both were fined only EGP 200, which Mr. Munir stated that he has never paid.<sup>230</sup> Also, neither official appears to have suffered any repercussions in their careers. As noted above, the Ministry of Tourism chose not to exercise its authority to remove Mr. Kandil as Chairman of EHC and, according to Ms. Jelcic, he currently is serving as an advisor to a senior member of the Egyptian parliament.<sup>231</sup> Since the seizures, Mr. Munir has been promoted to become the Head of the Legal Affairs Division at EHC and is expecting a further promotion in the near future.<sup>232</sup> This absence of any punishment of EHC and its officials suggest that Egypt condoned EHC's actions.

**95.** For all of these reasons, the Tribunal concludes that Egypt violated its obligation under Article 2(2) of the IPPA, by failing to accord Wena's investments “fair and equitable treatment” and “full protection and security.”

### **3. Article 5 of the IPPA: Expropriation Without “Prompt, Adequate and Effective” Compensation**

**96.** The Tribunal also agrees with Wena that Egypt's actions constitute an expropriation and one without “prompt, adequate and effective compensation,” in violation of Article 5 of the IPPA. That article provides in relevant part that:

**(1)** Investments of nationals or companies of either Contracting Party shall not be nationalised, expropriated or subjected to measures having effect equivalent to nationalisation or expropriation (hereinafter referred to as ‘expropriation’) in the territory of the other Contracting Party except for a public purpose related to the internal needs of the Party and against prompt, adequate and effective compensation. Such compensation shall amount to the market value of the investment expropriated immediately before the expropriation itself or before there was an official Government announcement that expropriation would be effected in the future, whichever is the earlier, shall be made without delay, be effectively realizable and be freely transferable. The national or company affected shall have a right under the law of the Contracting Party making the expropriation, to prompt review, by a judicial or other independent authority of that Party, of whether the expropriation is in conformity with domestic law and of the valuation of his or its investment in accordance with the principles set out in this paragraph.<sup>233</sup>

**97.** Although, as Professor Ian Brownlie has commented, “the terminology of the subject is by no means settled,”<sup>234</sup> the fundamental principles of what constitutes an expropriation are well established under international law. For example, as the ICSID tribunal in *Amco Asia v. Indonesia* noted, “it is generally accepted in International Law, that a case of expropriation exists not only when a state takes over private property, but also when the expropriating state transfers ownership to another legal or natural person.”<sup>235</sup> The tribunal continued by observing that an expropriation “also exists merely by the state withdrawing the protection of its courts from the owner expropriated, and tacitly allowing a *de facto* possessor to remain in possession of the thing seized...”<sup>236</sup>

**98.** It is also well established that an expropriation is not limited to tangible property rights. As the panel in *SPP v. Egypt* explained, “there is considerable authority for the proposition that Contract rights are entitled to the protection of international law and that the taking of such rights involves an obligation to make compensation therefore.”<sup>237</sup> Similarly, Chamber Two of the Iran-U.S. Claims Tribunal observed in the *Tippets* case that “[a] deprivation or taking of property may occur under international law through interference by a state in the use of that property or with the enjoyment of its benefits, even where legal title to the property is not affected.”<sup>238</sup> The chamber continued by noting:

[w]hile assumption of control over property by a government does not automatically and immediately justify a conclusion that the property has been taken by the government, thus requiring compensation under international law, such a conclusion is warranted whenever events demonstrate that the owner has been deprived of fundamental rights of ownership and it appears that this deprivation is not merely ephemeral.<sup>239</sup>

**99.** Here, the Tribunal has no difficulty finding that the actions previously described constitute such an expropriation. Whether or not it authorized or participated in the actual seizures of the hotels, Egypt deprived Wena of its “fundamental rights of ownership” by allowing EHC forcibly to seize the hotels, to possess them illegally for nearly a year, and to return the hotels stripped of much of their furniture and fixtures.<sup>240</sup> Egypt has suggested that this deprivation was merely “ephemeral” and therefore did not constitute an expropriation.<sup>241</sup> The Tribunal disagrees. Putting aside various other improper actions, allowing an entity (over which Egypt could exert effective control) to seize and illegally possess the hotels for nearly a year is more than an ephemeral interference “in the use of that property or with the enjoyment of its benefits.”<sup>242</sup>

**100.** Moreover, even after the hotels were returned to Wena, Egypt failed to satisfy its obligation under the IPPA, and international norms generally, by refusing to offer Wena “prompt, adequate and effective compensation” for the losses it had suffered as result of Egypt's failure to act.<sup>243</sup> For example, as already noted, on November 11, 1992, Mr. Malins wrote to U.S. Congressman Lee Hamilton, complaining that “the Minister of Tourism, Dr. Fouad Sultan, will not consider our requests” and that “it is clear that subsequent to any perceived movement, Dr. Sultan personally intervenes to obstruct a solution.”<sup>244</sup>

**101.** For all these reasons, the Tribunal concludes that Egypt violated its obligation under Article 5 of the IPPA, by failing to provide Wena with “prompt, adequate and effective compensation” for the losses it suffered as a result of the seizures of the Luxor and Nile Hotel.

### **C. Whether Wena's Claims are Time Barred**

**102.** In its Memorial on the Merits, Egypt argues that Wena's claims are time barred under Article 172(i) of the Egyptian Civil Code.<sup>245</sup> This article provides that:

A case filed for damages claimed for an illegal act, shall fall by prescription by lapse of three years from the day the wronged person learns of the damage taking place and of the person who is responsible for it, in all events the case shall fall with the lapse of 15 years from the day the illegal act takes place.<sup>246</sup>

Egypt also observes that “[e]ven if, contrary to the above, the Tribunal were to refuse to apply Article 172(i), it nevertheless would clearly still have the discretion to determine whether there has been unreasonable delay in the submission of the Claimant's claims to ICSID.”<sup>247</sup> Finally, Egypt contends that “if Egyptian law is not applied, it would be reasonable ... to have regard to the principles of prescription that are common to both of the Contracting Parties to the IPPA, *i.e.*, in this case, the United Kingdom,” noting that the statute of limitation, under the English Limitation Act 1980, for breach of Contract or tortious behavior is six years.<sup>248</sup>



**103.** Ironically, as Wena notes, Respondent did not previously raise this “time bar” claim in its objections to jurisdiction.<sup>249</sup> To the contrary, Respondent asserted, as part of its objections, that Wena's Request for Arbitration was “premature.”<sup>250</sup>

**104.** Setting aside this apparent inconsistency, however, the Tribunal sees no legal or equitable reason to bar Wena's claim. First, contrary to Respondent's claim that “Claimant severely compromised the ability of the Respondent to defend itself in these proceedings,”<sup>251</sup> the Tribunal agrees with Wena that, given the voluminous evidence produced by the parties as well as the extensive testimony provided by several witnesses (in particular, EHC's counsel, Mr. Munir, who showed a remarkable recollection of the case), neither party seems to have been disadvantaged — which, of course, is one of the equitable reasons for disallowing an untimely claim.

**105.** Another equitable principle is the notion of “repose” — that a respondent who reasonably believes that a dispute has been abandoned or laid to rest long ago should not be surprised by its subsequent resurrection.<sup>252</sup> Here, however, the Tribunal finds that Wena has continued to be aggressive in prosecuting its claims and that Egypt has had ample notice of this on-going dispute.<sup>253</sup>

**106.** Second, as Wena notes, municipal statutes of limitation do not necessarily bind a claim for a violation of an international treaty before an international tribunal. In *Alan Craig v. Ministry of Energy of Iran*, Chamber Three of the Iran-U.S. Claims Tribunal declined to apply an Iranian statute of limitation, despite the applicability of Iranian law.<sup>254</sup> The tribunal noted:

Municipal statutes of limitation have not been considered as binding on claims before an international tribunal, although such periods may be taken into account by such a tribunal when determining the effect of an unreasonable delay in pursuing a claim.<sup>255</sup>

This general principle was recognized as long ago as 1903 by the Italy-Venezuela Mixed Claims Commission, which held in the *Gentini* case that, although local statutes of limitation cannot be invoked to defeat an international claim, international tribunals may consider equitable principles of prescription to reject untimely claims.<sup>256</sup> Indeed, in the *Gentini* case, the American Umpire dismissed a thirty-year old claim. As discussed above, however, the Tribunal sees no reason to exercise such discretion in this case, where Egypt has had ample notice of Wena's continued claims and where neither party appears to have been substantially harmed in its ability to bring its case.

**107.** Egypt contends that Article 42(1) of the ICSID Convention mandates that the Tribunal must apply Article 172(i)'s three-year statute of limitation. The Tribunal does not agree. Article 42(1) of the ICSID Convention provides that a Tribunal shall apply domestic law “and such rules of international law as may be applicable.” As Wena notes, the decision in the *Amco Asia* case advised that one situation where a tribunal should apply rules of international law is “to ensure the precedence of international law norms where the rules of the applicable domestic law are in collision with such norms.”<sup>257</sup> Here, strict application of Article 172(i)'s three-year limit, even if applicable, would collide with the general, well-established international principle recognized since before the *Gentini* case: that municipal statutes of limitation do not bind claims before an international tribunal (although tribunals are entitled to consider such statutes as well as equitable principles of prescription when handling untimely claims).

**108.** Moreover, as discussed in Section III.A, *supra*, the principal source of substantive law in this case is the IPPA itself. The Tribunal notes that although the IPPA's concise provisions do not contain detailed procedures for bringing an arbitration, Article 8(1) does expressly provide that if a dispute “should arise and agreement cannot be reached within three months between the parties to this dispute through pursuit of local remedies, through conciliation or otherwise, then,” and only then, may a party institute ICSID proceedings.<sup>258</sup> This provision suggests a greater concern that the parties not rush into arbitration than that the parties will delay the initiation of proceedings.

**109.** Finally, although not necessary to the Tribunal's decision, the Tribunal is not convinced by the interpretation of Egyptian law presented by Respondent. As Respondent's expert noted, normally "[a]ctions for liability for administrative acts are time-barred after fifteen years."<sup>259</sup> Article 172(i), to the contrary, is viewed as an "exception to the general principle concerning the statute of limitation [because] it relates to ... unlawful acts."<sup>260</sup> Dr. Elehwany reached the conclusion that the normal 15-year prescription did not apply and that the exceptional three-year period of Article 172(i) did, because "what was being attributed to Egypt is liability for the physical acts *the police* are alleged to have committed on 1 April 1991 — namely the storming Nile and Luxor Hotels, the forcible eviction of the hotel guests and staff, the theft of cash, the detention of employees, the wrecking of everything...."<sup>261</sup>

**110.** Of course, as Egypt argued on the merits, and the Tribunal agrees, it has not been demonstrated that the police physically participated in the seizure of the hotels. As discussed in section III.B., *supra*, Egypt's liability does not arise from physical acts by the police, but from Egypt's failure to accord Wena's investments as required by IPPA, "full protection and security" — by failing to prevent or immediately reverse EHC's physical acts. Such failure to provide legal protection would appear to constitute the typical administrative act for which the normal, fifteen-year prescription period applies. Thus, Egypt's response to the contention that it failed to provide "full protection and security" is inadequate.

#### **D. Consultancy Agreement with Mr. Kandil**

**111.** Finally, the Tribunal considers Egypt's contention that "Claimant improperly sought to influence the Chairman of EHC with respect to the award of the leases" for the Luxor and Nile hotels.<sup>262</sup> If true, these allegations are disturbing and ground for dismissal of this claim. As Egypt properly notes, international tribunals have often held that corruption of the type alleged by Egypt are contrary to international *bonos mores*.<sup>263</sup> However, as Professor Lalive notes, "the delicate problems remains" for an arbitral tribunal "to determine precisely where the line should be drawn between legal and illegal contracts, between illegal bribery and legal 'commissions.'"<sup>264</sup>

**112.** As noted above in section II.H (paragraphs 70–74), it is undisputed that Wena and Mr. Kandil entered into an agreement in August 1989, that the purpose of the agreement was for Mr. Kandil "to give advice and assistance to the company as to opportunities available to the company for developing its hotel business in Egypt,"<sup>265</sup> that between August 18, 1989 and January 30, 1990 Wena made a total of GB£ 52,000 in payments to Mr. Kandil, and that on March 26, 1991, Wena initiated a lawsuit against Mr. Kandil for allegedly breaching the agreement.<sup>266</sup>

**113.** Egypt notes that, coincidentally, the first payment (on August 18, 1989) was ten days after the execution of the Luxor Hotel lease and that the last payment (on January 30, 1990) was two days after the signing of the Nile Hotel lease. It also observes that the amount paid to Mr. Kandil exceeds that which would have been authorized under the consultancy agreement.

**114.** Wena, however, contends that the agreement did not concern the Nile and Luxor hotels, but was to help Wena pursue development opportunities in Misr Aswan, where Mr. Kandil was a tourist consultant. This assertion is supported by both Mr. Kandil's response to Wena's March 1991 lawsuit,<sup>267</sup> as well as the letters Wena has submitted from December 1989 and January 1990, evincing its interest in the Abou Simbal and Aswan City developments in Misr Aswan.<sup>268</sup>

**115.** Wena also noted that according to Mr. Yusseri, the Luxor lease was awarded to Wena in a competitive bid with another investor, with Wena winning the lease because it agreed to pay a higher rent.<sup>269</sup> Finally, Mr. Farargy testified that the Egyptian government was aware of the agreement that Mr. Kandil "offered his help and assistance officially above board with their knowledge."<sup>270</sup>

**116.** Although the Tribunal believes Minister Sultan's testimony that he was not personally aware

that “Mr. Kandil was an agent to Farargy” and that when he did learn about it, “I passed that to the prosecutor requesting a full fledged investigation,”<sup>271</sup> it is undisputed that Mr. Kandil was never prosecuted in Egypt in connection with this agreement.<sup>272</sup> Regrettably, because Egypt has failed to present the Tribunal with any information about the investigation requested by Minister Sultan, the Tribunal does not know whether an investigation was conducted and, if so, whether the investigation was closed because the prosecutor determined that Mr. Kandil was innocent, because of lack evidence, or because of complicity by other government officials. Nevertheless, given the fact that the Egyptian government was made aware of this agreement by Minister Sultan but decided (for whatever reasons) not to prosecute Mr. Kandil, the Tribunal is reluctant to immunize Egypt from liability in this arbitration because it now alleges that the agreement with Mr. Kandil was illegal under Egyptian law.

**117.** Moreover, with the exception of the coincidence in the timing of the payments and the signing of the Luxor and Nile hotels (and the apparent over-payment of Mr. Kandil), the Tribunal notes that Egypt — which bears the burden of proving such an affirmative defense — has failed to present any evidence that would refute Wena’s evidence that the Contract was a legitimate agreement to help pursue development opportunities in Misr Aswan. Nor did either party offer to present live testimony from Mr. Kandil.

#### **IV. Damages**

**118.** Article 5 of the IPPA between Egypt and the United Kingdom provides that in the event of an expropriation, the private investor shall be entitled to “prompt, adequate, and effective compensation” and “such compensation shall amount to the market value of the investment immediately before the expropriation.”<sup>273</sup> The Tribunal shall apply this standard to the determination of damages.

**119.** Altogether Wena claims damages of GB£ 20.4 million for lost profits, GB£ 22.8 million for lost opportunities and GB£ 2.5 million for reinstatement costs, making a total of GB£ 45.7 million.<sup>274</sup> In addition, it seek interest on the previous sum and makes a claim of US\$ 1,251,541 for counsel fees and costs of experts and witnesses incurred in pursuing its claim.<sup>275</sup>

**120.** In the alternative, Wena claims US\$8,819,466.93 as the amount of its investment in the Egyptian hotel venture.<sup>276</sup>

**121.** The Respondent disputes these requests, contending that the claims summarized in paragraphs 119–120 are inappropriate and greatly overstated.<sup>277</sup> In the alternative, the Respondent suggest that if anything were awarded for damages it should be the amount of Wena’s investment in the Egyptian hotel venture, which, according to Respondent’s expert, could not be more than GB£ 750,000.<sup>278</sup>

**122.** Although experts presented by each party adopted variations of the well-known discounted cash flow (“DCF”) method of calculating the amount of the damages sustained by Wena, the experts reached widely varying results from their calculations.<sup>279</sup> Since, however, the Tribunal is not persuaded that the DCF method is appropriate in this case, it deems it unnecessary to enter into a detailed discussion of the differences that the experts’ calculations disclosed.

**123.** The Tribunal agrees with Egypt that, in this case, Wena’s claims for lost profits (using a discounted cash flow analysis), lost opportunities and reinstatement costs are inappropriate—because an award based on such claims would be too speculative. As another ICSID panel recently noted in the *Metalclad* decision:

Normally, the fair market value of a going concern which has a history of profitable operation may be based on an estimate of future profits subject to a discounted cash flow analysis. However, where the enterprise has not operated for a sufficiently long time to

establish a performance record or where it has failed to make a profit, future profits cannot be used to determine going concern or fair market value.<sup>280</sup>

Similarly, the ICC panel in the *SPP (Middle East) v. Egypt* arbitration case declined to accept a discounted cash flow projection because, *inter alia*, “by the date of cancellation the great majority of the work had still to be done,” and “the calculation put forward by the Claimants produces a disparity between the amount of the investment made by the Claimants” and the “supposed value” of the investment as calculated by the DCF analysis.<sup>281</sup>

**124.** Like the *Metalclad* and *SPP* disputes, here, there is insufficiently “solid base on which to found any profit ... or for predicting growth or expansion of the investment made” by Wena.<sup>282</sup> Wena had operated the Luxor Hotel for less than eighteen months, and had not even completed its renovations on the Nile Hotel, before they were seized on April 1, 1991. In addition, there is some question whether Wena had sufficient finances to fund its renovation and operation of the hotels.<sup>283</sup> Finally, the Tribunal is disinclined to grant Wena's request for lost profits and lost opportunities given the large disparity between the requested amount (GB£ 45.7 million) and Wena's stated investment in the two hotels (US\$8,819,466.93).<sup>284</sup>

**125.** Rather, the Tribunal agrees with the parties that the proper calculation of “the market value of the investment expropriated immediately before the expropriation”<sup>285</sup> is best arrived at, in this case, by reference to Wena's actual investments in the two hotels. As noted above, Wena pleads in the alternative for award of at least the amount of Wena's proven investment in the Egyptian hotel venture. Similarly, Respondent pleads in the alternative that if any award were made it should not be more than the amount of Wena's proven investment.

**126.** The Tribunal is not persuaded by the relevance of the Respondent's contention that much of the Egyptian investment came from affiliates of Wena rather than from Wena. Instead the panel takes the view that whether the investments were made by Wena or by one of its affiliates, as long as those investments went into the Egyptian hotel venture, they should be recognized as appropriate investments. The panel was persuaded from the testimony it received that it is a widely established practice for hotel enterprises to adopt allocation measures, which spread the profits from the group operations into various jurisdictions where there are tax advantages to the group as a whole.

**127.** On the basis of investment, Claimant states its loss as US\$8,819,466.93. However, the panel in pursuing an objection raised by the Respondent that there were certain elements of double counting,<sup>286</sup> decided that the gross figure should be diminished by US\$322,000.00 to eliminate probably double counting in certain instances. Beyond that, however, the panel was not persuaded by Respondent's evidence that there were significant other instances of double counting. Thus, the figure of US\$8,819,466.93 should be diminished by US\$322,000.00, leaving a total of US\$8,497,466.93, which the Tribunal judges to be the approximate total for Wena's investment. From this, the Tribunal agreed that \$435,570.38 should be deducted for the amount received already by Claimant as a result of the Egyptian arbitration award (the equivalent of EGP 1,477,498.30 at the exchange rate of \$1 = EGP 3.3921 on June 9, 1997, the date of payment of the Egyptian award).<sup>287</sup>

**128.** To this should be added an appropriate sum for interest. Claimant has claimed interest but neither specified a rate nor whether interest should be compounded.<sup>288</sup> Moreover, the IPPA, the lease agreements, and the ICSID Convention and Rules are all silent on the subject of interest. The Panel is of the view that in this case interest should be awarded and that it would be appropriated adopt a rate of 9%, to be compounded quarterly.<sup>289</sup>

**129.** Like the distinguished panel in the recently-issued *Metalclad* decision, this Tribunal also has determined that compounded interest will best “restore the Claimant to a reasonable approximation of the position in which it would have been if the wrongful act had not taken place.”<sup>290</sup> Although

the *Metalclad* tribunal awarded compound interest without comment, this panel feels that a brief explanation of its decision is warranted.<sup>291</sup> This Tribunal believes that an award of compound (as opposed to simple) interest is generally appropriate in most modern, commercial arbitrations. As Professor Gotanda has observed “almost all financing and investment vehicles involve compound interest .... If the claimant could have received compound interest merely by placing its money in a readily available and commonly used investment vehicle, it is neither logical nor equitable to award the claimant only simple interest.”<sup>292</sup> For similar reasons, Professor Mann has “submitted that ... compound interest may be and, in absence of special circumstances, should be awarded to the claimant as damages by international tribunals.”<sup>293</sup>

**130.** Thus, the total, with interest through December 1, 2000 (US\$11,431,386.88) is US\$19,493,283.43. To this figure there should be added an appropriate sum to reimburse Claimant for attorney's fees and related costs, as reparation for losses sufficiently related to its central claims and in keeping with common practice in international arbitration. It will be recalled that the Tribunal, in its *Decision on Jurisdiction*, rejected Wena's claims for costs incurred in rebutting Egypt's objections to jurisdiction.<sup>294</sup> Accordingly, the Tribunal shall only reimburse Claimant for that portion of its attorney's fees and costs incurred in presenting the merits of this arbitration. Wena has claimed US\$1,107,703 for these expenses.<sup>295</sup> Thus, including the Claimant's attorney's fees and costs, the grand total to be awarded Claimant is US\$20,600,986.43. This award will be payable within 30 days from the date hereof. Thereafter, it will accumulate additional interest at 9% compounded quarterly until paid.

## V. Conclusion

**131.** In sum, the Tribunal concludes that Egypt breached its obligations under Article 2(2) of the IPPA by failing to accord Wena's investments in Egypt “fair and equitable treatment” and “full protection and security.” Even if the Egyptian Government did not authorize or participate in the attacks, its failure to prevent the seizures and subsequent failure to protect Wena's investments give rise to liability. The Tribunal also finds that Egypt's actions amounted to an expropriation — transferring control of the hotels from Wena to EHC without “prompt, adequate and effective compensation” in violation of Article 5 of the IPPA.

**132.** The Tribunal also dismisses the two affirmative defenses raised by Egypt. First, the Tribunal does not agree with Egypt's contention that Wena's claims are time barred. Second, although Egypt has raised some disturbing allegations regarding payments made to Mr. Kandil, the Tribunal finds that Egypt has failed to meet its evidentiary burden of proving that these payments were illegitimate.

## VI. The Operative Part

**133.** For these reasons

THE TRIBUNAL, unanimously,

**134.** FINDS that Egypt breached its obligations to Wena by failing to accord Wena's investments in Egypt fair and equitable treatment and full protection and security in violation of Article 2(2) of the IPPA;

**135.** FINDS that Egypt's actions amounted to an expropriation without prompt, adequate and effective compensation in violation of Article 5 of the IPPA;

and

**136.** AWARDS to Wena US\$20,600,986.43 in damages, interest, attorneys fees and expenses. This award will be payable by Egypt within 30 days from the date of this Award. Thereafter, it will

accumulate additional interest at 9% compounded quarterly until paid.

/s/

Prof. Ibrahim Fadlallah

/s/

Prof. Don Wallace, Jr.

/s/

Monroe Leigh, Esq.

### **Statement of Professor Don Wallace, Jr.**

Professor Wallace concurs in the Tribunal's entire award and is persuaded that compound interest should be awarded. However, he is not persuaded that compounding should be quarterly.

## Footnotes:

**1.** Wena Hotels Limited is a British company incorporated in 1982 under the laws of England and Wales. See Certificate of Incorporation on Change of Name of Wena Hotels Limited (April 22, 1982) [Annexes W1 & E-J2]. Note, in referencing the documentary annexes submitted by the parties, the notation “W” indicates a document submitted by Claimant, Wena Hotels Limited. The notation “E-J” indicates a document submitted by Respondent, the Arab Republic of Egypt as part of its briefing on jurisdiction; a notation of “E-M” indicates a document submitted by Egypt as part of its briefing on the merits.

**2.** Claimant’s Request for Arbitration, at 1 (submitted on July 10, 1998).

**3.** *Id.*, at 18.

**4.** Respondent’s Memorial on its Objections to Jurisdiction, at 1 (submitted on March 4, 1999) (“Respondent’s Memorial on Jurisdiction”).

**5.** *Id.*

**6.** *Id.*, at 2.

**7.** *Id.*

**8.** Tribunal’s Decision on Jurisdiction, at 8–9 (released on June 29, 1999) (quoting Recordings from Tribunal’s Session on Jurisdiction, Offices of the World Bank, Paris (on May 25, 1999)).

**9.** *Id.*, at 9.

**10.** *Id.*

**11.** *Id.*, at 10–19.

**12.** *Id.*, at 21–23.

**13.** Full, verbatim transcripts were made of the session and distributed to the parties and the Tribunal following each day of the hearing.

**14.** Annexes W179 & 187–194.

**15.** Annex W183. Wena had sought the Arthur Anderson report (which was prepared for the benefit of Egypt under a Contract with the U.S. Agency for International Development) from Egypt as early as August 30, 1999. Notwithstanding this request and the Tribunal’s subsequent directions to search for this document, Egypt never produced a copy of the report. At the Tribunal’s April 25, 2000 session on the merits (and, again, in the Respondent’s Post-Hearing Memorial), Egypt’s counsel explained what efforts the Egyptian State Lawsuit Authority had taken to obtain a copy of the report, without success. See Transcript of Tribunal’s Session on the Merits (“TR”) Day 1, at 80:27–81:21; Respondent’s Post-Hearing Memorial, Appendix E (submitted on May 30, 2000). Shortly after the session, however, the ICSID Secretariat obtained a copy of the report from the U.S. Agency for International Development.

**16.** Agreement for the Promotion and Protection of Investments, June 11, 1975, U.K.-Egypt (“IPPA”) [Annexes W2 & E-J22].

**17.** *Id.*, art 2(2).

**18.** *Id.*, art. 5(1).

- 19.** See Certificate of Incorporation on Change of Name of Wena Hotels Limited (April 22, 1982) [Annexes W1 & E-J2]. As discussed above, although Egypt never challenged the fact that Wena Hotels Limited was incorporated as a British company, it asserted as part of its objections to jurisdiction that Wena “by virtue of Mr. El-Farargy’s ownership and his Egyptian nationality, [should] be treated as an Egyptian company pursuant to Article 8(1)” of the IPPA. Respondent’s Reply on Jurisdiction, at 2 (submitted on April 8, 1999). The Tribunal, however, rejected Egypt’s proposed construction of Article 8(1) of the IPPA and, thus, determined that Wena was an English company for purposes of the IPPA. See Decision on Jurisdiction, at 10–19.
- 20.** See section II.G, *infra*, concerning the relationship between EHC and Egypt.
- 21.** Luxor Hotel Lease and Development Agreement (August 8, 1989) [Annex W5]
- 22.** *Id.*, art. III.
- 23.** *Id.*, arts. I, XIII & XV(3).
- 24.** Direct Examination of Mr. Yusseri Mahmud Hamid Hajjaj, TR Day 5, at 4:3-11 (“Yusseri Direct Ex.”).
- 25.** El Nile Hotel Lease and Development Agreement (January 28, 1990) [Annex W4].
- 26.** An Agreement between His Excellency Fouad Sultan, Minister of Tourism for the Egyptian Government, jointly with Mr. Kamal Kandil of the Egyptian Hotels Company and Wena Hotels Limited (October 1, 1989) [Annex W6].
- 27.** Claimant’s Request for Arbitration, at 8.
- 28.** Respondent’s Memorial on Jurisdiction, at 4.
- 29.** Final Award in *Wena Hotels Ltd. v. Egyptian Hotel Company* (November 14, 1990) [Annex E-M17].
- 30.** Declaration of Mr. Nael El-Farargy, ¶ 14, attached to Claimant’s Memorial on the Merits (submitted on July 26, 1999) (“Farargy Declaration”). The Respondent’s Memorial on Jurisdiction also reports that Wena brought “a nullity action (No. 18644 of 1990), which was refused by South Cairo Court on February 27, 1994.” Respondent’s Memorial on Jurisdiction, at 4. However, a copy of the South Cairo Court’s decision was not provided to the Tribunal.
- 31.** Direct Examination of Mr. Humfrey Malins, M.P., TR Day 4, at 174:26–29 (“Malins Direct Ex.”). The Tribunal generally found Mr. Malins to be a reliable and convincing witness, with no apparent financial or personal stake in the outcome of the arbitration. See *also* Farargy Declaration, ¶¶ 17–19.
- 32.** Malins Direct Ex., TR Day 4, at 175:1–4.
- 33.** *Id.*, at 175:25–29. See *also* Declaration of Mr. Humfrey Malins, MP., ¶ 4, attached to Claimant’s Memorial on the Merits (“Malins Declaration”).
- 34.** Letter from Mr. Nael El-Farargy (Wena Hotels Ltd.) to Minister Fouad Sultan (Minister of Tourism) (February 11, 1991) [Witness Statement of Minister Fouad Sultan, Attachment A, attached to Respondent’s Memorial on the Merits (submitted on September 6, 1999) (“Sultan Statement”); also Annexes E-M21 & W127]. At the time of the events that are the subject of this dispute, Minister Sultan was the Minister for Tourism and Civil Aviation of Egypt. Minister Sultan held this position from 1985 to 1993. Sultan Statement, ¶ 3. Although Minister Sultan has now returned to the private sector (serving as Chairman and Managing Director of Alahly for Development and Investment S.A.E.), the Tribunal shall for convenience refer to the witness as Minister Sultan.



**35.** *Id.* (emphasis added; brackets in original English translation) [Sultan Statement, Attachment A; also Annexes E-M21 & W127].

**36.** Minutes of Meeting between Representatives of the Ministry of Tourism, EHC and Wena (February 26, 1991) [Sultan Statement, Attachment B; also Annexes E-M22 & W124].

**37.** *Id.*

**38.** Direct Examination of Mr. Nael El-Farargy, TR Day 1, at 147:17–25 (“Farargy Direct Ex.”). See *also* Letter from Mr. Kamal Kandil (Chairman, EHC) to Mr. Ahmad Al-Khawaga (Attorney for Wena) (March 3, 1991) [Annexes W125 & E-M23]; Witness Statement of Mr. Munir Abdul Al-Aziz Gaballah Shalabi, ¶ 13, attached to Respondent’s Rejoinder on the Merits (submitted on October 18, 1999) (“Munir Statement”). The Witness Statement of Mr. Munir should not be confused with the Summary of Evidence to be given by Mr. Munir Abdul Al-Aziz Gaballah Shalabi, attached to Respondent’s Memorial on the Merits, because counsel for Egypt were unable to obtain a signed witness statement from Mr. Munir before submitting their Memorial on the Merits, counsel submitted a short Summary of Evidence instead — providing the witness statement when it subsequently became available.

**39.** Letter from Mr. Kamal Kandil (Chairman, EHC) to Minister Fouad Sultan (Minister of Tourism) (March 21, 1991) [Sultan Statement, Attachment D; also Annex W126].

**40.** *Id.* (emphasis added; brackets in original English translation).

**41.** *Id.*

**42.** *Id.* (emphasis added).

**43.** *Id.* (Arabic original). See *also* Cross examination of Minister Fouad Sultan, TR Day 3, at 235:23–237:27 (“Sultan Cross-Ex.”); Sultan Statement, ¶ 17.

**44.** Letter from Mr. Humfrey Malins, M.P. (Parliamentary Consultant, Wena) to Minister Fouad Sultan (Minister of Tourism) (March 25, 1991) [Annex W 128].

**45.** *Id.*

**46.** Letter from Mr. Kamal Kandil (Chairman, EHC) to Mr. Humfrey Malins, M.P. (Parliamentary Consultant, Wena) (March 31, 1991) [Annexes W81 & W129]. During the session on the merits, Minister Sultan suggested that perhaps Mr. Malins’ March 25, 1991 letter had been faxed to EHC, not the Minister of Tourism (thus, potentially explaining why Mr. Kandil, and not Minister Sultan, responded to the letter). See Sultan Cross-Ex., TR Day 4, at 47:9–10 & 48:29–49:1. However, both the attached fax cover sheet and confirmation sheet for Mr. Malins’ letter show that the letter was faxed to number 2829771 in Egypt. See Annex W128. Subsequent inquiry by counsel for Wena “on May 29, 2000 to France Telecom’s International Yellow Pages service” determined that the “same number (2829771) was given as the fax number listed for the Egyptian Ministry of Tourism.” Claimant’s Post-Hearing Brief, at 16 & n. 5 (submitted on May 30, 2000). In contrast, as reflected in EHC’s contemporaneous letterhead, the fax number for EHC at that time was 3911322. See Annex W129.

**47.** *Id.*

**48.** Munir Statement, ¶ 14.

**49.** *Id.*

**50.** *Id.*

- 51.** Witness Statement of Mr. Yusseri Mahmud Hamid Hajjaj, ¶ 8, attached to Respondent's Memorial on the Merits ("Yusseri Statement").
- 52.** Munir Statement, ¶ 14.
- 53.** See, e.g., Kasr El-Nile Police Report, at 4 (April 1 & 2, 1991) [Annex E-M25]; Resolution Number [blank] for the Year 1991) [Annex E-M26].
- 54.** Letter from Mr. Kamal Kandil (Chairman, EHC) to Mr. Nael El-Farargy (Wena Hotels Ltd.) (March 30, 1991) [Annexes W80 & W186].
- 55.** *Id.* (Brackets in original English translation); emphasis added by the Tribunal.
- 56.** Mr. Munir also asserted that a copy of Resolution Number 215 concerning the seizures was "sent to Wena in EHC's letter dated 30 March 1991 addressed to its head office in England." Munir Statement, ¶ 14. However, there is no evidence to confirm that a copy of this resolution was attached to the letter. See Annex W 80.
- 57.** See registered mail receipt in Annex W80.
- 58.** See fax legend in Annex W186.
- 59.** Cross-examination of Mr. Munir Abdul Al-Aziz Gaballah Shalabi, TR Day 5, at 76:22–78:3 ("Munir Cross-Ex."). During the fifth day of the Tribunal's session on the merits, the absence of a confirmatory fax cover sheet (or a fax number of the letter) was noted. Both parties agreed that EHC should be asked to search its files for any record that could confirm that the document was faxed on March 30, 1991. TR Day 5, at 77:12–78:15.
- 60.** Administrative Decision Number 216 (March 31, 1991) [Annex E-M28].
- 61.** *Id.* See also Yusseri Statement, ¶ 9.
- 62.** Munir Cross-Ex., TR Day 5, at 55:26–56:1. See also Munir Statement, ¶ 18. The Tribunal notes that this plan to seize the hotels surreptitiously, while Wena management were away from the hotels, contradicts Mr. Munir's claim that EHC had previously notified Wena of its intentions to repossess the hotels.
- 63.** Respondent's Memorial on Jurisdiction, at 4.
- 64.** Direct Examination of Mr. Simon Webster, TR Day 3, at 12:8–9 ("Webster Direct Ex."); Direct Examination of Ms. Angela Jelcic, TR Day 3, at 91:26–92:5 ("Jelcic Direct Ex.").
- 65.** See, e.g., Police Statements, at 6, 9, 10 & 12 (July 6, 1991) [Annex W134]; Webster Direct Ex., TR Day 3, at 12:15–21; Jelcic Direct Ex., TR Day 3, at 95:13–19. Mr. Munir, however, testified that he arrived at the hotel in a single bus, with "approximately 35 accountants, receptions and other management staff required to run the hotel." Munir Statement, ¶ 17.
- 66.** Kasr El-Nile Police Reports, at 3 (April 1, 1991) [Annex E-M25]. See also *id.*, at 2.
- 67.** *Id.*, at 3.
- 68.** *Id.*
- 69.** Police Statement of Mr. Tamim Foda, at 5–6 (July 5, 1991) [Annex W134].
- 70.** Police Statement of Mr. Mostafa Ahmed Osman, at 3 (July 6, 1991) [Annex W134].
- 71.** *Id.*, at 3–4.

- 72.** Police Statement of Mr. Sherif Ibrahim Mohamed Khalifa, at 8 (July 6, 1991) [Annex W134].
- 73.** *Id.*
- 74.** *Id.*, at 9.
- 75.** *Id.*
- 76.** Police Statement of Mr. Mohamed Sabry Ismail Emam, at 10 (July 6, 1991) [Annex W134] (capital letters in original).
- 77.** *Id.*
- 78.** “British Tourists are Beaten and Thrown Out of Egypt Hotels,” *Daily Telegraph* (April 4, 1991) [Annex W7].
- 79.** *Id.*
- 80.** Police Statement of Mr. Hany Mohamed Hassan Mohamed Wahba, at 11–12 (July 6, 1991).
- 81.** *Id.*, at 12.
- 82.** *Id.*
- 83.** *Id.*
- 84.** *Id.* (capital letters in original).
- 85.** Jelcic Direct Ex., TR Day 3, at 92:17–93:24. See also Declaration of Ms. Angela Jelcic, ¶ 13, attached to Claimant’s Memorial on the Merits (“Jelcic Declaration”).
- 86.** Jelcic Direct Ex., TR Day 3, at 94:11–16.
- 87.** Jelcic Direct Ex., TR Day 3, at 97:1–5.
- 88.** Jelcic Direct Ex., TR Day 3, at 97:7–8. See also Jelcic Declaration, ¶ 13 (“I recognized certain EHC executives and personnel, some of whom were standing with some other well-groomed men in suits. These men were identified as Ministry of Tourism officials by our staff who recognized them.”).
- 89.** Jelcic Direct Ex., TR Day 3, at 97:10–13.
- 90.** Webster Direct Ex., TR Day 3, at 14:6–12. See also Webster Direct Ex., TR Day 3, at 14:25–15:6 & 16:9–12.
- 91.** Statement of Ms. Angela Jelcic to Kasr El-Nile Police (April 2, 1991) [Annex W82]
- 92.** Statement of Mr. Simon Webster to Kasr El-Nile Police (April 2, 1991) [Annex W83]. Similar contemporaneous evidence of Wena’s impression that the Egyptian government was involved in the seizures is reflected in several of the newspaper articles describing the events. For example, an article in the *Caterer and Hotelkeeper* reported that “Mr. Faragy believed the attack ... was organised either by government elements or people who are fiercely opposed to foreign ownership in Egypt.” “Wena Hotels Attacked by Crowds,” *Caterer & Hotelkeeper* (April 18, 1991) [Annex W85]. Similarly, an article in the *Crawley Observer* quoted “Wena Managing Director Bernard Dibrberg” as saying “[t]his is a legal dispute with the Egyptian government. We owe money to them and they owe money to us.” “Mob Turn on Hotel Workers,” *The Crawley Observer* (April 24, 1991) [Annex W86].
- 93.** Sultan Cross-Ex., TR Day 4, at 52:19–22.

- 94.** Direct Examination of Mr. Munir Abdul Al-Aziz Gaballah Shalabi, TR Day 5, at 12:29 (“Munir Direct Ex.”).
- 95.** Jelcic Direct Ex., TR Day 3, at 97:23–98:13; Webster Direct Ex., TR Day 3, at 16:17–17:12 & 19:8–15; Jelcic Declaration, ¶ 14; Declaration of Mr. Simon Webster, ¶¶ 30–31, attached to Claimant’s Memorial on the Merits (“Webster Declaration”).
- 96.** *Id.*
- 97.** See Kasr El-Nile Police Report (April 1, 1991) [Annex E-M25]; Munir Cross-Ex., TR Day 5, at 101:11–12.
- 98.** Kasr El-Nile Police Report, at 1 (April 1, 1991) [Annex E-M25].
- 99.** *Id.*
- 100.** Kasr El-Nile Police Reports, at 9 (April 1, 1991) [Annex E-M25] (brackets in original English translation).
- 101.** See Jelcic Direct Ex., TR Day 3, at 100:22–101:4; Webster Direct Ex., TR Day 3, at 20:2–8.
- 102.** See Jelcic Direct Ex., TR Day 3, at 100:26–101:15; Webster Direct Ex., TR Day 3, at 21:20–22:1; Statement of Ms. Angela Jelcic to Kasr El-Nile Police (April 2, 1991) [Annex W82]; Statement of Mr. Simon Webster to Kasr El-Nile Police (April 2, 1991) [Annex W83].
- 103.** See Kasr El-Nile Police Reports (April 2, 1991) [Annex E-M25]. The Tribunal also heard testimony from Mr. Tahir Al-Misiri Qasim (TR Day 4 at 223:8 *et seq.*) and Mr. Sameer Muhammad Khatir (TR Day 4 at 231:23 *et seq.*) to the effect that there was no violence at the time of the takeover. This testimony is inconsistent with the testimony of Webster and Jelcic and the other witnesses who testified consistently with Webster and Jelcic. Since the testimony of Mr. Qasim and Mr. Khatir has also been found inconsistent with the decision of the Southern Cairo Court of Appeal, which characterized the situation at the Nile Hotel on April 1, 1991 as including many acts of violence, the Tribunal has chosen not to rely on the testimony of these two witnesses.
- 104.** Yusseri Statement, ¶¶ 9–11.
- 105.** Police Statement Number 984, at 1 (April 2, 1991) [Annex W132].
- 106.** *Id.*
- 107.** *Id.*, at 3.
- 108.** Police Statement Number 959, at 1 (April 1, 1991) [Annex E-J18].
- 109.** *Id.*
- 110.** Memorandum from the Public Prosecutor’s Office, at 3 (April 13, 1992) [Annex W133].
- 111.** Sultan Cross-Ex., TR Day 4, at 55:14–18. See also Sultan Statement, ¶ 20.
- 112.** Sultan Cross-Ex., TR Day 4, at 55:21–23.
- 113.** Sultan Cross-Ex., TR Day 4, at 56:2.
- 114.** See, e.g., Direct Examination of Minister Fouad Sultan, TR Day 3, at 180:19–21 (“Sultan Direct Ex.”); Sultan Cross-Ex., TR Day 4, at 58:12–13.
- 115.** See, e.g., Sultan Direct Ex., TR Day 3, at 176:11–14 (“I fully agree that it is a wrong action taken by the EHC, notwithstanding their rights, but they should not have taken that action. They

should have gone to arbitration or to the court.-).

**116.** Sultan Direct Ex., TR Day 3, at 175:9–11. Minister Sultan apparently was referring to the dispute between Southern Pacific Properties (Middle East) Limited (“SPP”) and the Arab Republic of Egypt regarding the development of tourist complex in Egypt, which eventually resulted in a decision that Egypt had expropriated SPP’s investment and an award in favor of SPP. See *Southern Pacific Properties (Middle East) Limited v. Arab Republic of Egypt*, ICSID Case No. ARB/84/3, 8 ICSID Review 328 (1993) [Annex W61].

**117.** See, e.g., Sultan Cross-Ex., TR Day 4 at 57:10–28 & 59:9–61:1.

**118.** Sultan Direct Ex., TR Day 4, at 176:25–28. See also Sultan Cross-Ex., TR Day 4, at 57:17–21 (“As I said, I will not take back again the law in my hand and take action with the police to evict him [Mr. Kandil] from the hotel. This is something which has to be settled according to our description [sic] laws by a court and not by an administrative decision.”).

**119.** See, e.g., Malins Declarations, ¶ 6.

**120.** See Letter from Mr. Nael El-Faragy (Wena Hotels Ltd.) to His Excellency, Ambassador Shaker (Egyptian Ambassador to the United Kingdom) (July 9, 1991) [Annex W50].

**121.** See Letter from the Director General of the Civil Defense Authority (January 4, 1992) [Annex E-M43].

**122.** See Munir Direct Ex., TR Day 5, at 31:6–7; Munir Statement, ¶ 22.

**123.** Letter from Mr. Webster (Wena Hotels Ltd.) to Mr. Ceurvost (British Embassy, Egypt) (February 21, 1991) [Annex W130].

**124.** *Id.* See also Webster Direct Ex., TR Day 3, at 26:6–16.

**125.** Munir Statement, ¶ 22.

**126.** Munir Direct Ex., TR Day 5, at 30:10–28. See also Munir Statement, ¶ 22–23.

**127.** *Id.*

**128.** Police Report on Hand-over of the Nile Hotel (February 25, 1992) [Annex W137].

**129.** See, e.g., Malins Direct Ex., TR Day 4, at 179:1–20; Webster Direct Ex., TR Day 3, at 26:20–24; Jelcic Direct Ex., TR Day 3, at 109:3–8.

**130.** See Munir Cross-Ex., TR Day 5, at 89:3–11; Munir Statement, ¶ 24.

**131.** Jelcic Direct Ex., TR Day 3, at 110:23–25; Faragy Declaration, ¶ 27.

**132.** Yusseri Statement, ¶ 13.

**133.** Report on Hand-over of the Luxor Hotel (April 28, 1992) [Annex E-M30].

**134.** See, e.g., Malins Direct Ex., TR Day 4, at 179:1–20; Jelcic Direct Ex., TR Day 3 at 110:13–22.

**135.** See, e.g., Yusseri Direct Ex., TR Day 5, at 113:7–11; Jelcic Direct Ex., TR Day 3, at 113:15–20; Letter from Classic Edition Travel to Wena (March 16, 1995); Letter from Inter Air Travel Limited to Wena (April 11, 1995).

**136.** See, e.g., Malins Direct Ex., TR Day 4, at 180:23–181:23.

**137.** Letter from Mr. Humfrey Malins, M.P. (Parliamentary Consultant, Wena) to the Honorable Lee

H. Hamilton (Chairman, Subcommittee on Europe & the Middle East, U.S. House of Representatives) (November 11, 1992) [Annex W131].

**138.** See decision of the Southern Cairo Court of Appeal (January 16, 1994) [Annex W135].

**139.** *Id.*

**140.** See Munir Direct Ex., TR Day 5, at 32:11–17; Munir Cross-Ex., TR Day 5, at 91:11–92:12.

**141.** Decision of the Southern Cairo Court of Appeal (January 16, 1994) [Annex W135]; Munir Cross-Ex., TR Day 5, at 94:23.

**142.** Munir Cross-Ex., TR Day 5, at 93:20–94:26.

**143.** Redirect Examination of Ms. Angela Jelcic, TR Day 3, at 155:22–156:22 (“Jelcic Redirect Ex.”).

**144.** Nile Hotel Arbitration Award, at 1 (April 10, 1994) [Annex E-M19].

**145.** Luxor Hotel Arbitration Award, at 1 (September 29, 1994) [Annex E-J31].

**146.** Nile Hotel Arbitration Award (April 10, 1994) [Annex E-M19].

**147.** Annual Return and Financial Statements for Wena Hotels Limited (period ended December 31, 1995) [Annex E-J14]; Letter from Kevin Heath, Esq. (Lester Aldridge, Solicitors for Wena) to Mr. Nael El-Faragy (Wena Hotels Ltd.) (March 20, 1999) [Annex W16].

**148.** Check drawn in Wena's favor by the Egyptian Ministry of Justice [Annex W93].

**149.** Luxor Hotel Arbitration Award, at 1 (September 29, 1994) [Annex E-J31].

**150.** Cairo Court of Appeal's Judgement (December 20, 1995) [Annex E-J32].

**151.** Yusseri Direct Ex., TR Day 5, at 112:9–29; Annual Return and Financial Statements for Wena Hotels Limited (period ending December 31, 1996) [Annex E-J15].

**152.** Claimant's Request for Arbitration, at 16.

**153.** See Munir Statement, ¶ 3; Egyptian Law Number 97 of 1983 governing Public Sector Authorities and Affiliated Companies (“Law Number 97 of 1983”) [Annex W65].

**154.** Sultan Statement, ¶ 4.

**155.** Sultan Cross-Ex., TR Day 3, at 227:26–28.

**156.** *Id.*, at 228:2–8

**157.** See Sultan Statement, ¶8; Sultan Cross-Ex., TR Day 3, at 211:26–212:2; Law Number 97 of 1983, art. 30 [Annex W65].

**158.** See Prime Minister's Decree No. 539 of 1989 [Annex E-M27]; Sultan Statement, ¶8; Sultan Cross-Ex., TR Day 3, at 211:17–23. Mr Kandil's appointment “by virtue of the Decree of the Prime Minister No. 539/1989” was noted in both the Nile and Luxor agreements. See Luxor Hotel Lease and Development Agreement, at 1 [Annex W4]; El Nile Hotel Lease and Development Agreement, at 1 [Annex 5].

**159.** See Munir Statement, ¶ 4.

**160.** Law Number 97 of 1983, art. 37 [Annex W65]. See *also* Sultan Cross-Ex., TR Day 3, at

214:18–215:11; Munir Cross-Ex., TR Day 5, at 44:4–17.

**161.** Munir Statement, ¶4.

**162.** Record of the Lower House Session No. 99, at 36 (July 14, 1992) [Annex W67] (Arabic original). See *also* Sultan Cross-Ex., TR Day 3, at 209:12–26.

**163.** Letter from Mr. Abdel-Moneim Rashad (Director General, Minister's Office — Ministry of Tourism) to Ms. Angela Jelcic (Wena Hotels Ltd.) (February 20, 1992) [Annex W66].

**164.** See, e.g., Luxor Police State Report No. 959 of 1991, at 12 & 26 (April 1, 1991) [Annex E-M18]; Kasr El-Nile Police Report, at 6 (April 1, 1991) [Annex E-M25] (“The Egyptian Hotels Corporation is a public sector company and its funds are property of the state.”); Letter from Mr. Kamal Kandil (Chairman, EHC) to Mr. Nael El-Faragy (Wena Hotels Ltd.) (March 30, 1991) [Annex W80]. See *also* Munir Cross-Ex., TR Day 5, at 47:10–11.

**165.** Letter from Mr. Kamal Kandil (Chairman, EHC) to Mr. Humfrey Malins, M.P. (Parliamentary Consultant, Wena) (March 31, 1991) [Annex W129].

**166.** Minutes of Meeting between Representatives of the Ministry of Tourism, EHC and Wena (February 26, 1991) (emphasis added) [Sultan Statement, Attachment B; also Annexes E-M22 & W124]. During testimony regarding the meaning of this statement, Minister Sultan explained that “I cannot give up entitlements or the rights of the State. If the right of the State is to collect rent I cannot give that right up.” Sultan Cross-Ex., TR Day 3, at 230:2–4.

**167.** Luxor Police State Report No. 959 of 1991, at 8 (emphasis added) [Annex E-M18].

**168.** Respondent's Post-Hearing Memorial at 15.

**169.** See Consultancy Agreement between Mr. Kamal Kandil and Wena Hotels Limited [Annex WI49].

**170.** *Id.*

**171.** Writ of Summons issued by Wena Hotels Limited against Mr. Mohamed Kamal Ali Mohamed Kandil (March 26, 1991) [Annex E-M7].

**172.** Letter from Mr. Kamal Kandil to the Senior Master of the Royal Court of Justice (August 19, 1991) [Annex W150].

**173.** *Id.* at 1.

**174.** *Id.*

**175.** *Id.*

**176.** See Facsimile from Mr. Dimopolous (Wena Hotels Ltd.) to Mr. Kamal Kandil (Chairman, EHC) (December 13, 1989), enclosing letter from Mr. Nael El-Faragy (Wena Hotels Ltd.) to His Excellency, the Governor of Aswan (December 11, 1989) [Annex W188]; letter from Mr. Nael El-Faragy (Wena Hotels Ltd.) to His Excellency, the Governor of Aswan (January 15, 1990) [Annex W189].

**177.** Faragy Direct Ex., TR Day 1, at 142:27–28. See *also* Faragy Direct Ex., TR Day 1, at 142:26–143:6.

**178.** Sultan Direct Ex., TR Day 3, at 188:11–14.

**179.** Respondent's Post-Hearing Memorial, at 14.

- 180.** Claimant's Post-Hearing Reply, at 16 (submitted on June 15, 2000).
- 181.** Claimant's Memorial on the Merits, at 43–51.
- 182.** *Id.*, at 51–54.
- 183.** Respondent's Memorial on the Merits, at 8–40.
- 184.** *Id.*, at 40–42.
- 185.** *Id.*, at 42–44.
- 186.** Respondent's Post-Hearing Memorial, at 15.
- 187.** IPPA, art. 2(2) [Annexes W2 & E-J22].
- 188.** IPPA, art 5(1) [Annexes W2 & E-J22].
- 189.** Respondent's Opening Statement, TR Day 1, at 29:24–28. *See also* Claimant's Opening Statement, TR Day 1, at 15:24–25 (“the basis of this action is the breach of [the] Bilateral Treaty by Egypt”).
- 190.** *See, e.g.*, Claimant's Reply on the Merits, at 48–50. *See also* Claimant's Memorial on the Merits, at 42; Respondent's Memorial on the Merits, at 7–8 (referring, in regard to Respondent's second defense, to “practices condemned by both Egyptian and international law.”).
- 191.** *See, e.g.*, Claimant's Memorial on the Merits, at 43–51; Claimant's Reply on the Merits, at 29–38 (submitted on September 27, 1999); Claimant's Post-Hearing Brief, at 41–44.
- 192.** Claimant's Memorial on the Merits, at 51–54; Claimant's Reply on the Merits, at 39–44; Claimant's Post-Hearing Brief, at 44–46.
- 193.** Respondent's Post-Hearing Rebuttal Memorial, at 8 (submitted on June 15, 2000).
- 194.** IPPA, art. 2(2) [Annex W2 & E-J22].
- 195.** *American Manufacturing and Trading, Inc. v. Republic of Zaïre*, ICSID Case No. ARB/93/1, at 28 (1997) [Annex W115]. Article 11(4) of the Zaire-United States bilateral investment treaty, much like Article 2(2) of the IPPA, provides that “[i]nvestment of nationals and companies of either Party shall at all times be accorded fair and equitable treatment and shall enjoy protection and security in the territory of the other party.” *Id.*, at 28 [Annex W115].
- 196.** *AAPL v. Sri Lanka*, ICSID Case No. ARB/87/3, at 545 (1990) [Annex W1 17; a digested version of the decision has also been provided at Annex E-M35] The wording of Article 2(2) of the bilateral investment treaty in that case (between Sri Lanka and the United Kingdom) is almost identical to that in the same article in the IPPA: “Investment of nationals and companies of either Party shall at all times be accorded fair and equitable treatment and shall enjoy protection and security in the territory of the other Party.” Agreement for the Promotion and Protection of Investments, February 13, 1980, U.K.-Sri Lanka [Annex W41].
- 197.** *AAPL v. Sri Lanka*, at 546 (quoting Alwyn V. Freeman, *Responsibility of States for Unlawful Acts of Their Armed Forces*, 14 (1957)) [Annex W1 17; also Annex E-M35].
- 198.** The evidence submitted by the parties does suggest a unity of interest between EHC and Egypt such that it is possible that Egypt might have authorized and participated in the seizures of the hotels. The repeated reference in contemporaneous documents to EHC as a “government company,” to its money as “public money” and to its rights as “the Government's rights” or “state ownership” is particularly compelling in this regard. *See, e.g.*, Luxor Police State Report No. 959 of



1991, at 8, 12 & 26 (April 1, 1991) [Annex E-M18]; Kasr El-Nile Police Report, at 6 (April 1, 1991) [Annex E-M25]; Letter from Mr. Kamal Kandil (Chairman, EHC) to Mr. Nael El-Faragy (Wena Hotels Ltd.) (March 30, 1991) [Annex W80]; Letter from Mr. Kamal Kandil (Chairman, EHC) to Mr. Humfrey Malins, M.P. (Parliamentary Consultant, Wena) (March 31, 1991) [Annex W129]; Minutes of Meeting between Representatives of the Ministry of Tourism, EHC, and Wena (February 26, 1991) [Sultan Statement, Attachment B; also Annexes E-M22 & W124]. Nevertheless, the Tribunal concludes that Wena has failed to satisfy its burden of proving that Egypt actually participated in the seizures of the two hotels. For example, although both Ms. Jelcic and Mr. Webster believe that Ministry of Tourism officials were present at the Nile Hotel, they both admit that they were, personally, unable to identify any such officials. See, e.g., Jelcic Direct Ex., TR Day 3, at 97:10–13; Webster Direct Ex., TR Day 3, at 14:6–12.

**199.** Malins Direct Ex.. TR Day 4, at 175:1–4.

**200.** *Id.*, at 175:26–29. See also Malins Declaration, ¶ 4.

**201.** Letter from Mr. Nael El-Faragy (Wena Hotels Ltd.) to Minister Fouad Sultan (Minister of Tourism) (February 11, 1991) (emphasis added; brackets in original English translation) [Sultan Statement, Attachment A; also Annexes E-M21 & W127].

**202.** Letter from Mr. Kamal Kandil (Chairman, EHC) to Minister Fouad Sultan (Minister of Tourism) (March 21, 1991) [Sultan Statement, Attachment D; also Annex W126].

**203.** *Id.*

**204.** *Id.* (Arabic original). See also Sultan Cross-Ex., TR Day 3, at 235:23–237:27; Sultan Statement, ¶ 17.

**205.** Letter from Mr. Humfrey Malins, M.P. (Parliamentary Consultant, Wena) to Minister Fouad Sultan (Minister of Tourism) (March 25, 1991) [Annex W128].

**206.** Letter from Mr. Kamal Kandil (Chairman, EHC) to Mr. Humfrey Malins, M.P. (Parliamentary Consultant, Wena) (March 31, 1991) [Annex W128].

**207.** *Id.*

**208.** Sultan Cross-Ex., TR Day 3, at 233:2–5.

**209.** Sultan Cross-Ex., TR Day 3, at 175:9–10.

**210.** See, e.g., Kasr El-Nile Police Reports (April 1–2, 1991) [Annex E-M25]; Police Statement of Mr. Tamim Foda (July 6, 1991) [Annex W134]; Police Statement of Mr. Mostafa Ahmed Osman (July 6, 1991) [Annex W134]; Police Statement of Mr. Sherif Ibrahim Mohamed Khalifa (July 6, 1991) [Annex W134]; Police Statement of Mr. Mohamed Sabry Ismail Emam (July 6, 1991) [Annex W134]; “British Tourists are Beaten and Thrown Out of Egypt Hotels,” *Daily Telegraph* (April 4, 1991) [Annex W7].

**211.** See Jelcic Direct Ex., TR Day 3, at 97:23–98:13; Webster Direct Ex., TR Day 3, at 16:17–17:12 & 19:8–15; Jelcic Declaration, ¶ 14; Webster Declaration, ¶ 30–31; Kasr El-Nile Police Report (April 1, 1991) [Annex E-M25]; Munir Cross-Ex., TR Day 5, at 101:11–12.

**212.** See Police Statement Number 984 (April 2, 1991) [Annex W132]; Police Statement Number 959 (April 1, 1991) [Annex E-J18].

**213.** See, e.g., Sultan Direct Ex. TR Day 3, at 180:19–21 Sultan Cross-Ex., TR Day 4, at 58:12–13.

**214.** See, e.g., Sultan Direct Ex., TR Day 3, at 176:11–14 (“I fully agree that it is a wrong action taken by the EHC, notwithstanding their rights, but they should not have taken that action. They

should have gone to arbitration or to the court.”).

**215.** See, e.g., Sultan Cross-Ex., TR Day 4 at 57:10–28 & 59:9–61:1.

**216.** Law Number 97 of 1983, art. 37 [Annex W65]. See also Sultan Cross-Ex., TR Day 3, at 214:18–215:11; Munir Cross-Ex., TR Day 5, at 44:4–17.

**217.** Sultan Cross-Ex., TR Day 3, at 227:26–28.

**218.** *Id.*, at 228:2–8.

**219.** Munir Statement, ¶ 4. See also Record of the Lower House Session No. 99, at 36 (July 14, 1992) [Annex W67]; Letter from Mr. Abdel-Moneim Rashad (Director General, Minister's Office — Ministry of Tourism) to Ms. Angela Jelcic (Wena Hotels Ltd.)(February 20, 1992) [Annex W66].

**220.** See Munir Direct Ex., TR Day 5, at 31:6–7; Munir Statement, ¶ 22; Yusseri Statement, ¶ 13.

**221.** See, e.g., Farargy Declaration, ¶ 26.

**222.** Letter from Mr. Webster (Wena Hotels Ltd.) to Mr. Ceurvost (British Embassy, Egypt) (February 21, 1991) [Annex W130].

**223.** *Id.* See also Webster Direct Ex., TR Day 3, at 26:6–16.

**224.** See, e.g., Malins Direct Ex., TR Day 4, at 179:1–20; Webster Direct Ex., TR Day 3, at 26:20–24; Jelcic Direct Ex., TR Day 3, at 109:3–8 & 110:13–22.

**225.** See Munir Cross-Ex., TR Day 5, at 89:3–11; Munir Statement, ¶ 24.

**226.** See Munir Direct Ex., TR Day 5, at 30:10–28; Munir Statement, ¶ 22–23; Police Report on Hand-over of the Nile Hotel (February 25, 1992) [Annex W137].

**227.** Munir Direct Ex., TR Day 5, at 30:10–28.

**228.** See, e.g., Malins Direct Ex., TR Day 4, at 180:23–181:23.

**229.** Letter from Mr. Humfrey Malins, M.P. (Parliamentary Consultant, Wena) to the Honorable Lee H. Hamilton (Chairman, Subcommittee on Europe & the Middle East, U.S. House of Representatives) (November 11, 1992) [Annex WI 31].

**230.** See Decision of the Southern Cairo Court of Appeal (January 16, 1994) [Annex W134]; Munir Cross-Ex., TR Day 5, at 94:23.

**231.** Jelcic Redirect Ex., TR Day 3, at 155:22–156:22.

**232.** Munir Cross-Ex., TR Day 5, at 93:20–94:26.

**233.** IPPA, art 5(1) [Annex W2&E-J22].

**234.** Ian Brownlie, *Principles of International Law*, 537 (4<sup>th</sup> Ed. 1990) [Annex W104]. Professor Brownlie also accurately observes that “in any case form should not take precedence over substance.” *Id.*

**235.** *Amco Asia Corporation, et al. v. Republic of Indonesia*, Award on the Merits, ICSID Case No. ARB/81/1, at 62 (1984) [Annex W94].

**236.** *Id.*

**237.** *Southern Pacific Properties (Middle East) Limited v. Arab Republic of Egypt*, ICSID Case No.

ARB/84/3, 8 ICSID Review 328, 375 (1993) [Annex W61]. See also G.C. Christie "What Constitutes a Taking of Property Under International Law," 38 Brit. Y.B. Int'l L. 308, 310–311 (1962) (citing *German Interests in Polish Upper Silesia*, Judgement No. 7, PCIJ, Series A (1926)) [Annex E-M11].

**238.** *Tippets, Abbett, McCarthy, Stratton v. TAMS-AFFA Consenting Engineers of Iran et al.*, Iran-U.S. Claims Tribunal, Award No. 141-7-2, at 225 (June 22, 1984) [Annex E-M12]. In some legal systems, a lease of land or a building is deemed real property.

**239.** *Id.*

**240.** See generally discussion in section III.B.1, *supra*.

**241.** See, e.g. Respondent's Memorial on the Merits, at 10–11; Respondent's Rejoinder on the Merits, at 6–8.

**242.** *Tippets*, at 225 [Annex E-M12]. Such a deprivation easily qualifies as an expropriation within the meaning of Article 3(a) of the Harvard Draft Convention on the International Responsibility of States for Injuries to Aliens, 55 *Amer. J. Int'l L.* 545 (1961) ("A 'taking of property' includes not only an outright taking of property but also any such unreasonable interference with the use, enjoyment, or disposal of property as to justify an inference that the owner will not be able to use, enjoy or dispose of the property within a reasonable period of time after the inception of such interference." ("as quoted in G.C. Christie "What Constitutes a Taking of Property Under International Law," 38 Brit. Y.B. Int'l L. 308, 330 (1962) [Annex E-M11])).

**243.** IPPA, art 5(1) [Annex W2 & E-J22]. See also Ian Brownlie, *Principles of International Law*, 537 (4<sup>th</sup> ed. 1990) ("Expropriation of particular items of property is unlawful unless there is provision for payment of effective compensation." [Annex W104]).

**244.** Letter from Mr. Humfrey Malins, M.P. (Parliamentary Consultant, Wena) to the Honorable Lee H. Hamilton (Chairman, Subcommittee on Europe & the Middle East, U.S. House of Representatives) (November 11, 1992) [Annex W131]. See also Malins Direct Ex., TR Day 4, at 180:23–181:23; Letter from Mr. Nael El-Faragy (Wena Hotels Ltd.) to His Excellency, Ambassador Shaker (Egyptian Ambassador to the United Kingdom) (July 9, 1991) (complaining about the apparent breakdown in negotiations between Egypt and Wena) [Annex W50].

**245.** Respondent's Memorial on the Merits, at 42–44.

**246.** Translation of Article 172(I) of the Egyptian Civil Code (Annex E-M36).

**247.** Respondent's Memorial on the Merits, at 43.

**248.** *Id.*, at 44.

**249.** Claimant's Reply on the Merits, at 49.

**250.** See, e.g., Respondent's Memorial on Jurisdiction, at 2.

**251.** Respondent's Post-Hearing Memorial, at 25.

**252.** See, e.g., *Gentini Case*, Italy-Venezuela Mixed Claims Commission, X R.S.A. 551, 560–561, (1903) [Annex W147].

**253.** See, e.g., Letter from Mr. Nael Faragy (Wena Hotels Ltd.) to His Excellency Dr. Kamal El Ganzouri (Prime Minister of Egypt) (February 23, 1998) (complaining of Wena's "long and bitter disputes with the Egyptian State over direct foreign investment in Egypt.") [Annex W15].

**254.** *Alan Craig v. Ministry of Energy of Iran*, 3 Iran-U.S. Claims Tribunal 280 (1984) [Annex W155]. See also George Aldrich, *The Jurisprudence of the Iran-United States Claims Tribunal* 480–482

(1996) [Annex E-M47].

**255.** *Id.*, at 287.

**256.** *Gentini Case*, Italy-Venezuela Claims Commission, X R.S.A. 551 (1903) [Annex W147]

**257.** *Amco Asia Corporation, et al. v. Republic of Indonesia*, ICSID Case No. ARB/81/1, International Arbitration Report 649,654 (1986) [Annex W102].

**258.** IPPA, art 8(1) [Annexes W2 & E-J22].

**259.** Legal opinion of Dr. Hossam Al' din Kamil Elehwany, at 23 (September 1999) [Annex E-M8].

**260.** *Id.*

**261.** *Id.*, at 25 (emphasis added).

**262.** Respondent's Post-Hearing Memorial, at 15.

**263.** See, e.g., Professor Ibrahim Fadlallah, *L'ordre public dans les sentences arbitrales*, Académie de Droit International, Recueil des Cours, 377 (1994-V); Professor Pierre Lalive, "Transnational (or Truly International) Public Policy and International Arbitration," *ICCA Congress Series*, No. 3, 276–277 (1987) [Annex E-M10].

**264.** Lalive, at 277 [Annex E-M10].

**265.** Consultancy Agreement between Mr. Kamal Kandil and Wena Hotels Limited [Annex W149].

**266.** Writ of Summons issued by Wena Hotels Limited against Mr. Mohamed Kamal AH Mohamed Kandil (March 26, 1991) [Annex E-M7].

**267.** Letter from Mr. Kamal Kandil to the Senior Master of the Royal Court of Justice (August 19, 1991) [Annex W150] (the "subject of the above-mentioned Draft Contract was to develop new hotels in Egypt, these hotels being the Ramses Village project in Abou Simbal and a Conference Center in Aswan city. ... I did not act in my quality of Chairman of the Egyptian Hotels Company nor did the Draft Contract concern either the Nile Hotel or the Luxor Hotel, instead I acted as Tourist Consultant for the Aswan Government and Chairman of the Board of Directors of Misr Aswan Tourist Co.").

**268.** Facsimile from Mr. Dimopolous (Wena Hotels Ltd.) to Mr. Kamal Kandil (Chairman, EHC) (December 13, 1989), enclosing letter from Mr. Nael El-Faragy (Wena Hotels Ltd.) to his Excellency, the Governor of Aswan (December 11, 1989) [Annex W188]; letter from Mr. Nael El-Faragy (Wena Hotels Ltd.) to his Excellency, the Governor of Aswan (January 15, 1990) [Annex W189].

**269.** Yusseri Direct Ex., at 4:3–11.

**270.** Faragy Direct Ex., TR Day 1, at 142:27–28. See also Faragy Direct Ex., TR Day I, at 142:26–143:6.

**271.** Sultan Direct Ex., TR Day 3, at 188:11–14.

**272.** See, e.g., Claimant's Post-Hearing Reply, at 16; Respondent's Post-Hearing Memorial, at 14.

**273.** IPPA, art. 5 [Annexes W2 & E-J22].

**274.** Claimant's Post-Hearing Brief, at 67.

**275.** *Id.*, at 68; Claimant's Statement of Fees and Expenses [Annex W194].

- 276.** Claimant's Post-Hearing Brief, at 67 & n. 64; Claimant's Post-Hearing Reply, at 36.
- 277.** Respondent's Post-Hearing Memorial, at 25–42; Respondent's Post-Hearing Rebuttal Memorial, at 22–34.
- 278.** Respondent's Post-Hearing Memorial, at 43; Respondent's Post-Hearing Rebuttal Memorial, at 34; *Provisional Evaluation of Lost Investment and Review of Financial Information* prepared by Pannell Kerr Forster, attached to Respondent's Rejoinder on the Merits; Direct Examination of Mr. Hugh Matthew Jones, TR Day 4, at 135:12–15.
- 279.** See *Expert Report* prepared by BDO Hospitality Consulting, attached to Claimant's Memorial on the Merits (calculating a profit of GB£ 4 million for the Luxor Hotel and a profit of GB£ 21.3 million for the Nile Hotel); *Reports for El-Nile and Luxor Hotels* prepared by Pannell Kerr Forster, attached to Respondent's Post-Hearing Memorial (calculating a profit of less than GB£ 10,000 for the Luxor Hotel and an actual loss for the Nile Hotel).
- 280.** *Metalclad Corporation v. United Mexican States*, ¶¶ 119–120, ICSID Case No. ARB(AF)/97/1 (2000) (internal citation omitted). The *Metalclad* award is publicly available from the U.S Securities Exchange Commission, Washington, D.C. 20549, and electronically at <http://www.edgar-online.com>, as an attachment to an 8-K filing of September 5, 2000 by Metalclad Corporation. See also *Southern Pacific Properties (Middle East) Limited v. Arab Republic of Egypt*, ICSID Case No. ARB/84/3, 8 ICSID Review 328, 381 (1993) [Annex W61] (“In the Tribunal's view, the DCF method is not appropriate for determining the fair compensation in this case because the project was not in existence for a sufficient period of time to generate the data necessary for a meaningful DCF calculation.”).
- 281.** *SPP (Middle East) Ltd. (Hong Kong), et al. v Arab Republic of Egypt*, ¶65, Appendix IV of ICC Arbitration (1983) [Annex E-M38].
- 282.** *American Manufacturing & Trading, Inc. v Republic of Zaire*, ICSID Case No. ARB/93/1, at 28 (1997) [Annex WI 15].
- 283.** See, e.g., *Review of Financial Information* prepared by Pannell Kerr Forster, attached to Respondent's Rejoinder on the Merits.
- 284.** Approximately GB£ 6 million at current exchange rates.
- 285.** IPPA, art. 5 [Annexes W2 & E-J22].
- 286.** See *Provisional Evaluation of Lost Investment*, ¶¶ 2.2–2.3 & 2.8, attached to Respondent's Rejoinder on the Merits.
- 287.** Check drawn in Wena' favor by the Egyptian Ministry of Justice [Annex W93].
- 288.** Claimant's Post-Hearing Brief, at 68.
- 289.** *Report for El-Nile Hotel* prepared by Pannell Kerr Forster, at 18, attached to Respondent's Post-Hearing Memorial (“Long-term government bonds in Egypt are currently yielding 10%....”).
- 290.** *Metalclad Corporation v. United Mexican States*, ¶ 128, ICSID Case No. ARB(AF)/97/1 (2000).
- 291.** As several authorities have noted, “virtually all monetary judgements ... contain rulings on interest,” and yet, this decision to award interest is often made without any discussion. See, e.g., J. Gillis Wetter, *Interest as an Element of Damages in Arbitral Process*, 5 Int'l Fin. L. Rev. 20 (1986); F.A. Mann, *Compound Interest as an Item of Damage in International Law*, 21 Univ. of California, Davis L.J. 577, 578(1988).

**292.** John Y. Gotanda, *Awarding Interest in International Arbitration*, 90 Amer. J. Int'l L. 40, 61 (1996).

**293.** F.A. Mann, *Compound Interest as an Item of Damage in International Law*, 21 Univ. of California, Davis L. J. 577, 586 (1988). *See also id.*, at 585 (“In this spirit it is necessary first to take account of modern economic conditions. It is a fact of universal experience that those who have a surplus of funds normally invest them to earn compound interest. On the other hand, many are compelled to borrow from banks and therefore must pay compound interest. This applies, in particular, to business people whose own funds are frequently invested in brick and mortar, machinery and equipment, and whose working capital is obtained by way of loans or overdrafts from banks.”); *Starrett Housing Corp. v. Iran*, 16 Iran-U.S. Claims Tribunal 112,251–254(1987) (Holtzmann, concurring).

**294.** Tribunal's Decision on Jurisdiction, at 9 (released on June 29, 1999).

**295.** Claimant's Statement of Fees and Expenses as of June 13, 2000 (Annex W194); letter from Mr. John Savage (Counsel for Wena) to Mr. Alejandro Escobar (Secretary to the Tribunal) (November 21, 2000).

Date of Dispatch to the Parties: February 21, 1997

INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES

A W A R D

AMERICAN MANUFACTURING & TRADING, INC.

v.

REPUBLIC OF ZAIRE

ICSID Case ARB/93/1

A W A R D

RENDERED BY THE ICSID ARBITRAL TRIBUNAL

composed of

Mr. Sompong	SUCHARITKUL	President
Mr. Heribert	GOLSONG	Arbitrator
and		
Mr. Kéba	MBAYE	Arbitrator
Mr. Nassib	ZIADE	Secretary

RENDERED BY THE ARBITRAL TRIBUNAL

Constituted under the Auspices  
of the International Centre for Settlement of Investment Disputes  
(ICSID)

in the Matter

AMERICAN MANUFACTURING & TRADING, INC.

v.

REPUBLIC OF ZAIRE

(ICSID CASE ARB/93/1)

Appearance before the Tribunal

For : AMT		For : ZAIRE	
Mr. Hassan	YAHFOUFI	Mr. Manzila	LUNDUM SAL'ASAL
Mr. Daniel D.	DINUR	H.E. Mr. Ramazani BAYA	
		(designated without appearance)	

## PART ONE : INTRODUCTION

### I : INSTITUTION OF ARBITRAL PROCEEDINGS

- 1.01 American Manufacturing & Trading Corporation (Zaire), Inc. (AMT), an American company incorporated in the State of Delaware of which the majority shareholders are nationals of the United States of America, addressed to the Secretary General of the International Centre for Settlement of Investment Disputes (ICSID) a letter of 25 January 1993, instituting arbitral proceedings against the Republic of Zaire by virtue of Article 36 of the Washington Convention on the Settlement of Investment Disputes between States and Nationals of other States, of 18 March 1965 (the CONVENTION).
- 1.02 After acknowledging receipt of this request for arbitration on 26 January 1993, the Secretary General transmitted on the same day a copy of said request to the Republic of Zaire delivered by special courier to the Minister of Plan of Zaire at Kinshasa, as well as by a registered letter addressed to the Ambassador of Zaire in Washington, D.C. The Secretary-General of ICSID registered the request on 2 February 1993.
- 1.03 The request of AMT is based on the provisions of a Bilateral Treaty concluded between the United States of America and the Republic of Zaire concerning the Reciprocal Encouragement and Protection of Investment (the BIT) of which the English and French text submitted by AMT was certified as true copy by the Secretary of State of the United States of America on 21 February 1995. The BIT was signed on 3 August 1984, and entered into force on 28 July 1989.
- 1.04 By letter of 2 July 1993, received by ICSID on 7 July 1993, the Claimant party informed ICSID of a change of name, and that it would hence forth be called "American Manufacturing & Trading, Inc."

1.05 In the Request for Arbitration (paragraphs 10, 11 and 15) as well as in the Additional Request of 16 March 1993, AMT in its final submission requests the Tribunal to adjudge and declare :-

- (1) That the Republic of Zaire has violated the rights of AMT recognized and protected by the provisions of BIT of 1984;
- (2) That the Republic of Zaire is thereby responsible for failing to fulfill its obligations of protection provided by the BIT, especially as regards the destructions caused by the elements of the armed forces of Zaire on 23-24 September 1991 and on 28-29 January 1993, in respect of damage to the properties and installations belonging to Société Industrielle Zaïroise (SINZA) Société privée à responsabilité limitée (SPRL) limited liability private company. 94 per cent of whose stocks are subscribed by AMT, including all losses suffered by SINZA as the result of the looting; and
- (3) That the Republic of Zaire be condemned to pay to AMT, as a measure of compensation and as damages and interests, an indemnity equivalent to
  - a) The fair market value of all the losses suffered by the investment of AMT in Zaire;
  - b) The loss of profits (*Lucrum Cessans*) which AMT would have acquired on its own behalf; and
  - c) The interests on the amount of compensation under a) and b) at a commercial rate equal to the appropriate international rate of interest for transactions in dollars from 23 September 1991 until the final payment.

1.06 Furthermore, AMT requests the Tribunal (paragraph 16 of the Request for Arbitration) to condemn the Republic of Zaire to pay for all the costs of the arbitral



proceedings, including the fees and expenses of the Members of the Tribunal, the charges for the use of ICSID facilities, as well as all other expenses incurred by AMT in the course of the proceedings, consisting of the total amount of the fees and expenses of its own counsel, advocates and other persons called upon to appear before the Tribunal, and the interests thereon calculated at a commercial rate equal to the appropriate international rate for transactions in dollars from the date of the rendering of the Award until the day of the final payment.

- 1.07 In its Request (paragraph 15), AMT asserts that in the report prepared by a branch office of Lloyds in Zaire on 14 November 1991, the direct losses were estimated at US\$ 10,524,023, without prejudice to the calculation of the total amount of compensation and interests that AMT will subsequently present. In its submission of additional claims of 16 March 1993 (paragraph 3), AMT adds that the value of the goods taken, destroyed or looted during the incidents of 28-29 January 1993 is estimated at US\$ 324,868.

## II : CONSTITUTION OF THE TRIBUNAL

- 2.01 Without any positive reaction on the part of the Republic of Zaire to the notification of the Request for Arbitration by ICSID more than 60 days after 2 February 1993, the date of registration of the Request for Arbitration, above all with regard to the nomination of arbitrators, and in the absence of agreement between the Parties, AMT has opted as for the number of arbitrators for the formula to constitute the Tribunal in accordance with the provisions of Article 37 (2)(b) of the Convention which provides for an Arbitral Tribunal composed of three arbitrators : each Party appointing one arbitrator and the President of the Tribunal appointed by agreement of the Parties.
- 2.02 At the same time, AMT has nominated Mr. Heribert GOLSONG, of German nationality as arbitrator and proposed Mr. Robert COUZIN, of Canadian nationality, as President of the Arbitral Tribunal in accordance with Article 3 (1)(a) of the ICSID

Arbitration Rules. In the absence of any nomination by the Government of Zaire more than 90 days following the delivery of notification of registration of the Request for Arbitration to the parties, AMT has requested by its letter of 5 July 1993, addressed to the Chairman of the Administrative Council of ICSID, to appoint the arbitrator not yet appointed and to nominate the arbitrator to perform the function of the President of the Tribunal in accordance with Article 4 (1) of the ICSID Arbitration Rules. The Chairman of the Administrative Council is bound to give effect to this request by AMT within 30 days following its receipt in accordance with Article 4 (4) of the Arbitration Rules, (letter of the Secretary-General of ICSID of 8 July 1993).

- 2.03 By a letter of 13 July 1993, ICSID informed the parties that the Secretary-General intended to recommend to the Chairman of the Administrative Council to appoint to the Tribunal Judge Kéba MBAYE and Professor Sompong SUCHARITKUL and to nominate Professor SUCHARITKUL as President of the Tribunal. Judge Kéba MBaye, national of Senegal, domiciled in Dakar, is a former President of the Supreme Court of Senegal and former Vice-President of the International Court of Justice. Professor Sompong Sucharitkul, national of Thailand, domiciled in San Francisco, United States, is a former member of International Law Commission and a former Ambassador of Thailand. He is currently Professor of Law at Golden Gate University School of Law. The appointments of these arbitrators as well as the nomination of the President of the Tribunal, have been confirmed by the Chairman *ad interim* of the Administrative Council of the Centre and communicated to the Parties on 26 July 1993.

- 2.04 Upon notification of the acceptance by Judge MBaye and Professor Sucharitkul, the Arbitral Tribunal of ICSID was thus constituted on 4 August 1993 in accordance with ICSID Arbitration Rule 6 (1). The establishment of the Tribunal and its composition were duly notified to the Parties on 4 August 1993. The Arbitral Tribunal is composed of :-

Mr. Sompong	SUCHARITKUL	President
Mr. Heribert	GOLSONG	Member
Mr. Kéba	MBAYE	Member

Mr. Nassib G. Ziadé, Counsel, ICSID, was designated as Secretary of the Tribunal by the Secretary-General of ICSID.

### III : PROCEDURAL DEVELOPMENTS

#### A. THE FIRST SESSION OF THE TRIBUNAL

3.01 On 1 October 1993, the Arbitral Tribunal held its first meeting with the Parties in Washington, D.C. This session was devoted exclusively to the questions concerning organization of the procedures to follow, including the written proceedings as well as the oral proceedings. In the absence of representation on the part of Zaire, the oral phase of the proceedings has become inevitable. The Tribunal fixed the time-limits for the filings of the Memorial and the Counter-Memorial by the Parties. The conclusion of the Tribunal were recorded in details in the Minutes of the Meeting for preliminary procedural consultation of 1 October 1993, of which a copy was distributed to each Party to the dispute.

#### B. WRITTEN PLEADINGS FILED BY THE PARTIES

3.02 In accordance with the time-limits fixed for the filing of written pleadings and the requests made by each Party in turn for extension of the time-limits thus fixed by the Tribunal, the Parties filed the following written pleadings :

- a) The Memorial by the Claimant  
on 9 December 1993;

- b) The Counter-Memorial by the Respondent raising at the same time an objection to the jurisdiction of ICSID and of the Tribunal  
on 30 May 1994;
- c) The Reply by the Claimant, replying and making observations on the objection to the jurisdiction of ICSID and of the the Tribunal  
on 17 June 1994;
- d) The Rejoinder by the Respondent  
on 19 July 1994.

3.03 a) The Memorial, filed by the Claimant on 9 December 1993 with 8 annexes, reiterated and consolidated the claims contained in the Request for Arbitration of 20 January 1993 and the Additional Request of 16 March 1993, giving an account of the events preceding and giving rise to the dispute between the Parties. The Memorial recalled the origin of the investments made by AMT which through SINZA was engaged in industrial and commercial activities in Zaire, namely, (a) the production and sale of automotive and dry cell batteries; and (b) the importation and resale of consumer goods and foodstuffs.

3.04 In its Memorial, AMT gave further details of the losses suffered by SINZA as the result of the destruction of property located in the industrial complex for the production of automotive and dry cell batteries and the looting on 23-24 September 1991 by certain members of the Zairian armed forces stationed at Camp Kolole in Zone de la Gombe. These soldiers also broke into the commercial complex and the stores, destroyed, damaged and carried away all the finished goods and almost all the raw materials and objects of value found on the premises. The commercial complex was reopened in February 1992, but since the second destruction of 28-29 January 1993, it was permanently closed.

- 3.05 In the Annexes, the Memorial estimated the total amount of compensation at US\$ 14,339,610. This total comprises : (a) US\$ 12,793,850 for the industrial complex in 1991; (b) US\$ 1,220,900 for the commercial complex and the two stores in 1991; and (c) US\$ 324,860 for the physical damage suffered by the commercial complex and the two stores in 1993.
- 3.06 AMT requested a sum of US\$ 21,574,405 to be paid by the Government of Zaire as compensation, plus 8 per cent interest on this sum since 23 September 1991, and for the sum of US\$ 305,368 since 30 January 1993. In addition, AMT claimed compensation for all expenses incurred in the course of the proceedings, the two reports of Lloyds for US\$ 126,500, and all other expenses and fees paid by AMT including those of the Centre, of the Members of the Tribunal as well as of the Counsel and Advocate and other expenses that the Tribunal may consider appropriate.
- 3.07 In its Memorial, AMT based its claims on the provisions of Article 42 (1) of the Convention and on Articles II (4), III (1) and IV (2) of the BIT.
- 3.08 b) The Counter-Memorial filed by the Respondent on 30 May 1994, contained a summary of the facts, emphasizing that SINZA *"has been the object of looting in 1991, as it was indeed the case with all the others"*.
- 3.09 The Counter-Memorial raised several preliminary objections to the jurisdiction of ICSID and consequently to the competence of the Tribunal, on the ground of a defect in the status of AMT without the capacity to act in the name of SINZA. The Respondent challenged the jurisdiction of ICSID to entertain the case instituted by AMT, without the existence of a dispute between AMT and the Republic of Zaire, but in the actual case, the dispute was ultimately between SINZA, a Zairian Company, and the Republic of Zaire.
- 3.10 Zaire raised the objection based on AMT's failure to comply with Article VIII of

- the BIT, requiring settlement of dispute by means of consultation between representatives of the two Parties and, failing that, by other diplomatic channels. The Counter-Memorial maintained that it was only after all these means had failed that it would have been possible to have recourse to ICSID Arbitration.
- 3.11 The Counter-Memorial raised another objection on the ground of inadmissibility of AMT's request for non-compliance with Articles II, IV and IX of the BIT without adducing any evidence that the State of Zaire *"has granted in like circumstances a treatment no less favorable to SINZA than it had accorded to its own nationals or companies"*.
- 3.12 Besides, Zaire relied on Article IX of the BIT which stipulates that the present Treaty (BIT) shall not supersede, prejudice, or otherwise derogate from the laws, regulations, administrative practices or procedures or adjudicatory decisions of either Party, basing itself on Zairian Ordinance Law No. 69-044 of 1 October 1966, relating to the injuries suffered as the result of the disturbances which declared inadmissible all actions based on general law in matters of civil liability, seeking to condemn the State to pay compensation for the losses or injuries suffered in connection with the riots or insurrections. The Counter-Memorial confirmed as a consequence that the claim made by AMT was inadmissible, because the Treaty under reference could not derogate from this legal provision on public policy matters.
- 3.13 Finally, the Government of Zaire raised an additional objection based on the inadmissibility of AMT's claim for violations of Articles 45 and 46 of the Code of Investment of Zaire, AMT being a United States company which has never made any direct investment in the State of Zaire, whereas SINZA, the direct investor for this purpose is a legal entity of Zairian nationality, exclusively empowered to institute arbitral proceedings under Article 45 of Zairian Investment Code.
- 3.14 c) The Reply, filed by AMT on 17 June 1994, answered the objections raised

by the Government of Zaire to the jurisdiction of ICSID and consequently to the competence of the Tribunal. AMT presented its observations on the questions of inadmissibility of its claims as to the jurisdiction of ICSID as well as its merits.

3.15 In its Reply, AMT rejected all the objections and exceptions raised by the Respondent, underlying the fact that it was AMT which was always the direct investor in Zaire, as majority stockholder of SINZA, an industrial corporation established in Zaire but deemed to be a legal entity of United States nationality for the purpose of ICSID jurisdiction.

3.16 In this Reply, the Claimant took occasion to propose the date for the hearing before the Tribunal in the course of the first week of September 1994. After consultation with the Parties, the Tribunal fixed the date of the beginning of hearing on 4 November 1994 at the headquarters of ICSID in Washington, D.C. and this date was communicated to the Parties by the Secretary of the Tribunal in his letter of 23 August 1994. On 13 October 1994, AMT requested that this date be postponed till after 4 November 1994. Upon this request, the Tribunal fixed 5 and 6 December 1994 as new dates for the hearing of the Tribunal at the offices of the World Bank in Paris.

3.17 d) The Rejoinder, filed by the Republic of Zaire on 19 July 1994, reconfirmed the position of the Government of Zaire as reflected in the Counter-Memorial and earlier documents, regarding lack of jurisdiction on the part of ICSID and the inadmissibility of AMT's claim, rejecting all allegations put forward by AMT in support of its claim for compensation plus interests, which the Claimant alleged that the State of Zaire had the duty to pay.

3.18 In short, the Republic of Zaire has never contended on the merit that the property of SINZA was not damaged. SINZA was actually subjected to the same plight as those who were victims of the looting of 1991 and 1993. But, the Rejoinder further maintained, that *"the question of compensation is something else, because none of these*

*victims has ever received any treatment more favorable than that accorded to SINZA".* To the best of the Government of Zaire's knowledge, no victim of the looting of 1991 and 1993 has been compensated by the Zairian Government, for which no proof of compensation was ever furnished by AMT.

3.19 In the end, the Republic of Zaire reaffirmed its disposition with regard to ICSID, which has never been one of disdain, as AMT had led to believe, and that it was a false accusation by AMT.

### C. THE ORAL PROCEDURE

3.20 a) Representation of the Parties : By letter dated 2 November 1994, AMT communicated to ICSID the names of the persons composing its representation :

1. Mr. Hassan YAHFOUFI, President of AMT; and
2. Mr. Daniel D. DINUR, Counsel and Advocate.

Apart from these representatives, the following witnesses would give evidence before the Tribunal :

1. Mr. David W. NICHOLAS, a U.S. national;
2. Mr. Madioko Julian MUTSHUNU, a Zairian national; and
3. Mr. Firas Mohammad YAHFOUFI, a Lebanese national.

3.21 By a letter No. 130.03/000817, dated 30 November 1994, from Minister LUNDA-BULULU to the President of the Tribunal, the Government of Zaire nominated its representation to the oral procedure, as follows :

1. Attorney Manzila Lundum SAL'ASAL, Advocate of the Government in this case; and
2. His Excellency Mr. Ramazani BAYA, ambassador of the

Republic of Zaire to France.

3.22 b) The Oral Hearing By the above-cited letter of 30 November 1994, the Government of Zaire requested a postponement of the hearing until towards the end of January 1995. Having notified the Parties that the hearing could not at this stage be postponed and was as such maintained, the Tribunal held the sittings of the oral hearing in Paris on 5 December 1994 as scheduled, having also received a communication from the Claimant opposing any postponement of the hearing, (Procedural Order No. 2, 6 December 1994).

3.23 The oral hearing took place in Paris, as scheduled, at the offices of the World Bank on 5 and 6 December 1994. The Claimant, AMT, was represented by the persons previously designated. However, the Respondent remained without representation except in the person of a Counsellor of the Embassy without nomination, authorization or accreditation of any kind.

3.24 AMT thus proceeded to present its proofs and all grounds in support of its claims for reparation for the losses and injuries caused by members of the armed forces of Zaire during the destructions of 1991 and 1993 and the injurious consequences which ensued. The Tribunal heard the evidence given by two witnesses as well as a deposition of an expert concerning the assessment of compensation and interests thereon. The witnesses and the expert were questioned by the Arbitrators and by the President of the Tribunal on 5 December 1994, as provided by Article 35 of the Arbitration Rules.

#### D. PROCEDURAL ORDER NO. II

3.25 In the course of the hearing on 5 December 1994 at the offices of the World Bank in Paris, the Tribunal adopted a Procedural Order No. II, of which the relevant Paragraphs read as follows :

#### THE TRIBUNAL...

Having noted that the Respondent failed to present its case at the oral hearing, and

Having duly deliberated thereon,

GRANTS the Respondent a period of grace in accordance with Article 45 (2) of the ICSID Convention and ICSID Arbitration Rule 42, and in the present case

DECIDES to hold a supplemental hearing in Paris on 13 and 14 February 1995, provided that

a) The Republic of Zaire informs the Arbitral Tribunal that it agrees to cover the fees and expenses of the Arbitrators as well as the administrative fees related to such hearing, and

b) The Republic of Zaire deposits not later than 25 January 1995 the funds requested by the Secretary of the Tribunal in his letter of today's date to cover the fees and expenses referred to above.

3.26 The Republic of Zaire has not chosen to confirm either its intention to appear before the Tribunal in the course of the supplemental hearing scheduled for 13 and 14 February 1995, or its acceptance of the conditions stipulated in paragraphs a) and b) of the Procedural Order No. II, cited above. The supplemental hearing was thus never held in Paris.

3.27 The time has come for the Tribunal to pronounce upon the questions presented by the Parties as to the competence of ICSID and that of the Tribunal itself, as well as on the merit of the dispute. The Tribunal will therefore examine these questions

successively before reaching its conclusions.

## PART TWO : QUESTIONS OF COMPETENCE

### IV : GENERAL CONSIDERATIONS : OBJECTION TO THE COMPETENCE

4.01 The various procedural steps relating to the competence of the Tribunal have been mentioned and described in paragraphs 1, 2 and 3 above.

4.02 After the Tribunal had had its first session at the headquarters of ICSID in the absence of Zaire, the Respondent, the latter submitted a "Counter-Memorial" dated 30 May 1994. Zaire never failed to take that opportunity to express its gratitude to the Tribunal for acceding to its request for an extension of the time-limit for the filing of its Counter-Memorial.

4.03 In its Counter-Memorial, Zaire maintains that the Tribunal is incompetent to hear the case brought before it by AMT. In support of this proposition, Zaire resorts to the following :

- Lack of status;
- Incompetence of ICSID to consider the proceeding instituted before it by AMT;
- Non-compliance by AMT with Article VIII of Zaire-U.S. Treaty (BIT); and
- Violations of Articles II, IV and IX of the same Treaty.

Zaire further concludes that AMT's claim was inadmissible by reason of its violations of Articles 45 and 46 of the Zairian Investments Code.

4.04 In its Rejoinder of 19 July 1994, Zaire reiterates its argument regarding the

inadmissibility of AMT's claim for the reasons elaborated in the Counter-Memorial which Zaire reconfirms in its entirety.

4.05 The core defense of Zaire consists in the argument that the Zairo-United States Treaty may well relate to the natural and juridical persons of the United States or Zairian nationality; and although AMT is clearly a U.S. company, it has never made any direct investment in its name in the Republic of Zaire. According to Zaire, AMT has furnished no proof whatsoever of its direct investment. Zaire indicates that AMT has merely participated, as a stockholder, in the investment made by SINZA, a Zairian company. Zaire thereupon concludes that SINZA, being a Zairian company, cannot benefit from the Zaire-U.S. Treaty. Deducing consequences from this observation, Zaire contends that the Centre is without competence, considering that the dispute in question is between a State and a national of the same State, such a dispute has never entered into the scope of application of the Convention.

4.06 In its Rejoinder, Zaire denies ever entertaining any disdainful attitude towards the Tribunal and explains that its failures were due to the *"unfortunate and disastrous"* consequences triggered by the disturbances which happened to take place in the country.

4.07 The Tribunal notes that it has amply taken into consideration the circumstances referred to by Zaire throughout the proceedings. The Tribunal has in effect demonstrated a deep understanding in regard to Zaire.

4.08 In any event, as Zaire itself admits, it follows clearly from the facts of the case that Zaire has been in default, while invoking the incompetence of ICSID and of the Tribunal.

4.09 After having carefully examined the different arguments raised by Zaire to persuade the Tribunal to declare itself incompetent, the Tribunal has decided to join the preliminary objections to the merits of the case. On the other hand, the Tribunal deems

it its duty to ascertain whether it is properly seized of the case and that it shall, in all cases, examine the question of its own competence before embarking upon consideration of the merits of the case.

## V. QUESTIONS RELATING TO THE COMPETENCE OF THE TRIBUNAL AND THAT OF ICSID

### A. REGISTRATION OF THE REQUEST FOR ARBITRATION

5.01 The competence of the Tribunal is obviously derived from that of the Centre. One may presume that by registering the Request for Arbitration of AMT, the Secretary General of ICSID does not consider, "on the basis of the information contained" in the Request "that the dispute is manifestly outside the jurisdiction of the Centre". In reality, the Secretary-General would not have registered this Request if, in accordance with Article 36 (3) of the Convention on the Settlement of Investment Disputes between States and Nationals of other States, it was otherwise. Nevertheless, this fact does not prevent the Tribunal from examining the competence of ICSID, because, evidently Article 36 (3) does not confer upon the Secretary-General of ICSID, responsible for the registration of Request, notably as concerns verification of the competence of the Centre, the task other than a mere obligation of an extremely light control which in the execution does not, in any sense, bind the Tribunal in any way in the latter's appreciation of its own competence or lack thereof. The Tribunal will still have a number of questions to raise and also to find answers thereto.

5.02 In the process, the Tribunal will have to apply, in the present case, in addition to the Convention and the Rules of Procedure for Arbitration proceedings (Arbitration Rules), the Bilateral Treaty between the United States of America and the Republic of Zaire concerning the Reciprocal Encouragement and Protection of Investment (BIT).

Neither Party has contested the applicability of this Treaty to the present case.

### B. GROUNDS ADVANCED BY ZAIRE FOR ITS OBJECTIONS TO THE COMPETENCE

5.03 The Tribunal will now examine the different grounds upon which Zaire founds its objections to the competence. It will, in addition, inquire into every question relating to its competence, as is already indicated.

#### (1) First Ground : The three prerequisites of ICSID Competence

5.04 In the first place, the Tribunal must respond to the question whether ICSID is competent in the present case. The problem of competence of the Centre is treated in Article 25 of the Convention. For this purpose, three conditions are required :

- a) There must be a legal dispute arising out of an investment;
- b) The dispute must have arisen between a Contracting State and a national of another Contracting State; and
- c) The parties must have consented to submit their dispute to the Centre.

5.05 The Tribunal will take up these three conditions for verification of the fulfillment.

#### (a) A LEGAL DISPUTE (*RATIONE MATERIAE*)

5.06 Is it a legal dispute?

Under Article 25 of the Convention, "*The jurisdiction of the Centre shall extend to any legal dispute...*"

In this regard, there does not seem to be the least discrepancy between the Parties and the Tribunal is of the view that there is clearly a legal dispute and not

a dispute of another nature, the dispute requiring the application of rules of law and calling for legal solutions.

- (b) A DISPUTE BETWEEN A STATE AND A NATIONAL OF ANOTHER STATE (*RATIONE PERSONAE*)

5.07 Is it a dispute between a Contracting State and a national of another Contracting State?

The same Article 25 of the Convention expressly provides that the dispute must be between "a Contracting State (or any constituent subdivision or agency of a Contracting State) and a national of another Contracting State". In this case, the Contracting State is the Republic of Zaire. The dispute is with AMT. Is AMT truly, in accordance with Article 25, "a national of another Contracting State"? Zaire admits that AMT is clearly a national of another Contracting State, the United States of America. The Tribunal, in turn, reaches the same conclusion. Article 25 (2) defines what is regarded as a national of a Contracting State, as follows :

- (a) "Any natural person who had the nationality of a Contracting State other than the State party to the dispute on the date on which the parties consented to submit such dispute to conciliation or arbitration as well as on the date on which the request was registered pursuant to paragraph (3) of Article 28 or paragraph (3) of Article 36, but does not include any person who on either date also had the nationality of the Contracting State party to the dispute; and
- (b) "Any juridical person which had the nationality of a Contracting State other than the State party to the dispute on the date on which

*the parties consented to submit such dispute to conciliation or arbitration and any juridical person which had the nationality of the Contracting State party to the dispute on that date and which, because of foreign control, the parties have agreed should be treated as a national of another Contracting State for the purposes of this Convention."*

5.08 The criticism of Zaire is not directed against the nationality of AMT but rather against its status or capacity to act. In effect, on its first ground in the Counter-Memorial, Zaire denies that AMT possesses any capacity to act in the present case. To support this argument, Zaire recalls that Article 1 of the Treaty identifies the beneficiaries of the advantages "which it has in mind and cites, on the one hand the juridical person, national of one of the Signatory States of the Treaty...", and on the other, "natural persons of Zairian nationality or of American nationality who invest in the United States or in the Republic of Zaire", and Zaire thus contends that AMT "is not an investor in the Republic of Zaire". An investor, in the view of Zaire, is certainly SINZA in its own country, an investor in whose name AMT could not act. AMT therefore does not have the capacity to act, according to Zaire.

5.09 The Tribunal finds that the dispute is brought before the Centre by AMT. It does not consider it possible to contest that AMT is not a juridical person with United States nationality. Besides, an appropriate document has been filed with the Tribunal which clearly proves this fact. It suffices for this purpose to refer to the developments contained in paragraphs 4.03 to 4.05 above. Furthermore, it should be recalled, Zaire also recognizes this fact.

5.10 Indeed, Zaire denies that the dispute is with AMT. It regards the dispute rather as being with SINZA that has assumed the function of Claimant, since it is SINZA that has been established in the territory of Zaire, which has operated the industry damaged



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by the destruction, the object of the dispute. Besides, Zaire continues, SINZA is a Zairian company and the dispute it has with Zaire would have to be settled in accordance with the normal law of Zaire, and not by and in accordance with the procedure provided by the ICSID Convention.

5.11 The Tribunal does not concur in the argument presented by Zaire because it does not find it pertinent. In fact, Zaire itself recognizes in its Reply (page 2, paragraph 2 (1) in fine) that AMT "*invested by participating in the capital of SINZA*". But at the same time, Zaire contends that the fact that AMT participated in the capital even at one hundred per cent (100 %) to form a Zairian company, SINZA, does not confer upon AMT any power to act in the place and instead of SINZA.

5.12 This reasoning has not convinced the Tribunal. For the Tribunal, the Zaire-United States Treaty concerning the Reciprocal Encouragement and Protection of Investments (BIT) states, in its preamble, that "*The two States parties, desiring to promote greater economic cooperation between themselves*", particularly "*with respect to investment by nationals and companies of each Party in the territory of the other Party.*"

5.13 And in Article I on definitions, it is provided in paragraph (a) that "*Company means any kind of juridical entity, including any corporation, company, association, or other organization, that is duly incorporated, constituted, or otherwise duly organized, regardless of whether or not the entity is organized for pecuniary gain, privately or governmentally owned, or organized with limited or unlimited liability.*"

5.14 In paragraph (c) of the same Article I, the authors of the Treaty have made it even more abundantly clear when they define the term "investment". In effect, it is provided that the term "*investment*" means every kind of investment, owned or controlled directly or indirectly, including equity, debt, and service and investment contracts; and

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includes : ..... ii) "*A company or shares of stock or other interests in a company or interests in the assets thereof.*"

5.15 It is uncontested that SINZA belongs to AMT 94 per cent and that AMT, formed in the United States of America with 55 per cent of its shares owned by United States citizens, is controlled by the Americans, and hence is a U.S. company. Thus, SINZA should be considered in terms of the perfectly clear provisions of the Treaty as an investment of AMT. It follows that SINZA falls within the category of juridical person envisaged in Article 25 (2) of the Convention as previously cited. It is not called into question whether, as Zaire suggests, AMT can act in the name of SINZA. AMT acts in its own name and in its capacity as an American enterprise having invested in Zaire, that is to say, a national of a State party having a dispute with another State party which has welcomed his investments on its territory.

5.16 For the foregoing reasons, the argument based on the defect in the capacity of the Claimant must be rejected.

(c) THE CONSENT OF THE PARTIES TO THE DISPUTE  
(*RATIONE VOLUNTATIS*)

5.17 Is there absence of consent of the Parties?

The Tribunal will now examine, as earlier stated, whether the Parties have consented to submit the dispute to the Centre. Such a question is directly linked to the first ground already examined.

The first question that comes to mind is this : Is it necessary, in the present case, that there must be consent between the State (Zaire) and the national (AMT) of another State (U.S.A.), to submit the dispute to the Centre? The bilateral Treaty does not suffice since it provides that the disputes of the type to be considered by the Tribunal must be justiceable before ICSID.

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In other words, does the consent of the United States creates an obligation for its national? Should there not be, in addition to that consent, also the consent by AMT itself relating to a specific dispute? Can the United States impose upon its national the passage of consent to ICSID? Or, better still, in the absence of AMT's consent, will the Treaty signed by the United States of America and Zaire suffice to take its place?

5.18 The Tribunal holds that this question must be answered in the negative. The requirement of the consent of the parties does not disappear with the existence of the Treaty. The Convention envisages an exchange of consents between the Parties. When Article 25 states in paragraph 1 that "the parties" must have consented in writing to submit the dispute to the Centre, it does not speak of the States or more precisely, it speaks of a State and a national of another State. It appears therefore that the two States cannot, by virtue of Article 25 of the Convention, compel any of their nationals to appear before the Centre; this is a power that the Convention has not granted to the States.

5.19 By the same token, reference should be made to Article VII, paragraph 2 of the Treaty, which provides : *"Each Party hereby consents to submit investment disputes to the International Centre for the Settlement of Investment Disputes (Centre) for settlement by conciliation or binding arbitration."* This provision is further clarified by paragraph 3, *in fine*, of the same Article VII which reads : *"If the dispute cannot be resolved through consultation and negotiation, then the dispute shall be submitted for settlement in accordance with the applicable dispute-settlement procedures upon which the Parties to the dispute may have previously agreed."*

5.20 It appears clearly that if Zaire and the United States agree that the disputes of the type which is submitted to the Tribunal could be brought before ICSID, they have thus, each on its part, accepted the competence of ICSID to be eventually proceeded against by a national of the other co-contracting State. But this acceptance is not automatic for all disputes, the Parties in question, (that is to say, a State and a national of another State), remain masters of the procedure of their choice which they may deem appropriate

to apply in order to resolve an emerging dispute. This is the way it is necessary to understand the meaning of Article VII, paragraph 3, *"in fine"*, and sub-paragraph (a) of paragraph 4 of the same Article.

5.21 On the other hand, to be more convinced, it is enough to read paragraph 4 of Article VII of which sub-paragraph (b) is thus worded : *"Once the national or company concerned has so consented, either party to the dispute may institute proceedings before the Centre or Additional Facility at any time after six months from the date upon which the dispute arose"*, provided the *"dispute has not, for any reason, been submitted by the national or company for resolution in accordance with any applicable dispute settlement procedures previously approved by the parties to the dispute"*, and *"the national or company concerned has not brought the dispute before the courts of justice or administrative tribunals or agencies of competent jurisdiction of the Party that is a party to the dispute."*

5.22 Finally, it is convenient to cite the end of paragraph 4, which reads : *"If the parties to the dispute disagree over whether conciliation or binding arbitration is the more appropriate procedure to be employed, the procedure desired by the national or company concerned shall be followed."* A right of option is thus recognized for the national of the other contracting State.

5.23 It seems that upon reading this provision of the Treaty, it cannot be contended that consent of the parties to come before ICSID simply results from a pre-existing agreement by the United States and Zaire. It is therefore necessary to show that there has also been an agreement between the Parties, or in the absence of this agreement, it would have been necessary to apply Article VII, paragraph 4 *in fine* which confers upon a national of the other State the power to compel the State party to the dispute to appear before the Centre. This is very much the case before us.

In the present case, it happens that AMT (the national envisaged in paragraph 4)

has opted for a proceeding before ICSID. AMT has expressed its choice without any equivocation; this willingness together with that of Zaire expressed in the Treaty, creates the consent necessary to validate the assumption of jurisdiction by the Centre.

(2) Other Supplementary Grounds Examined by the Tribunal

5.24 The second ground raised by Zaire is founded on the fact that ICSID is competent only to entertain proceedings between nationals and juridical persons of different nationalities and the present case is apparently a proceeding between SINZA, a Zairian corporation and the Republic of Zaire, the competence of the said ICSID is therefore not well-founded in this case.

5.25 The Tribunal has already found in paragraphs 5.06 to 5.16 above that the present case is in fact between AMT and Zaire, by virtue of the Convention and the Treaty between the United States of America and Zaire. The argument advanced by Zaire as its second ground cannot therefore be sustained, an argument which, in the ultimate analysis, is but an aspect of the first ground already rejected by the Tribunal.

5.26 In the third place, Zaire has raised a ground based upon AMT's failure to apply Article VIII of the Zaire-U.S. Treaty before instituting arbitral proceedings.

This Article provides that *"Any dispute between the Parties concerning the interpretation or application of this Treaty should, if possible, be resolved through consultations between representatives of the two Parties, and if this should fail, through other diplomatic channels."*

5.27 Zaire contends that, to the best of its knowledge, AMT has not used, as a prior requirement, the various means of dispute resolution referred to above, before addressing ICSID, and in so doing deduces from this fact that AMT has violated the above cited provision, which should entail rejection of its claim.

5.28 The Tribunal notes that Article VIII of the Treaty, as the title suggests *"Settlement of Disputes between the Parties concerning Interpretation or Application of this Treaty"*, does not relate to the dispute of the type which is brought before it, but rather the disputes between two signatory States as to the interpretation or application of the Treaty. It follows that this ground also must fail.

5.29 The fourth ground presented by Zaire is based on the alleged violation of Articles II, IV and IX of the Zaire-U.S. Treaty. Article II relates to the investments and prescribes the obligation of the parties to apply to these investments the most favorable treatment.

5.30 As for Article IV, it concerns compensation in certain circumstances.

5.31 These two provisions are clearly concerned with the merit of the case and the Tribunal does not see how they can be invoked to pre-empt the admissibility of AMT's claim, subject to the reservation regarding its soundness.

5.32 Consequently, the Tribunal declares these grounds inadmissible.

5.33 The fifth ground presented by Zaire is founded on the alleged violation of Article IX of the Zaire-U.S. Treaty. Article IX, entitled "Preservation of Rights", runs :  
*"This Treaty shall not supersede, prejudice, or otherwise derogate from :*

- (a) laws and regulations, administrative practices or procedures, or adjudicatory decisions of either Party;*
- (b) international legal obligations; or*
- (c) obligations assumed by either Party, including those contained in an investment agreement or an investment authorization,*

*whether extant at the time of entry into force of this Treaty or*

*thereafter, that entitle investments, or associated activities, of nationals or companies of the other Party to treatment more favorable than that accorded by this Treaty in like situations."*

5.34 Zaire deduces from these provision that "Ordinance-Law No. 69-044 of 1 October 1966 relating to losses and injuries caused by the disturbances, declaring inadmissible any action based on ordinary law in matters of civil liability and seeking to condemn the State to compensate for the damage caused either by riots or insurrections...", AMT's claim is inadmissible. This Treaty cannot derogate from the prescription of the above-cited ordinance-Law in public policy matters.

5.35 This way of proceeding cannot be retained by the Tribunal. In effect, the Treaty is supreme over the law. But what is more decisive is that Zaire gives to Article IX an interpretation which is untenable.

5.36 Certainly, the manner in which Article IX of the Treaty is formatted could mislead any reader and could entail an interpretation not in conformity with the object and purpose of the provisions in question. Such an interpretation would lead to an absurd result and an unacceptable fact. A careful reading, consistent with the title of the Article, clearly shows that a typographical error has tempted us to join the part of the Article starting with "Whether extant at the time of entry into force of this Treaty or thereafter, that entitle investments....." to paragraph (c) only, whereas, although the French word "*donne*" does not end with "*ent*" in French, and does not take a plural form, the end of paragraph (c) concerns points (a), (b), and (c), and has no other object but to preserve the treatments which would remain more favorable than those resulting from the Treaty. The format in the English version of Article IX reaffirms this method of viewing the provision.

5.37 It follows that this ground is also unfounded.

5.38 The sixth and final ground presented by Zaire is based in essence on its first ground, (that is to say, it is SINZA that has the capacity to act) and rests on the provisions of Article 45 of the Zairian Investments Code which provides for an arbitral proceeding organized by Articles 159 to 174 of Titles III and IV of the Code of Procedure of Zaire.

5.39 The Tribunal has already responded to this argument. This last ground is not well founded either.

5.40 It remains for the Tribunal to recall Article VII of the Treaty.

5.41 Under paragraph 3 of Article VII of the Treaty, the parties to the dispute shall initially seek to resolve the dispute by consultation and negotiation. And it is only when the parties have failed to settle their dispute by these two means of settlement that they have to resort to another method of settlement.

5.42 This ground is raised by the Tribunal *proprio motu*.

5.43 When Article VII is carefully read, it will become clear that the efforts of negotiation and consultation have not been slight. There have been serious endeavors. In fact, by way of illustration the Parties can agree on any of the third-party dispute settlement procedures, of which the decisions are non-binding, such as the machinery of enquiry available under the ICSID Additional Facility.

5.44 In the case on hand, there have been incontestably serious negotiation attempts undertaken by AMT. These endeavors are recalled in paragraphs 12 and 13 of the Request for Arbitration filed by AMT on 20 January 1993. They result profusely from the documents filed. Unfortunately, they have been without any success.

5.45 It follows that this last ground also is unfounded.

- 5.46 It thus appears that none of the grounds advanced by Zaire or by the Tribunal itself in support of lack of competence on the part of the Tribunal is valid and that the proceeding instituted by AMT before ICSID is perfectly admissible.

### PART THREE : QUESTIONS OF MERIT

#### VI. THE RESPONSIBILITY OF THE STATE OF ZAIRE

- 6.01 After having examined the questions of competence, of the Centre as well as of the Tribunal, and having reached an affirmative conclusion, by discarding each of the grounds invoked by the Republic of Zaire in support of its objections to the competence and by dismissing *proprio motu* other conceivable grounds for declining jurisdiction by ICSID and the Tribunal itself, the Tribunal must now examine the questions of merit.

##### A. LEGAL BASIS OF STATE RESPONSIBILITY

- 6.02 Once the questions of competence have been determined in the affirmative, it is necessary in the first place to determine the legal basis of the right to compensation and consequently the quantum of the compensation.
- 6.03 AMT suggests in paragraph 11 of its Request for Arbitration dated 25 January 1993, and repeated in its Memorial of 8 December 1993 that the Republic of Zaire has breached its obligations arising out of the Bilateral Treaty between Zaire and the United States of America of 1984 (BIT). These obligations are incorporated in the various provisions of the BIT, in particular, Articles II (4), III and IV (1)(b) and (2)(b).

- 6.04 a) **Obligation of Protection and Security of Investment**

In the first place, AMT invokes its right to the treatment of protection and security corresponding to the obligation provided by Article II paragraph 4 of the BIT which reads :

*ARTICLE II : TREATMENT OF INVESTMENT*

- (4) *"Investment of nationals and companies of either Party shall at all times be accorded fair and equitable treatment and shall enjoy protection and security in the territory of the other Party. The treatment, protection and security of investment shall be in accordance with applicable national laws, and may not be less than that recognized by international law..... Each Party shall observe any obligation it may have entered into with regard to investment of nationals or companies of the other Party."*

- 6.05 The obligation such as cited above contracted by the Republic of Zaire and the United States of America constitutes an obligation of guarantee for the protection and security of the investments made by nationals and companies of one or the other Party, in the case before us, by American nationals or companies, AMT, in the territory of Zaire, at Kinshasa. The obligation incumbent upon Zaire is an obligation of vigilance, in the sense that Zaire as the receiving State of investments made by AMT, an American company, shall take all measures necessary to ensure the full enjoyment of protection and security of its investment and should not be permitted to invoke its own legislation to detract from any such obligation. Zaire must show that it has taken all measure of precaution to protect the investments of AMT on its territory. It has not done so, by mere recognition of the existing reality of the damage caused while designating SINZA as the victim and alleging that its own national legislation has exonerated Zaire from all obligations to make reparation for the injuries sustained on its territory in the

circumstances such as those giving rise to the present dispute. In this regard, the Tribunal has demonstrated the contrary.

6.06 These treatments of protection and security of investment required by the provisions of the BIT of which AMT is beneficiary must be in conformity with its applicable national laws and must not be any less than those recognized by international law. For the Tribunal, this last requirement is fundamental for the determination of the responsibility of Zaire. It is thus an objective obligation which must not be inferior to the minimum standard of vigilance and of care required by international law.

6.07 The question to be considered relates to the means by which to ascertain whether there has been a breach of duty on the part of the State of Zaire in regard to its obligation of vigilance, such as provided by Article II paragraph 4 of the BIT to ensure the protection and security of the investment made by AMT in Zaire. What then is the practical criterion to determine the level of the precautionary measure to be taken by the receiving State consistent with the minimum standard recognized by international law? More particularly, what are the appropriate measures to be adopted by the Republic of Zaire in the circumstances to protect the security of the investment of AMT? Has Zaire taken any of these measures? These questions are not at all answered by Zaire.

6.08 It would not appear useful for the Tribunal to enter into the debate whether in the case on hand Zaire is bound by an obligation of result or simply an obligation of conduct. The Tribunal deems it sufficient to ascertain, as it has done, that Zaire has breached its obligation by taking no measure whatever that would serve to ensure the protection and security of the investment in question. The Tribunal finds that Zaire has breached the obligation it has contracted by signing the above-cited provisions of the BIT in the face of the events from which the ensuing disastrous consequences have been sufficiently described in the documents filed with the Tribunal. Zaire is responsible for its inability to prevent the disastrous consequences of these events adversely affecting the investments of AMT which Zaire had the obligation to protect.

6.09 *Res ipsa loquitur* : what has happened is self-explanatory without requiring extraneous proof. Yet, Zaire has never denied its breach of the obligation of vigilance. Simply, admits Zaire that it is SINZA which "has been the object of looting in 1991 as indeed it was the case with all the others." But, continues Zaire, AMT has not adduced any evidence to show that the State of Zaire "has accorded in like circumstances a treatment less favorable to SINZA than that which it has accorded to its own nationals or companies." Or else, Zaire could have contended that it has accorded to SINZA a treatment no less favorable in the circumstances than that which it has accorded to nationals or companies of any third State whatsoever.

6.10 If the argument advanced by Zaire does not seem altogether unfounded, the fact remains that Zaire has manifestly failed to respect the minimum standard required of it by international law. It should be added that Zaire has equally failed to perform a similar obligation with regard to a third State or all other third States. In effect, the argument advanced by Zaire that it has not accorded to nationals and companies of these States any protection or reparation, is not pertinent for the Tribunal. Since the repetition of breaches and failures to perform similar obligations it owes to third States will not in any way exonerate the objective responsibility of the State of Zaire for the breach of its obligation of the treatment of protection and security it owes to AMT by virtue of Article II paragraph 4 of the BIT.

6.11 Consequently, the reasoning presented by Zaire is not acceptable. The responsibility of the State of Zaire is incontestably engaged by the very fact of an omission by Zaire to take every measure necessary to protect and ensure the security of the investment made by AMT in its territory.

6.12 b) **Obligation to prevent losses resulting from the event envisaged  
in Article IV paragraph 1 (b)**

The engagement of the responsibility of the State of Zaire is more specifically reinforced by the provisions of Article IV paragraph 1 (b) of the BIT : titled : Compensation for Damages due to War and Similar Events", covering, in part the cases in which :

"1. Nationals or companies of either Party whose investments in the territory of the other Party suffer.....

(b) damages due to revolution, state of national emergency revolt, insurrection, riot or act of violence in the territory of such other Party..."

6.13 Without discussing for the moment the question of the quantum of appropriate compensatory indemnity, it suffices to confirm once more the engagement of the responsibility of the State of Zaire for all the losses resulting "*from riot or act of violence in the territory of such other Party*", in this case, Zaire. Such is the case without the Tribunal enquiring as to the identity of the author of the acts of violence committed on the Zairian territory. It is of little or no consequence whether it be a member of the Zairian armed forces or any burglar whatsoever. This responsibility Zaire cannot set aside by invoking its own national legislation. It is an international obligation which Zaire has freely contracted within the framework of the BIT.

6.14 It is by the process of this two-fold reasoning based on the double legal foundation of the bilateral Treaty, either Article II (4), or Article IV (1)(b), or the combination of both provisions that the Tribunal arrived at the conclusion that the Republic of Zaire is inevitably responsible for the losses and damages resulting from the events of 23-24 September 1991 and of 28-29 January 1993, without having to determine by whom these losses were caused. And this falls directly within the scope of Article IV paragraph (1)(b) of the said Treaty, which serves at the same time to reinforce further the engagement of the responsibility of the State of Zaire for ensuring the protection and security of the investment made by AMT on the Zairian territory in accordance with

Article II paragraph 4 of the BIT, as well as the obligation to prevent the occurrence of any act of violence on its territory. It is the duty or obligation to prevent the occurrence of a given event that is at issue.

6.15 c) **Obligation to make restitution or to pay compensation for the destruction of property "by the forces or authorities of the other Party which was not caused in combat action"**

Furthermore, AMT alleges in its Request for Arbitration and in its Memorial that the losses and damages suffered by SINZA resulted from "*the destruction of property by the forces or the authorities of the other Party which was not caused in combat action*".

6.16 It is true that the damages and injuries sustained by AMT were not caused in combat actions. However, there has never been any claim that the injuries suffered in the course of the events of 23-24 September 1991 and of 28-28 January 1993 were caused in combat actions.

6.17 The only question that occupies the attention of the Tribunal up till now is whether there is a third reason to strengthen still further the responsibility of the State of Zaire with particular regard to the losses and damages suffered by AMT during the course of the above mentioned events. This third reason, if there ever was one, would merely serve as a complementary ground to engage the responsibility of the State of Zaire. The Tribunal could very well leave aside the question whether there is in reality a third legal basis in this case to engage once more the responsibility of Zaire for the same losses or injuries incurred to the detriment of AMT.

6.18 The Tribunal does not see any use in seeking to reach a definite conclusion to establish for the third time the responsibility of the Republic of Zaire, for the same losses and for the same injuries caused to the detriment of AMT. The Tribunal therefore refrains from making any pronouncement on this very question.

6.19 The Tribunal fails to see any usefulness in searching for yet an additional legal ground on which to found the responsibility of the State of Zaire by application of Article IV paragraph 2 (b) of the Zaire-U.S. Bilateral Treaty in favor of AMT. When it subsequently examines this question, it will not be to draw any conclusions regarding responsibility, but it will be simply to review the method of evaluation of the compensation due to AMT.

#### B. LEGAL CONSEQUENCES OF STATE RESPONSIBILITY

6.20 With the establishment of doubly reinforced legal foundation for the responsibility of the State of Zaire vis-a-vis AMT, it is now time to examine the legal consequences flowing from the ascertainment of international responsibility of the State of Zaire.

6.21 The delicate question that the Tribunal is called upon to consider is how the Tribunal should proceed to assess the amount of compensation or indemnification required by international law in order to restore to AMT the conditions previously existing as if the events had never occurred or taken place. This question may be better examined in the light of a critical analysis of the amount of compensation and interests thereon which the Tribunal must determine with precision and on a solid basis of a well-defined scientific measurement. Otherwise as an alternative, the Tribunal could have recourse to another path to follow, that of exercising its sovereign discretion to determine the amount of compensation to be paid to AMT by the Republic of Zaire, taking into account the actual injury suffered.

6.22 Zaire contends in its Rejoinder of 19 July 1994 that *"The Republic of Zaire has never claimed that the property of SINZA was never damaged. SINZA has been subjected to the same plight as all those who were victims of the looting in 1991 and 1993."* *"But"*, adds Zaire, *"the question of compensation is something else, because none of these victims has been accorded a treatment more favorable than SINZA."*

6.23 The question of the amount of compensation should be considered separately from the question of responsibility which has been definitively determined. Zaire has claimed that it has now fulfilled all the obligations it was bound to perform if only no one could provide any proof that Zaire had accorded a treatment in regard to indemnification or compensation more favorable than that it has accorded to SINZA or to AMT, the Claimant in the present instance. Zaire adds that, having offered no one any compensation, it has in this sense not violated the principle of equality and of non-discrimination of treatment.

6.24 The argument as presented above by the Republic of Zaire could only be appreciated by the Tribunal to the extent that Zaire had accorded a favorable treatment to one of its own nationals or companies or to one of the nationals or companies of any third State whatsoever. In the absence of such a treatment, there would not be any possible comparison to ascertain the level or even the type of the treatment, whether by means of restitution, compensation or indemnification, or else precisely Zaire has not accorded any indemnity, any compensation. Accordingly, the Tribunal does not find such an argument sustainable. The contention of the Republic of Zaire is untenable. It is therefore rejected by the Tribunal. The only remaining issue is that envisioned in Article II of the BIT, that is to say the treatment, the protection and security at least equivalent to *"those recognized by international law."* It is therefore upon this basis that the Tribunal will proceed to assess the compensation due to AMT.

#### PART FOUR : THE QUANTUM OF DAMAGES THE AMOUNT OF COMPENSATION

7.01 Having firmly established the responsibility of the State of Zaire for all the losses, injuries and damages sustained by AMT, and caused by the acts of violence committed



to the detriment of the investment made by AMT on the territory of Zaire, the Tribunal will now determine the quantum of compensation to be paid by Zaire regardless of the existence or absence of fault or independently thereof. Suffice it to prove that Zaire has not fulfilled its obligation of vigilance, and *a fortiorissime*, Zaire has also breached its obligation to prevent the occurrence of a given event, above all whether there have been acts of violence on the Zairian territory, giving rise to losses, damages and injuries sustained by AMT.

#### A. THE METHOD OF ASSESSMENT OF COMPENSATION

7.02 There are apparently several different methods of assessment of the quantum or the total amount of compensation plus interests thereon which should be equitable in the circumstances of the present case.

7.03 Two different criteria seem to attract the attention of AMT as Claimant. The first is the criterion reflected in the most favorable treatment as required by the minimum standard provided in Article II paragraph 4 of the Zaire-U.S. Bilateral Treaty. The second criterion preferred by AMT is the one proposed in Article III of the Treaty. This article, entitled "Compensation for Expropriation" provides for compensation "*equivalent to the fair market value of the expropriated investment*". The said compensation shall "*include interests at a rate equivalent to current international rates from the date of expropriation, and be freely transferrable at the prevailing market rate of exchange on the date of expropriation*". The case in hand is clearly not a case of expropriation. But can it be assimilated to expropriation? The answer of the Tribunal is in the negative.

7.04 AMT has invoked, in support of its preference, Article IV paragraph (2)(b) of the Zaire-U.S. Bilateral Treaty as the legal basis for its claim for compensation in accordance with Article III of the said Treaty, viewing the case as one of "*destruction*

*of property by the forces or the authorities of the other Party which was not caused in combat actions*". It appears that this choice was essentially prompted by AMT's preference as to the method of calculation of compensation and interests thereon which should be allocated to it (Article III of the BIT). But for the Tribunal, the essence lies in the determination with certainty the basis of the responsibility and on that basis it may proceed to fix the just compensation due to AMT.

7.05 It has never been alleged that the destructions in question, neither that of 23-24 September 1991 nor that of 28-29 January 1993, were caused in combat actions. It is necessary to ascertain further whether there was "*destruction of property by the forces or the authorities*" of the Republic of Zaire.

7.06 AMT maintains that the destructions of both events in September 1991 and January 1993 were committed by the Zairian armed forces from Camp Kokolo. It is true that they appeared to be (in whole or in part - in this regard, the Tribunal is not certain) soldiers in uniform with weapons of the army, including grenades and automatic weapons belonging to the armed forces. The question to be considered by the Tribunal is whether the destruction of property was committed by the Zairian forces or authorities not in combat actions in the sense of Article IV paragraph 2(b) of the BIT.

7.07 To obtain more precise clarification on sub-paragraph (b) of paragraph 2 of Article IV, it is sufficient to read carefully once more sub-paragraph (a) which speaks of requisition of property by "the forces" or "the authorities" of the other Party, an action which can be assimilated to expropriation. It is suddenly apparent that in fact this relates to the organized forces, which even according to the evidences furnished by the only witness heard in this case is not at all the case in the circumstances of this case.

7.08 In the present case, it is true from the information received that they were the military, at least persons in military attire who manifestly acted individually without any one being able to show either that they were organized or that they were under order.

nor indeed that they were concerted.

7.09 The nature of the looting and the destruction of property which were looted show clearly that it was not "the army" or "the armed forces" that acted as such in the circumstance. And this in no way resembles expropriation or requisition by the State.

7.10 And the fact that thereafter the President of the Republic of Zaire decided of his own accord to pardon these persons who acted in 1991 and in 1993 against the property of others does not alter anything in the circumstance. On the contrary, it clearly shows that they were separate individuals and not the forces that performed the action, because the Tribunal does not see how one could speak of a pardon similar to an armistice if it was the armed forces that acted in a given circumstance. An armistice may be either of a general or a personal character, but it must always refer to a determinate offense.

7.11 Moreover, an armistice or such a pardon to persons who acted in 1991 and in 1993 does not entail in international law the effect of exculpating for those receiving pardon save to the extent and from the point of view of Zairian law, and does not produce the result of exoneration for the responsibility of the State of Zaire in respect of the destruction of property belonging to nationals or companies and forming integral part of the investment made by them in Zaire.

7.12 The Tribunal does not consider it necessary to insist on this question beyond measure. In effect, its relevance is not here discussed as a foundation of the responsibility of Zaire. That is why the Tribunal prefers at this stage to concern itself with the method of calculation of the amount of compensation to which AMT is entitled because of the injury sustained.

7.13 As between the two methods of assessment of the amount of compensation to be paid to AMT by the Republic of Zaire, the Tribunal does not see any substantial difference in practice. In principle, it is necessary to assess the true value or the actual

market value of the properties destroyed or the losses suffered by AMT. Is it necessary to add on top of that also the current interest to the total sum of compensation from the date of each destruction occurring in the territory of Zaire? The answer of the Tribunal will have to take into account the existing conditions of the country and not by making abstraction based on a criterion for the assessment which does not correspond at all to the reality, nor to the current happenings in Zaire, nor indeed to the commercial and industrial activities of the Claimant.

7.14 AMT would have liked to adopt a method of calculating compensation including interests practicable in the normal circumstances prevailing in an ideal country where the climate of investment is very stable, such as Switzerland or the Federal Republic of Germany. The Tribunal does not find it possible to accede to this way of evaluating the damages with interests in the circumstance under consideration, in which it is apparent that the situation remains precarious and that the *lucrum cessans* or the loss of profits is not at all measurable without a solid base on which to found any profit to take or for predicting the growth or expansion of the investment made. It would be neither practical nor reasonable to apply the method of assessment of compensation in a way so far removed from the striking realities of the current situation.

7.15 Preferably, the Tribunal will opt for a method that is most plausible and realistic in the circumstances of the case, while rejecting all other methods of assessment which would serve unjustly to enrich an investor who, rightly or wrongly, has chosen to invest in a country such as Zaire, believing that by so doing the investor is constructing a castle in Spain or a Swiss chalet in Germany without any risk, political or even economic or financial or any risk whatsoever.

#### B. COMPENSATION FOR THE LOSSES SUSTAINED

7.16 For practical reasons founded on equitable principles, the Tribunal finds that the Republic of Zaire which is responsible in international law, is under a duty to

compensate AMT for the very losses which have been caused by the acts of violence and looting occurring in September 1991 and in January 1993.

7.17 In effect, the Republic of Zaire has pleaded in its Rejoinder that *"No one on earth could ignore the fact that for the past four years, the Republic of Zaire has been going through a most painful and unfortunate period in its history."* Zaire continues, *"This requires a benevolent and compassionate attention on the part of all our partners, even those who have encountered unfortunate and disastrous consequences, for there was a time when these same persons were enjoying the benefit of the good situation of the State of Zaire."*

7.18 The Tribunal has never denied the Republic of Zaire any opportunity to defend itself for the sake of good administration of justice. The Tribunal has never forsaken the principle of the right to be heard. Even without the Republic of Zaire entering an appearance to present its case, the Tribunal fully takes into account the situation in Zaire.

7.19 The Tribunal appointed Mr. Bernard Decaux, of French nationality, former civil servant of the World Bank, as independent expert for the purpose of evaluating the damages and losses suffered by Société SINZA (Zaire) in 1991/1993. Having assumed his functions to this end on 26 June 1996, the expert prepared and submitted his report on 5 September 1996 on the evaluation of the damages and losses suffered. According to the expert, the evaluation of the damages and losses suffered by Société SINZA (Zaire) in 1991/1993 is as follows :-

1. Damages to the equipments of the production line (dry cell and car battery)	US \$
- Dry cell production line	1,750,000
- Car battery production line	1,465,000
- Factory repair shop	<u>72,500</u>
Subtotal	3,287,500

2. Damages to the building belonging to AMT	
- Factory building	311,000
- Office building	28,500
- Living quarters	<u>86,600</u>
Subtotal	426,100
3. Value of goods damaged	
- In offices (furnitures and equipment)	22,500
- In living quarters (furnitures and equipment)	<u>25,900</u>
Subtotal	48,400
4. Losses suffered by AMT (looting)	
- Factory inventory	670,000
- Vehicles	20,500
- Merchandise and cash in the retail store	
- Accounts receivable	
- Appraisal fees	
Subtotal	<u>690,500</u>
5. TOTAL (1+2+3+4)	<b>4,452,500</b>

7.20 This report was submitted to the Parties. It was contested by AMT in its response of 15 October 1996. The Republic of Zaire has not submitted its observations.

7.21 Thus the Tribunal must now determine the amount of compensation. The Tribunal proceeds to exercise its discretionary and sovereign power to determine the quantum of compensation that the Republic of Zaire shall pay to AMT, taking into account all the circumstances of the case before it.

**PART FIVE : THE DECISIONS OF THE TRIBUNAL**

FOR REASONS STATED IN THE PRECEDING PARTS OF THE PRESENT AWARD,

THE TRIBUNAL UNANIMOUSLY DECIDES

- (1) **On the competence**
  - that the Tribunal is competent to adjudicate the dispute between the Parties which is within the jurisdiction of the Centre, being a legal dispute arising out of an investment between a Contracting State and a national of another Contracting State in accordance with Articles 25 and 41 of the said Convention;
- (2) **On the admissibility of the Request for Arbitration**
  - that the Request for Arbitration made in writing in the Request of 25 January 1993 is admissible;
- (3) **On the responsibility of the State of Zaire**
  - that the responsibility of the Republic of Zaire as the Respondent is constituted for all the damage caused by the events of 23-24 September 1991 and of 28-29 January 1993, the object of the claim for compensation by AMT;
- (4) **On the claim for compensation**
  - that the Republic of Zaire is condemned to pay to AMT for the injuries sustained by the latter (inclusive of the principal, interests and all other claims) an all-inclusive total sum of

U.S. Dollars 9,000,000 (nine million), carrying an overdue interest of 7.5 percent per annum from the date of this Award, if this amount is not paid within sixty days of the notification of the Award;

- (5) **On the expenses between the Parties to the arbitral proceedings**
  - that each of the Parties shall bear an equal share of the expenses incurred in the present arbitral proceedings, including the fees and expenses of the Tribunal, and the entirety of its own expenses and fees for its own counsel and others.
  - that the Republic of Zaire shall in addition pay to AMT the sum of U.S. Dollars 104,828.96 representing one half of the costs of the proceedings for which advance payments have been made by AMT.

SO DECIDED

*Heribert Golsong*  
 Heribert GOLSONG  
 Arbitrator

*Sompong Sucharitkul*  
 Sompong SUCHARITKUL  
 President

Kéba MBAYE  
 Arbitrator

Date : *February 10, 1997*  
 Place : *Louvain*

Date : *Feb 5, 1997*  
 Place : *San Francisco*

Date :  
 Place :

\* Individual opinions of Mr. Heribert GOLSONG and of Mr. Kéba MBAYE are attached to this Award in accordance with Article 48 (4) of the Convention.

**INTERNATIONAL CENTRE FOR THE SETTLEMENT OF  
INVESTMENT DISPUTES (ADDITIONAL FACILITY)**

Washington D.C.

Case N° ARB(AF)/00/3

**Waste Management, Inc.  
(Claimant)**

**versus**

**United Mexican States  
(Respondent)**

**AWARD**

Before the Arbitral Tribunal  
constituted under Chapter Eleven  
of the North American Free Trade  
Agreement, and comprised of:

Professor James Crawford, President  
Mr. Benjamin R. Civiletti  
Mr. Eduardo Magallón Gómez

**Secretary of the Tribunal**  
Ms. Gabriela Alvarez Avila

Date of dispatch to the parties: April 30, 2004

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AWARD

**WASTE MANAGEMENT, INC.**  
**Claimant**

**v.**

**UNITED MEXICAN STATES**  
**Respondent**

**AWARD**

**A. PROCEDURAL HISTORY**

1. On 27 September 2000, the Acting Secretary-General of ICSID registered a notice for the institution of arbitration proceedings, lodged by Waste Management Inc. (“Claimant”) under the ICSID Arbitration Additional Facility Rules (“the Rules”) against the United Mexican States (“Respondent”). The Claimant alleged that the Respondent is liable under Articles 1110 and 1105 of NAFTA for the actions of various state organs concerning the Claimant’s investment in an enterprise to provide waste management services to the City of Acapulco in the State of Guerrero.

2. In accordance with Article 1123 of NAFTA and Article 6 of the Rules, the parties proceeded to constitute the Arbitral Tribunal. The Claimant appointed Mr. Benjamin R. Civiletti, a United States national. The Respondent appointed Mr. Guillermo Aguilar Alvarez, a Mexican national. Pursuant to Article 1124(2), the Claimant requested the Secretary-General to appoint the President of the Tribunal. The Secretary-General, following consultations with the parties, appointed Professor James Crawford, an Australian national, to serve as President of the Tribunal. Pursuant to Article 1125 of NAFTA, the Claimant had previously agreed, by letter of 19 June 2000 accompanying its request for arbitration, to the appointment of each individual member of the Tribunal.

3. On 30 April 2001, pursuant to Article 14 of the Rules, the Secretary-General of ICSID informed the parties that all the arbitrators had accepted their appointment and that the Tribunal was deemed to have been constituted, and the

proceeding to have begun, on that date. By that same letter, the Secretary-General informed the parties that Ms. Gabriela Alvarez Avila, Senior Counsel, ICSID, would serve as Secretary of the Tribunal. All subsequent written communications between the Arbitral Tribunal and the parties were made through the ICSID Secretariat.

4. On 1 June 2001, the Respondent informed the Centre that it objected to the competence of the Tribunal. This was the second occasion on which the Claimant had brought proceedings in respect of its claim. In the first proceeding, ICSID Case No. ARB/(AF)/98/2, a Tribunal constituted by Mr. Bernardo M. Cremades (President), Mr. Keith Hight and Mr. Eduardo Siqueiros (hereinafter the “First Tribunal”) rendered an award declining jurisdiction on the ground that the Claimant had not validly waived its right to pursue domestic remedies, a waiver required by NAFTA Article 1121 as a condition precedent to the submission of a claim to arbitration. Moreover this failure could not be remedied by any act of the Claimant, with the result that the Tribunal lacked jurisdiction over the claim.<sup>1</sup> The Respondent argued that the effect of the first unsuccessful proceedings was to debar the Claimant from bringing any further claim with respect to the measure alleged to be a breach of NAFTA.

5. On 8 June 2001, the first session of the Tribunal with the parties was held at the seat of the World Bank in Washington, DC. During the course of the session, the parties acknowledged that the Tribunal had been duly constituted pursuant to Article 1120 of NAFTA and the Rules. An exchange of views took place on the venue of the arbitration and on the procedure for dealing with the Respondent’s objection to jurisdiction based on the previous proceedings, and in particular on the decision of the previous Tribunal.

6. In its Procedural Order No. 1 of 8 June 2001, the Tribunal laid down timetables for written observations on the question of venue and on the preliminary objection. The parties filed their observations on the question of venue on 18 June 2001. On 6 August 2001, the Tribunal gave the parties an opportunity to make further observations on the question of venue in light of the possible relevance of the Panama

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<sup>1</sup> For the Award of 2 June 2000 see 5 ICSID Reports 443.



Convention.<sup>2</sup> The parties filed their further observations on venue on 28 August 2001. Subsequently, by a Decision on Venue of the Arbitration dated 26 September 2001, the Tribunal decided that the venue of the present proceedings would be the same as those of the first proceedings, viz., Washington, DC.<sup>3</sup>

7. Following a communication from the Respondent dated 16 November 2001 which did not, however, amount to a challenge, one of the Arbitrators, Mr. Guillermo Aguilar Alvarez, tendered his resignation from the Tribunal. Pursuant to Article 15(3) of the Rules, the Tribunal accepted his resignation. Pursuant to Article 18(1) of the Rules, Mexico thereupon nominated Mr. Eduardo Magallón Gómez to fill the vacancy so created. The Tribunal was reconstituted on December 14, 2001, following Mr. Magallón's acceptance of his appointment.

8. Pursuant to Procedural Order No. 1, Respondent lodged a Memorial on Jurisdiction of 8 August 2001. Claimant lodged a Counter-Memorial on jurisdiction on 9 October 2001. The hearing initially scheduled for 3 December 2001 having been postponed in order to allow the vacancy on the Tribunal to be filled, the Tribunal convened at the premises of the World Bank, Washington, DC, on 2 February 2002 to hear the parties' oral arguments on jurisdiction. The parties were represented as follows:

Attending on behalf of the Claimant:

Mr. J. Patrick Berry, Baker & Botts LLP  
Mr. Richard King, Baker & Botts LLP  
Ms. Lorena Perez, Baker & Botts LLP

Mr. Jay L. Alexander, Baker & Botts LLP  
Mr. Bob Craig, Assistant General Counsel, Waste Management, Inc.

Attending on behalf of the Respondent:

Mr. Hugo Perezcano Díaz, Lead Counsel, Ministry of Economy,  
Government of Mexico  
Mr. Salvador Behar Lavalle, Ministry of Economy, Government of Mexico  
Ms. Adriana González Arce Brilanti, Ministry of Economy,  
Government of Mexico  
Mr. Cameron Mowatt, Thomas & Partners

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<sup>2</sup> Inter-American Convention on International Commercial Arbitration, Panama City, 30 January 1975, 1438 UNTS 249.

<sup>3</sup> The Tribunal's Decision is reported at 6 ICSID Reports 541.

Mr. Carlos García, Thomas & Partners  
Mr. Robert Deane, Thomas & Partners  
Mr. Stephan E. Becker, Shaw Pittman  
Mr. Sanjay Mullick, Shaw Pittman  
Ms. Brooke Bentley, Shaw Pittman.

The Tribunal heard, on behalf of the Respondent, Mr. Hugo Perezcano Díaz, and on behalf of the Claimant, Mr. Jay Alexander.

9. Representatives of the other two NAFTA parties attended the hearing on 2 February 2002:

Attending on behalf of the United States of America:

Mr. Barton Legum, Chief of the NAFTA Arbitration Division, Office of Legal Adviser, Office of International Claims, Department of State  
Mr. David A. Pawlak, Attorney-Adviser, Office of Legal Adviser, Office of International Claims, Department of State.

Attending on behalf of the Government of Canada:

Mr. Douglas Heath, Embassy of Canada in Washington, DC.

10. In response to certain questions from the Tribunal concerning both the case as argued before the previous Tribunal and the proceedings brought by the Claimant in Mexico, the parties provided certain additional information and argument by letters both dated 19 February 2002.

11. On 28 June 2002, the Secretary of the Tribunal notified to the parties the Tribunal's Decision on Mexico's Preliminary Objection concerning the Previous Proceedings. A copy of the decision is attached as Annex 1. The Tribunal decided that the Claimant was not prevented from bringing its claim and reserved to a later stage the issue of the costs and expenses of the jurisdictional phase of the proceedings.<sup>4</sup> By the same letter, the Secretary of the Tribunal informed the parties that the Tribunal understood that the claim submitted by the Claimant was identical to that previously submitted to arbitration under NAFTA, and that the Memorial submitted as Appendix D to its Request of June 19, 2000 stood as the Claimant's Memorial in the present Arbitration. The Secretary of the Tribunal further invited the parties to consult with a view to agreeing on the time limits for the remaining written pleadings.

12. On the basis of the Claimant's observations of 5 and 13 August 2002 and of the Respondent's observations of 6 and 12 August 2002, and in view of the fact that the parties failed to agree in a schedule for the filing of the remaining pleadings, the Tribunal set up a schedule for the filing of pleadings by the parties, submissions by the NAFTA Parties and fixed a date for a hearing on the merits.

13. By letter of 12 August 2002, the Respondent submitted a request for interpretation and correction of certain translation errors into Spanish regarding the Tribunal's Decision of 26 June 2002, invoking Articles 56 and 57 of the Rules. On 13 August 2002, the Secretary of the Tribunal replied to Mexico, explaining that Articles 56 and 57 were only applicable to awards. The Secretary noted that Mexico's request would, however, be referred to the Tribunal for consideration pursuant to Article 35 of the Rules.

14. On 14 August 2002, the Secretary on behalf of the Tribunal invited the Claimant to file by 23 August 2002 any observations it might have in connection with Mexico's request of 12 August 2002.

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<sup>4</sup> The Tribunal's Decision is reported at 6 ICSID Reports 541.

15. On 22 August 2002, in a further letter to the Secretary-General, Mexico asserted that the Tribunal's Decision should be treated as an award. On 23 August 2002, the Acting Secretary-General responded to Mexico's letter of 22 August 2002, confirming that the term "award" in the ICSID Convention and Rules refers only to the final award which disposes of the case. With respect to the Additional Facility Rules, the Acting Secretary-General noted that these, being based on the Convention, were to the same effect. He further observed that a party could immediately ask the Tribunal to clarify, correct or supplement a preliminary or interim decision and that such question would be a matter for the Tribunal to decide under Article 35 of the Rules.

16. On 23 August 2002, the Claimant replied to the Tribunal's invitation to comment. It supported the Secretariat's interpretation of the term "award" in Articles 56 and 57 of the Rules, and argued that the Mexican request was accordingly inadmissible.

17. In a letter of 30 September 2002, the Secretary incorporated the Tribunal's observations to Mexico's request of 12 August 2002. The Tribunal affirmed that there was no request before it for interpretation or correction in accordance with Articles 56 and 57 of the Rules. It pointed out, however, that it had the power, while still exercising its functions and prior to the closure of the proceedings, to give any necessary interpretation of any of its decisions, to make any necessary supplementary decision, and to correct any error in the translation of a decision. The Tribunal further indicated that it could exercise such powers of its own motion or on the request of a party. The Tribunal, however, rejected Mexico's request, indicating that the two reasons given by Mexico for requesting interpretation were not relevant to the further proceedings before the Tribunal and that the Decision itself was clear. Regarding the correction of the Decision, the Tribunal stated that the points raised by Mexico did not reveal any inaccuracy in the translation of the Decision from English to Spanish or any inconsistency between the two versions.

18. By a letter of 23 September 2002, the Respondent requested an order from the Tribunal requiring disclosure of a series of documents which were said to be "relevant and necessary for the defense of this case". The request concerned two issues which were open at the merits phase, (A) damages and (B) ownership and control of the investment at issue, the Mexican company, Acaverde, S.A. de C.V., which was the actual concessionaire ("Acaverde").

19. By a letter of 30 September 2002, the Claimant noted that it was on the point of delivering to the Respondent's counsel in Washington, DC, a series of documents related to an opinion given by the Claimant's expert witness, Dr. Slottje, indicating that "most, if not all, of the financial information requested by the Respondent regarding the issue of damages will be contained in one form or another in those documents". However, it declined without an order from the Tribunal to provide documents in Category B, indicating that the Respondent appeared to be bringing an additional preliminary objection on the issue of standing. In the Claimant's view, the procedure followed by the First Tribunal had ensured that "all arguments of fact and law relating to jurisdiction" were disclosed; these did not include questions of standing.

20. By a further letter of 30 September 2002, the Respondent stressed that it had at no stage waived any right to raise other objections to the claim. In any event, it noted that the Claimant's ownership and control of Acaverde was relevant to the merits, including, eventually, to the quantum of damages.

21. On 1 October 2002, the Tribunal issued a Procedural Order concerning Disclosure of Documents, giving a certain number of indications regarding disclosure. The Tribunal expressed the view that documents concerning Acaverde's finances and operations in relation to the concession might be sought, provided they were sufficiently identified. The Tribunal further indicated that the Respondent's request for "copies of all the invoices issued in the period 1994-1998" was *prima facie* too burdensome, since it was likely to include large numbers of documents which were not in dispute as such. The Tribunal agreed that documents clarifying the extent of the Claimant's ownership and control of the investment were relevant. Finally, the Tribunal indicated that any remaining issues concerning specific documents could be referred back to the Tribunal by either party for a prompt ruling.

22. After an exchange of correspondence between the Respondent and the Claimant in connection with the production of documents, by a letter of 12 November 2002, the Respondent called on the Tribunal to order that it had access to information regarding Acaverde in possession of Servicios de Tecnología Ambiental, S.A. de C.V.

(“Setasa”).<sup>5</sup> The Respondent explained the reasons for its request of the Claimant’s consent to the hand-over by Setasa of documents that had been provided by a predecessor of the Claimant under cover of a confidentiality agreement, to enable Setasa to assess the value of Acaverde.

23. By a letter of 15 November 2002, the Claimant outlined aspects of the history of its relations with Setasa, underlining that Setasa did not return the documents provided to it and there had been earlier litigation between Setasa and the Claimant regarding Setasa’s compliance with the confidentiality agreement. It offered to disclose directly to the Respondent any responsive documents which were returned to it by Setasa. The Claimant also called on the Tribunal to order immediate disclosure by the Respondent of nine classes of documents previously requested to the Respondent.

24. By a letter of 15 November 2002 to the Tribunal, the Respondent sought directions from the Tribunal as to what it characterized as “the Claimant’s substantial failure to comply with the Tribunal’s order”. In particular, it sought directions as to two classes of documents not disclosed. The first concerned Claimant’s conveyance of its Mexico operations in 1997. The second concerned alleged discrepancies as to the effective date on which the Claimant’s predecessor acquired Acaverde.

25. By a letter of 20 November 2002 to the Tribunal, the Respondent summarized the disclosure so far made by the Claimant. It set out in further detail reasons why the Respondent should be given access to documents in the control of Setasa. It argued that any disclosure request by the Claimant should be entertained only after the deposit of the Counter-Memorial, when it could be considered in the light of the arguments and documents contained in that filing.

26. By letter of 21 November 2002 to the Tribunal, the Claimant commented on the Respondent’s 15 November 2002 requests for orders. As to the 1997 conveyance, it offered to make available to the Respondent a redacted version of the agreement, or to file with the Tribunal an unredacted copy, which the Tribunal could confirm did indeed

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<sup>5</sup> Setasa negotiated with Acaverde’s principal shareholder, Sanifill, for the purchase of Acaverde in 1997 and accordingly received confidential information about the company as part of the due diligence process. It is this information which was the subject of the Respondent’s letter to the Tribunal of 12 November 2002. See further para. 66.

exclude Acaverde from the sale. As to the Respondent's second request, the Claimant noted that the difference between October 1994 and June 1995 in terms of the completed acquisition of Acaverde was irrelevant to standing under NAFTA Chapter 11.

27. By a letter of 21 November 2002 to the Tribunal, the Respondent rejected both proposals the Claimant had made as to the Agreement of 1997. The Respondent further rejected the Claimant's argument regarding the information requested in connection with the Cayman Islands transactions.

28. By a letter of 22 November 2002 to the Tribunal, the Claimant attached a redacted version of the 1997 Agreement.

29. On 25 November 2002, the Respondent requested an extension to file its Counter-Memorial. The Secretary informed the parties by a letter of 26 November 2002, that the Tribunal granted the extension requested by the Respondent and indicated the new schedule for the filing of pleadings.

30. On 27 November 2002, the Tribunal issued Procedural Order No. 2 concerning Disclosure of Documents. The Tribunal indicated that to the extent that documents identified by the Respondent were relevant to the question of ownership or control but the Claimant had neither disclosed them nor explained why they were not available, the Tribunal could draw corresponding inferences. It further stated that the Tribunal did not believe that any additional order was required as to documents pertaining to control over Acaverde in the period 1994-1995. The Tribunal also decided that the 1997 Agreement did not appear to be relevant to the present dispute, and accordingly did not order further disclosure. Regarding the documents in possession of Setasa, the Tribunal found it appropriate that the Claimant disclose promptly to the Respondent all relevant documents that Setasa might provide to the Claimant. The Tribunal asked the Claimant to provide the Tribunal with an explanation of the situation within 7 days of the date of the order.

31. In its Procedural Order No. 2, the Tribunal also addressed the Claimant's request for production of 9 categories of documents. The Tribunal granted in part the Claimant's request, in particular the documents related to Mexico's financial expert

evidence, and denied or found not relevant other categories of documents. The Tribunal directed that the Respondent should disclose the documents concerned at the same time as the Counter-Memorial or at the latest within 7 days of the filing of the Counter-Memorial.

32. The Respondent lodged its Counter-Memorial on the merits on 6 December 2002. On 13 January 2003, the Claimant requested an extension to lodge its Reply. The Secretary informed the parties by a letter of 15 January 2003 that the Tribunal had granted the extension requested by the Claimant and indicated the new schedule for the filing of pleadings, including the filing of submissions by the NAFTA Parties under NAFTA Article 1128.

33. The Claimant filed its Reply on the merits on 22 January 2003. The Respondent filed its Rejoinder on the merits on 7 March 2003.

34. Pursuant to a request of the Tribunal, the parties submitted a joint letter of 12 March 2003 regarding the organization of the hearing on the merits. The parties further expressed their views by a letter submitted by each party on 13 March 2003. The Tribunal, having considered the above correspondence, issued directions regarding the hearing on the merits which were communicated by the Secretary's letter of 14 March 2003.

35. On 19 March 2003, the Government of Canada filed a submission under Article 1128 of NAFTA and the United States of America advised the Tribunal on the same date that it did not intend to make a submission.

36. The hearing on the merits was held from 7 April until 10 April 2003 at the premises of the World Bank in Washington DC to hear the parties' oral arguments and the witnesses and experts called by them. The parties were represented as follows:

Attending on behalf of the Claimant:

Mr. Bob Craig, Assistant General Counsel, Waste Management, Inc.  
Mr. Kemp Sawyers, Baker & Botts LLP  
Mr. J. Patrick Berry, Baker & Botts LLP  
Ms. Clara Poffenberger, Baker & Botts LLP  
Ms. Guillermina Calles, Baker & Botts LLP  
Ms. Lila Pankey, Baker & Botts LLP  
Ms. Sharon Katz, Baker & Botts LLP



Mr. Ulrich Brunnhuber.  
Attending on behalf of the Respondent:

Mr. Hugo Perezcano Díaz, Lead Counsel, Ministry of Economy  
Mr. J. Christopher Thomas QC, Thomas & Partners  
Mr. Cameron Mowatt, Thomas & Partners  
Mr. Stephan E. Becker, Shaw Pittman  
Ms. Adriana González Arce Brilanti, Ministry of Economy,  
Mr. Salvador Behar Lavalle, Ministry of Economy  
Ms. Alejandra Galaxia Treviño Solís, Ministry of Economy  
Mr. Sanjay Mullick, Shaw Pittman  
Mr. Rolando García, Thomas & Partners  
Mr. Carlos García, Thomas & Partners  
Mr. Humberto Guerrero Shaw Pittman.

The following witnesses and experts were heard at the hearing:

*Witnesses of the Claimant:*

Mr. Rodney Proto  
Mr. H. Steven Walton  
Mr. Jaime Eduardo Herrera Gutiérrez de Velasco

*Witnesses of the Respondent:*

Mr. Mario Alcaráz Alarcón

*Experts of the Claimant:*

Dr. Daniel Slottje

*Experts of the Respondent:*

Mr. Carlos de Rivas Ibañez  
Mr. Carlos de Rivas Oest.

37. Representatives of the other two NAFTA parties attended the hearing:

Attending on behalf of the United States of America:

Mr. David A. Pawlak, Office of International Claims, Department of State  
Ms. Jennifer Gehr, Department of Commerce.

Attending on behalf of the Government of Canada:

Mr. Douglas Heath, Embassy of Canada in Washington, DC.

38. Transcripts in English and Spanish of the hearing on the merits were prepared and distributed to the parties and the members of the Tribunal.

39. By letter of 14 April 2003, the Secretary distributed copies of certain questions from the Tribunal to both parties as made at the end of the hearing on the merits. The Secretary also informed the parties, following the Tribunal's instructions, of the schedule for submitting their answers. The parties submitted their answers to the Tribunal's questions on 28 April 2003.

## **B. THE DISPUTE BETWEEN THE PARTIES**

40. The present dispute arises from a concession for the provision of waste disposal services in the Mexican City of Acapulco in the State of Guerrero, one of the component states of Mexico. The agreed terms for this operation were laid down in a Concession Agreement (*Título de Concesion*), the parties to which were the City through its Council (*Ayuntamiento*) ("the City") and Acaverde. Acaverde was a Mexican company created in 1994. It is said at all relevant times to have been a wholly owned subsidiary of the Claimant, Waste Management Inc. ("Waste Management"), a Delaware corporation with substantial interests in municipal waste disposal services in the United States and elsewhere.<sup>6</sup> The question of Waste Management's entitlement to claim under Articles 1116 or 1117 of NAFTA in respect of the present dispute involving Acaverde is an issue in the case. In this section of the Award, the Tribunal will refer to Acaverde as the actual contracting party and provider of services under the Concession Agreement.<sup>7</sup>

41. The Concession Agreement was concluded on 9 February 1995. It was amended in significant respects by a further agreement of 12 May 1995. Under the Concession Agreement as so amended ("the Concession Agreement"), Acaverde undertook to provide on an exclusive basis certain municipal waste disposal and street cleaning services in a specified area of Acapulco. The area concerned, containing approximately 9000 residential and commercial addresses, covered the principal tourist and beachfront area of the City, which is a fraction of the total area of Acapulco, a city of approximately 1.5 million people. Tourism is the most important service industry in Acapulco, and there is no doubt that the waste collection system in the tourist area needed attention.

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<sup>6</sup> USA Waste Services Inc. merged with Acaverde's principal shareholder, Sanifill, in 1996. The merged company was subsequently renamed Waste Management, Inc.

<sup>7</sup> The relationship between Acaverde and its parent companies is discussed at paras. 77-85, below.

42. Clause 15 of the Concession Agreement provided that the City would not grant to any other company or person “any right or concession inconsistent with the rights of the Concessionaire under this Concession Agreement”. Under the Program of Operations, the City undertook to enact “such ordinances and local statutes as may be necessary to forbid manual street sweeping, the collection, transportation, use, recycling or disposal by any person or entity other than the Concessionaire of any Waste generated within the Concession Area”. These ordinances and statutes were to be fully and promptly enforced, both for residential and commercial waste collection. The Parties agreed that the enactment of the relevant ordinances would be a condition precedent to the commencement of operations and that Acaverde could “treat as a default any failure of the City to enforce these ordinances fully”.

43. On 30 June 1995, before Acaverde commenced services under the Concession Agreement, the City passed and subsequently promulgated a Regulation regulating the Rendering of the Public Cleaning Service Concession (“the Cleaning Services Ordinance”). The Cleaning Services Ordinance established exclusivity of waste collection services, prohibited dumping of rubbish in the area and provided for enforcement by way of fines. A schedule of rates was attached.

44. Article 8 of the Cleaning Services Ordinance provided that residents or businesses located in the concession area “must request” the public cleaning service within 90 days of commencement of operations. The Respondent argued that this provision did not correspond to any substantive obligation in the Concession Agreement, and noted that the obligation to pay scheduled rates was not imposed on residents as such. Formally this is true. Only persons who had signed a service contract with Acaverde were obliged to pay, and owners of holiday apartments in the concession area might not have any incentive to do so. Furthermore the terms of service contracts were a matter for agreement; the Ordinance established maximum but not minimum rates and Acaverde could (and did) enter into contracts at less than the scheduled rate. It is true that the Concession Agreement clearly contemplated that Acaverde would enjoy exclusivity within the concession area, and the City would not undermine this exclusivity by granting others the right to collect waste. But this did not necessarily translate into a situation where Acaverde’s market penetration in the concession area was sufficient to maintain its profitability.

45. In addition to providing collection services, Acaverde undertook under the Concession Agreement to build and operate a permanent solid waste landfill for the City as a whole, which would enable the closure of two existing temporary sites. The City would provide a site for the landfill “as [a] gratuitous loan for the term of the concession”. Fees for use of the landfill could be charged, at approved rates, to commercial customers. Pending the construction of the permanent landfill Acaverde would be given, free of charge, access to one of the existing sites.

46. The term of the Concession Agreement was to be 15 years from the date of commencement of services.

47. Under the Concession Agreement, Acaverde undertook to make an initial investment of up to US\$12.8 million. Its charges were to be in accordance with the agreed schedule, which was an integral part of the Concession Agreement and was subject to indexation. In return the City would pay Acaverde a monthly fee for services which, after 1 January 1996 would be NP1 million<sup>8</sup> (approximately equivalent to US\$170,000 at then-current exchange rates), and which was also indexed. Acaverde would pay the City a bonus calculated on the basis of its “success rate” in obtaining payment from customers in the concession area. The bonus payable was only 3% of certain revenues if the success rate was between .80 and .849, but rose to 30% with a success rate above .95. This gave the City some incentive to seek to ensure exclusivity and completeness of coverage. On the other hand it implicitly acknowledged that such coverage would not necessarily be achieved. In fact, the success rate never rose as high as .60, and no bonuses were ever paid to the City under these provisions.

48. Under the Concession Agreement, payments due to Acaverde by the City would bear interest at a specified rate if unpaid after 60 days. The City undertook to negotiate with a development bank established by the federal government of Mexico, Banco Nacional de Obras y Servicios Publicos, S.N.C. (“Banobras”), “an irrevocable, contingent and revolving line [of credit]” to guarantee “all payment obligations” of the City for the term of the Concession Agreement (Article 11).

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<sup>8</sup> “NP” refers to Mexican New Pesos.

49. The Line of Credit Agreement was issued on 9 June 1995. As envisaged by the Concession Agreement, the parties to the Line of Credit Agreement were the Government of the State of Guerrero (“Guerrero”), the City and Banobras. It recited the need to guarantee payment obligations under the Concession Agreement “in the event the City faces temporary cash flow problems that prevent the City to comply with such obligations” (Recitals, cl. III). Despite the reference in Article 11 of the Concession Agreement to “all payment obligations” of the City, the Line of Credit Agreement only covered “an amount equal to six monthly payments agreed to for the services rendered”, i.e. NP6,000,000 (Recitals, cl. XI). Demands for payment under the Line of Credit Agreement could be made by the City or by Acaverde. Disputes under the Line of Credit Agreement were referred to the federal courts of Mexico to the exclusion of “any other jurisdiction that might be available to them by reason of their present or future domiciles” (Clause 14, as translated by the Tribunal).

50. Although the Line of Credit Agreement was clear in limiting the total amount of credit available at any time to NP6 million, Banobras had the right to divert federal payments to Guerrero by way of reimbursement. In this regard Clause 6 provided:

“In the event that one or more requisitions made against the line [of credit] are not paid within 90 days, the Bank will proceed without delay to give effect to the guarantee corresponding to the present and future entitlements

due from federal income to the State Government of Guerrero, thereby recovering the amounts paid to ‘Acaverde, S.A. de C.V.’ against this credit.”<sup>9</sup>

Interpreted literally, this provision was directed at the question of replenishment for Banobras from the federal funds of Guerrero in respect of payments already made to Acaverde and not repaid by the City. It was not expressed in terms of a right of recourse by Acaverde against federal funds in the hands of Guerrero.

51. Before the Tribunal there was some discussion as to Acaverde’s role in the conclusion of the Line of Credit Agreement, and whether it had accepted the limitation of

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<sup>9</sup> Translation by the Tribunal. The original reads:  
“En caso que una o más disposiciones hechas contra la línea no se paguen en el plazo de 90 días, el Banco procederá sin demora a hacer efectiva la garantía correspondiente al las participaciones presentes y futuras que le correspondan en ingresos federales al Gobierno del Estado de Guerrero, recuperando así las cantidades pagadas a ‘Acaverde, S.A. de C.V.’, con cargo a este crédito.”

the Banobras guarantee contained in that Agreement.<sup>10</sup> In the Tribunal's view, although Acaverde may not have played any role in the negotiation or drafting of the Line of Credit Agreement, and although it was no doubt unhappy about the limitation of the guarantee insisted on by Banobras, it nonetheless accepted the resulting situation and went ahead with its investment. In other words, in the Tribunal's view, Acaverde accepted that the Line of Credit Agreement concluded in June 1995 was sufficient to meet the requirements of the amended Concession Agreement.<sup>11</sup>

52. As required by Mexican law, the grant of the Concession for a period of 15 years was approved by Decree of the State Congress in December 1994.<sup>12</sup>

53. Disputes under the Concession Agreement were to be submitted to arbitration in accordance with Clause 17, which provided that:

“Any dispute arising from, or related to, this Concession, shall be submitted to Arbitration by one Arbitrator jointly appointed by the CONCESSIONAIRE and the MUNICIPAL COUNCIL. In the event the parties fail to reach an agreement on such appointment, the Arbitration shall be conducted by three Arbitrators, one of whom shall be an independent expert on Mexican Law. In the latter case, the Arbitrators appointed by the Parties shall jointly select a third Arbitrator, who shall be designated as President.”

The arbitration was to take place in Acapulco under the rules of Conciliation and Arbitration of the National Chamber of Commerce of Mexico City.

54. On 15 August 1995, Acaverde began providing services under the Agreement. Difficulties were encountered almost immediately in enforcing the exclusivity arrangements contained in the Concession Agreement, and there was strong customer resistance to paying for waste disposal services, either at all or at the published

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<sup>10</sup> Mr. Rodney Proto, transcript, 7 April 2003, 102; Mr. Steven Walton, *ibid.*, 282-7. Acaverde's Mexican lawyer, Mr. Jaime Herrera stated that Acaverde did not participate in the drafting of the Line of Credit Agreement and that its suggestions in that regard were rejected by Banobras (Herrera Statement, para. 9; see also Banobras' letter to Sanifill of 19 June 1995). But it is clear that Acaverde, which had agreed to the amended Concession Agreement at Banobras' insistence, had notice of the precise terms of the Line of Credit Agreement when it commenced operations in August 1995: *ibid.*, para. 8.

<sup>11</sup> In the correspondence preceding the Line of Credit Agreement, its limitations are consistently spelled out: e.g. in the letter of the State Delegate, Banobras to Acaverde, 26 May 1995. Subsequently (but before operations commenced), Banobras made it clear that the terms of the Agreement could not be changed: State Delegate, Banobras to Acaverde, 19 June 1995.

<sup>12</sup> Decree No. 127, 15 December 1994, published in the Guerrero *Official Gazette*, 3 January 1995.

rate.<sup>13</sup> Many of those who had previously picked up and/or dumped waste in the concession area on an informal basis were resistant to the new arrangements. The cast of resisters included the pig-farmers (*porcicultores*) who took waste food from restaurants as food for their animals; the “pirates” (*piratas*) who ran unauthorised pick-up trucks looking for (and also dumping) waste, and the hawkers or barrow-men (*carretilleros*) who would do small jobs, including waste disposal, for a tip. Acaverde eventually reached an agreement with the pig-farmers association, but the *piratas* and the *carretilleros* were a continuing source of difficulty.<sup>14</sup> In particular, Acaverde complained that permits issued to the “pirates” allowing them to collect waste in the concession area were not revoked and even continued to be issued. Acaverde also complained that City drivers were picking up waste within the concession area in return for tips.

55. In addition, Acaverde complained at the City’s failure to provide premises for Acaverde’s operations or to enter into the gratuitous loan agreement for the new landfill. Under the Concession Agreement the City was required to provide, through a gratuitous loan, a municipally-owned piece of land for use as a permanent landfill. This would enable the existing open air dumps to be closed. Acaverde complained that the land, though identified and surveyed, was never made available. In lieu of the proposed landfill, Acaverde operated a temporary land-fill, and allowed the City to use it to dump waste collected outside the concession area.<sup>15</sup>

56. Following initial public unrest at the introduction of Acaverde’s services and charges, the Mayor of Acapulco in October 1995 is reported as having requested Acaverde to “make adjustments to fit the Mexican standards”. Mayor Almazán is reported to have said that “the obligation to contract Acaverde’s services will be eliminated in order to remove what was previously interpreted as an imposition”.<sup>16</sup> There is certainly evidence supporting the Mayor’s perception that Acaverde’s concession had been “interpreted as an imposition”. But notwithstanding his statement, neither the Cleaning Services Ordinance nor the Concession Agreement was amended. The Mayor’s statement

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<sup>13</sup> See e.g., Mr. Rodney Proto, transcript, 7 April 2003, 89, lines 7-11.

<sup>14</sup> E.g., letters of Acaverde to the City, 2 September 1996, 13 December 1996.

<sup>15</sup> See Statement by Mr. D. Harich, a civil engineer employed by Waste Management to design the proposed landfill.

<sup>16</sup> “No es obligatorio Acaverde: ROA”, *El Sol de Acapulco*, 13 October 1995, p. 1.

may have added to Acaverde's difficulties, but in the Tribunal's view it did not cause the difficulties, nor did it bring about the failure of the enterprise. Rather it was symptomatic of a public debate about the concession at a difficult time for all concerned.

57. Over time, and with a substantial input of resources, Acaverde built up its client base in the Concession area to approximately 5000 addresses, i.e., about 55% of the total; but it was generally forced to offer discounts in order to attract customers. It also provided considerably more personnel for public street sweeping and collection services than the minimum required by the Concession Agreement. It is clear that the arrangement was not commercially viable, taking into account both the lower than expected proportion of customers serviced and the additional costs incurred.

58. But Acaverde's financial difficulties were greatly exacerbated in that from the beginning there were severe problems in ensuring regular payments from the City under the Concession Agreement. Of 26 invoices presented by Acaverde, the City paid one in full and made partial payments with respect to two.<sup>17</sup> In June 1996 Banobras paid invoices for the 4 months January-April 1996 under the Line of Credit Agreement (but without the indexation element), thereby reducing the City's indebtedness. This was the only payment made under the Line of Credit Agreement. On 23 July 1996, Acaverde requested Banobras to pay the invoice for May 1996, which had not been rejected by the City and was therefore deemed to have been accepted, and it made a series of similar requests for subsequent months. On 2 August 1996, Banobras gave two reasons for denying Acaverde's request: first, what it stated to be the NP5.9 million already paid had not been reimbursed by the City; second, the parties to the Concession Agreement were actively considering modifications to it in response to the City's financial crisis. Banobras' State Delegate wrote:

“Contractually, the Municipality of Acapulco is obliged to refund all amounts [paid under the Line of Credit] within 90 days and, if it fails to do so, the Bank will proceed to use federal contributions made by the Government of the State.

On the other hand, as you know, in the current negotiations between said company and the Municipality of Acapulco, it is considered to make amendments in the Concession Instrument, including the financial part as the main problem to be resolved. This willingness to amend the Concession

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<sup>17</sup> The City made a swap proposal in respect of the 1995 invoices which Acaverde refused, as it was entitled to do.



Instrument was expressed by both parties to the authorities of the Secretariat of Finance and Public Credit and to the Bank, but, to date, there is no final proposal accepted by both.

For the above reasons, I am informing you that it is impossible to pay the bill submitted, until the Municipality refunds to us the amount disbursed and sends us the agreements accepted by your company and the Municipality of Acapulco, which are indispensable elements in order to update the amount of the Line.”

59. Acaverde replied on 6 August 1996. It made the valid point that the amount it had received under the Line of Credit in June 1996 was only NP4.9 million, and that fees and interest charges owed by the City to Banobras as a result of payments to Acaverde should not be counted against it. It also noted that the continuation of its negotiations with the City was no excuse for Banobras not to comply with its obligations under the Line of Credit Agreement. Faced with Banobras’ refusal Acaverde reserved its legal rights:

“our company is forced to terminate the negotiations fostered by your H[onourable] Institution, we will protect our interests and rights contained in said Instrument [Concession Agreement] in the venue and form we deem necessary.”

60. Banobras was in a difficult position. On the one hand the initial Line of Credit was substantially exhausted, and the seizure of the diminished federal grants to the City for the purposes of replenishing it would have been a controversial act locally. The fact that the parties were considering changes to the Concession Agreement was, if not a justification, at any rate an excuse for not considering the exercise of that power for the time being.

61. For its part, the City wrote to Banobras on 11 September 1996, reciting what it claimed were failures on the part of Acaverde to perform its obligations under the Concession Agreement, requesting it not to make further payments under the Line of Credit and threatening it with litigation if it did.

62. The Claimant argued that this letter was a mere excuse by the City to avoid meeting its obligations under the Line of Credit Agreement, that any problems notified to Acaverde were promptly rectified, and that there was no general complaint from the City, at the time, as to the level and quality of the service Acaverde was providing. The

Respondent argued on the contrary that there were persistent problems. This is a matter on which the Tribunal can only reach an impressionistic view. It notes the comment by one witness, who at the relevant time was the City's Secretary of Finance: in his opinion, "Acaverde's service was incomplete, because it only collected garbage from people who had contracts with the company. But *it was efficient for those with contracts.*"<sup>18</sup> There is other evidence to the same effect: the commercial side of Acaverde's operations was efficiently performed, given the constraints upon it.

63. On the other hand, in the Tribunal's view, whatever may have motivated the City's letter to Banobras of 11 September 1996 it did not simply invent a dispute about the level of servicing which had no basis in fact. For a variety of reasons the street sweeping operations conducted by Acaverde were not enough to keep the streets of the concession area consistently clean. Apart from illegal dumping by pirates and the inevitable boundary problems of a partial concession in a large city, there was a persistent problem of "black spots" (*puntos negros*). For much of the period of operations, Acaverde did not collect from addresses which were not contracted; from its point of view this was an attempt to induce residents and businesses to contract with it, and was understandable. But Acaverde's sanitary obligations were not limited to removing trash deposited by its customers. The City had to step in on various occasions to deal with complaints and black spots, and it continued to have to expend resources and manpower on sanitary operations in the tourist zone. Whatever the rights and wrongs of the situation, the fact is that the black spots were a recurring problem. For example on 15 May 1996, Acaverde's General Manager wrote to the City stating that:

"Our company is making its best efforts to keep the concession area clean, so that we are asking for your help to penalize the citizens who throw out garbage in the streets creating black spots throughout the concession area."

64. Thus after September 1996, Banobras could argue that—quite apart from the non-replenishment of the Line of Credit—the City's non-payment of Acaverde's invoices was not the result of the City's financial crisis. Arguably it arose from a dispute between Acaverde and the City over the performance of the Concession Agreement, a dispute which Banobras had no obligation to settle. Whether that position was justified

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<sup>18</sup> Witness statement of Mr. Rogelio Moreno Jarquín, 4 December 2002, para. 8 (emphasis added).

under the Line of Credit Agreement was a question—but at any rate it might help to extricate Banobras from its awkward situation as between Acaverde on one hand and the City on the other.

65. In a letter to the City of 15 November 1996, Banobras defended its payment of NP4.9 million in June on the ground that it was fully justified under the Concession Agreement, and it referred to Acaverde's subsequent demands for payment under the Line of Credit up to September 1996, implying that they might require similar treatment. But in fact it continued to refuse to pay Acaverde's invoices, and it did not seek to have resort to federal funds in Guerrero's hands.

66. By early 1997 the Claimant was seeking to withdraw from Acapulco and to sell its business. On 27 February 1997 Sanifill, principal shareholder of Acaverde's holding company, entered into a 60 day letter of intent with a Mexican company, Setasa, allowing the latter access to Acaverde's financial and operating information on a basis of confidentiality in order to assess the price. Subsequently, on 23 May 1997, a contingent sale agreement was concluded with a price of NP36.6 million (approximately equivalent to US\$4.7 million at the then current exchange rate). In June 1997, however, Sanifill discovered that Setasa was in direct communication with the City, and eventually the sale did not proceed.

67. On 9 October 1997, Hurricane Paulina struck the Acapulco region, causing hundreds of deaths and enormous destruction.

68. By letter of 27 October 1997—with unhappy timing given that the City was still reeling from the hurricane—Acaverde announced that with effect from 12 November 1997 it would suspend the provision of services under the Agreement. The tasks it had performed were immediately assumed by Setasa,<sup>19</sup> which contracted with the City rather than with individual residents.

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<sup>19</sup> In accordance with a request of the City to Setasa, 12 November 1997.

69. Over the 27 months of Acaverde's operations, its invoices to the City totalled more than NP49 million, of which the City itself paid NP2,225,000 and Banobras paid NP4.9 million. Approximately 80% of the total amount invoiced went unpaid.

70. Acaverde brought two sets of proceedings before the Mexican federal courts against Banobras for non-performance of the Line of Credit Agreement. These proceedings were dismissed and Acaverde's appeals were likewise dismissed. Acaverde also commenced arbitration under Clause 17 of the Concession Agreement against the City ("the CANACO arbitration"); this was subsequently discontinued. The domestic Mexican proceedings are examined in detail in paragraphs 118-132 below.

71. On 29 September 1998, while the Mexican proceedings were still pending, Waste Management commenced the first ICSID arbitration, referred to in paragraph 4 above. Indeed it was because those proceedings were pending, and because further proceedings were possible, that Waste Management qualified the terms of its waiver under Article 1121, leading to the dismissal of its claim by the First Tribunal. The present ICSID proceedings were registered on 27 September 2000, by which time Acaverde's claims in the Mexican courts had all been dismissed and the CANACO arbitration had been discontinued without any decision being reached.

72. Despite these developments, Claimant brought precisely the same claim before the present Tribunal as it had in the first ICSID arbitration. In other words, it did not express its claim in terms of a denial of justice through the subsequent Mexican proceedings. By agreement, Claimant's Memorial in the first proceedings was taken to constitute its Memorial in the present proceedings. Nonetheless, and in the Tribunal's view inevitably, attention was paid both to the outcome and to the reasoning behind the Mexican court decisions, as well as to the reasons for Claimant's withdrawal of the domestic arbitration, having regard to their potential relevance to the claim brought under NAFTA Chapter 11 to this Tribunal. In the circumstances the Tribunal proposes to ask whether the facts as disclosed to it involved a breach of NAFTA Articles 1105 or 1110, even though the position may not have been fully captured in Claimant's re-filed Memorial.

## C. THE BASES OF CLAIM UNDER NAFTA

### (1) Overview

73. The Tribunal begins by observing that—unlike many bilateral and regional investment treaties—NAFTA Chapter 11 does not give jurisdiction in respect of breaches of investment contracts such as the Concession Agreement. Nor does it contain an “umbrella clause” committing the host State to comply with its contractual commitments. This does not mean that the Tribunal lacks jurisdiction to take note of or interpret the contract. But such jurisdiction is incidental in character, and it is always necessary for a claimant to assert as its cause of action a claim founded in one of the substantive provisions of NAFTA referred to in Articles 1116 and 1117. Furthermore, while conduct (e.g. an expropriation) may at the same time involve a breach of NAFTA standards and a breach of contract, the two categories are distinct. Even as to Article 1105, while it will be relevant to show that particular conduct of the host State contradicted agreements or understandings reached at the time of the entry of the investment, it is still necessary to prove that this conduct was a breach of the substantive standards embodied in Article 1105. Showing that it was a breach of contract is not enough.<sup>20</sup>

74. The Claimant alleged that the circumstances outlined above disclosed a breach by the Respondent of its duties to United States investors under NAFTA Article 1110 or alternatively under Article 1105(1). It put its damages at more than US\$36,000,000. In addition it sought to recover its demobilization costs resulting from the revocation of the Concession Agreement, which were estimated at US\$630,000. It also sought an award of legal costs.

75. The Respondent did not deny that for the purposes of Chapter 11 of NAFTA the conduct of the City of Acapulco and the State of Guerrero was attributable to it. More difficult issues arise with respect to the conduct of Banobras, which is a development bank partly-owned and substantially controlled by Mexican government agencies. Banobras’ general objective, in the words of the regional director of Banobras

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<sup>20</sup> See further *Compañía de Aguas del Aconquija S.A. & Vivendi Universal v. Argentine Republic* (ICSID Case No. ARB/97/3), Decision on Annulment, (2002) 6 ICSID Reports 340, 365-7 (paras. 95-101), cited with approval by the Tribunal in *SGS Société Générale de Surveillance S.A. v. Islamic Republic of Pakistan*, (ICSID Case No. ARB/01/13), decision of 6 August 2003, (2003) 18 ICSID Rev.-FILJ 307, 352-6 (paras. 147-8). See also *Azinian, Davittian & Baca v. United Mexican States* (ICSID Case No. ARB(AF)/97/2), (1998) 5 ICSID Reports 269, 286 (paras. 81, 83).

in Guerrero, is “to promote and finance activities carried out by the Federal, State, and Municipal Governments of the Country”.<sup>21</sup> From the material available to the Tribunal it is doubtful whether Banobras is an organ of the Mexican State within the meaning of Article 4 of the ILC’s Articles on Responsibility of States for Internationally Wrongful Acts.<sup>22</sup> Shares in Banobras were divided between the public and private sector, with the former holding a minimum of 66%. The mere fact that a separate entity is majority-owned or substantially controlled by the state does not make it *ipso facto* an organ of the state. Nor is it clear that in its dealings with the City and the State in terms of the Line of Credit it was exercising governmental authority within the meaning of Article 5 of those Articles.<sup>23</sup> The Organic Law of 1986 regulating Banobras’ activity confers on it a variety of functions, some clearly public, others less so. A further possibility is that Banobras, though not an organ of Mexico, was acting “under the direction or control of” Guerrero or of the City in refusing to pay Acaverde under the Agreement.<sup>24</sup> again, it is far from clear from the evidence that this was so.<sup>25</sup> For the purposes of the present Award, however, it will be assumed that one way or another the conduct of Banobras was attributable to Mexico for NAFTA purposes.

76. Mexico’s legal defence involved three strands. First, it denied that the Claimant had the status of an investor for the purposes of Chapter 11 on the grounds that the Claimant did not have a direct interest in the investment in Mexico, because Acaverde’s direct shareholder was a company registered in the Cayman Islands, not a NAFTA Party. Secondly, while not denying that there may have been breaches of the Concession Agreement by the City, Mexico denied that these breaches, individually or collectively, rose to the level of conduct in violation of NAFTA Article 1105. Thirdly, it denied that there had been any expropriation, direct or indirect, of the investment, i.e., of Acaverde’s business, contrary to NAFTA Article 1110. The Tribunal will discuss the

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<sup>21</sup> Statement of Mr. Mario Alcaraz Alarcón, para. 3.

<sup>22</sup> Annexed to GA Res. 56/83, 12 December 2001.

<sup>23</sup> The ILC’s commentary describes the notion of a “para-statal” entity as a narrow category: the essential requirement is that the entity must be “empowered by the law of the State to exercise functions of a public character normally exercised by State organs, and the conduct of the entity [which is the subject of the complaint] relates to the exercise of the governmental authority concerned”: Commentary to Article 5, paras. 2 and 7, reproduced in J Crawford, *The International Law Commission’s Articles on State Responsibility* (Cambridge, 2002) 100, 102.

<sup>24</sup> ILC Articles, Art. 8; see the commentary, esp. para. 6, in Crawford, 112-113.

<sup>25</sup> See below, paras. 103, 139 for the Tribunal’s findings on this point.

legal issues in turn, dealing with the facts (and with any factual disputes) as far as necessary for the purpose.

**(2) The status of the Claimant as an “investor”**

77. At the time it was incorporated, Acaverde was owned, through a holding company called AcaVerde Holdings Ltd, by Sun Investment Co., a Cayman Islands company. AcaVerde Holdings Ltd., also a Cayman Islands company, was purchased by Sanifill Inc., a U.S. company (“Sanifill”), at about the time the City initially approved the concession. The sale agreement of 21 December 1994 was contingent upon conclusion of the Concession Agreement and the Line of Credit Agreement. In fact the sale was completed on 27 June 1995. The price paid, in instalments, was US\$5 million, plus the right to certain royalties based on Acaverde’s operations. Subsequently, in August 1996, Sanifill merged with USA Waste Services Inc.; the merged company later adopted the name Waste Management Inc.

78. A number of witnesses presented by the Respondent asserted that the City was not aware at the time the Concession Agreement was negotiated that Acaverde was not owned by Sanifill. The Claimant’s witnesses asserted that they had informed the City of this fact. The Tribunal does not need to resolve the discrepancy. Although the City may not have been aware of the specific financial arrangements between Sun Investments and Sanifill, it was certainly aware that United States interests were involved in the proposed arrangement,<sup>26</sup> as was reported in the local press at the time.<sup>27</sup> The Concession Agreement was signed by Mr. Proto, a senior employee of Sanifill, under a power of attorney granted by Acaverde. As noted, the actual purchase of Acaverde’s stock was contingent upon the conclusion of the Line of Credit Agreement, without which the project would not have gone ahead. By the time Acaverde commenced operations on 15 August 1995, almost all its shares were owned, through Cayman Islands companies, by Sanifill.<sup>28</sup>

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<sup>26</sup> Mr. Walton, transcript, 7 April 2003, 233.

<sup>27</sup> *Novedades* (Acapulco), 30 October 1994, identifying Sanifill Inc. as the prospective concessionaire.

<sup>28</sup> On 30 November 1995, a merger agreement left Sanifill de Mexico, S.A. de C.V., a Mexican company, as the sole successor of the various intermediate holding companies of Acaverde, the ultimate controlling interest of which was in Sanifill.

79. In any event there is no general requirement of *mens rea* or intent in Section A of Chapter 11. The standards are in principle objective: if an investor suffers loss or damage by reason of conduct which amounts to a breach of Articles 1105 or 1110, it is no defence for the Respondent State to argue that it was not aware of the investor's identity or national character. The only question is whether the various requirements of Chapter 11 in this regard are satisfied.

80. Chapter 11 of NAFTA spells out in detail and with evident care the conditions for commencing arbitrations under its provisions. In particular it distinguishes between claims brought by an investor of another Party in its own right and claims brought by an investor on behalf of a local enterprise. The relevant provisions cover the full range of possibilities, including direct and indirect control and ownership. They deal with possible "protection shopping", i.e. with situations where the substantial control or ownership of an enterprise of a Party lies with an investor of a non-party and the enterprise "has no substantial business activities in the territory of the Party under whose law it is constituted or organized".<sup>29</sup> In other words NAFTA addresses situations where the investor is simply an intermediary for interests substantially foreign, and it allows NAFTA protections to be withdrawn in such cases (subject to prior notification and consultation). There is no hint of any concern that investments are held through companies or enterprises of non-NAFTA States, if the beneficial ownership at relevant times is with a NAFTA investor.

81. The scope of protection, and the care with which the relevant provisions were drafted, can be seen from the definitions in Articles 201 and 1139. In accordance with Article 201:

**"enterprise** means any entity constituted or organized under applicable law, whether or not for profit, and whether privately-owned or governmentally-owned, including any corporation, trust, partnership, sole proprietorship, joint venture or other association;

**enterprise of a Party** means an enterprise constituted or organized under the law of a Party;"

Plainly the term "enterprise" includes corporations established under the law of a third State.

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<sup>29</sup> NAFTA, Article 1113(2).



82. Then under Article 1139, which defines certain terms for the purposes of Chapter 11, further definitions are relevant:

“**investment** means:

- (a) an enterprise;
- ...
- (e) an interest in an enterprise that entitles the owner to share in income or profits of the enterprise;
- ...

**investment of an investor of a Party** means an investment owned or controlled directly or indirectly by an investor of such Party”.

83. Of course these are only definitions, but they are used consistently in the substantive provisions of Section A of Chapter 11 and in the remedial provisions of Section B. Article 1101 specifies the scope and coverage of Chapter 11:

“1. This Chapter applies to measures adopted or maintained by a Party relating to:

- (a) investors of another Party;
- (b) investments of investors of another Party in the territory of the Party; and
- (c) with respect to Articles 1106 and 1114, all investments in the territory of the Party.”

Thus when Article 1105 specifies the treatment to be accorded to investments of investors of another Party, there is no trace of a requirement that the investment itself have the nationality of that Party either at the time it was acquired or at the time the conduct complained of occurs. Similarly under Article 1110 dealing with expropriation, the protected quantity is “an investment of an investor of another Party” in the territory of the expropriating State. The nationality of the investment (as opposed to that of the investor) is irrelevant. The same is true in respect of claims by investors on their own behalf under Article 1116: it is sufficient that the investor has the nationality of a Party and has suffered loss or damage as a result of action in breach of one of the specified obligations, including Articles 1105 and 1110. The extent of that loss or damage is a matter of quantum, not jurisdiction.

84. Article 1117 deals with the special situation of claims brought by investors on behalf of enterprises established in the host State. But it still allows such claims where

the enterprise is owned or controlled “directly or indirectly”, i.e., through an intermediate holding company which has the nationality of a third State.

85. Where a treaty spells out in detail and with precision the requirements for maintaining a claim, there is no room for implying into the treaty additional requirements, whether based on alleged requirements of general international law in the field of diplomatic protection or otherwise. If the NAFTA Parties had wished to limit their obligations of conduct to enterprises or investments having the nationality of one of the other Parties they could have done so. Similarly they could have restricted claims of loss or damage by reference to the nationality of the corporation which itself suffered direct injury. No such restrictions appear in the text. It is not disputed that at the time the actions said to amount to a breach of NAFTA occurred, Acaverde was an enterprise owned or controlled indirectly by the Claimant, an investor of the United States. The nationality of any intermediate holding companies is irrelevant to the present claim. Thus the first of the Respondent’s arguments must be rejected.

### **(3) The claim for breach of NAFTA Article 1105**

86. The Tribunal turns to the claim for breach of Article 1105(1). This was not the primary basis of claim. Rather the Claimant argued that Article 1105 “provides an alternative and overlapping basis for recovery by Waste Management”, alongside its claim for expropriation under Article 1110.<sup>30</sup> Nonetheless it was an autonomous basis of claim, and it is convenient to deal with it first, before turning to Article 1110.

87. According to the Claimant, the investment was subject to arbitrary acts by the City, Guerrero and Banobras which were capricious, lacking in due process of law and which rendered the investment valueless.<sup>31</sup> Furthermore Acaverde was subjected to a denial of justice at the hands of the City, Guerrero and Banobras, which conspired to obstruct its access to judicial and arbitral forums to resolve claims under the concession: more specifically, these entities “funnelled” the litigation by raising procedural issues to

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<sup>30</sup> Memorial, para. 5.43.

<sup>31</sup> Reply, paras. 4.32-4.33.

delay the merits claims and deny Acaverde the opportunity to obtain timely payment from Banobras, aggravating its bad financial position.<sup>32</sup>

88. In assessing these arguments it is necessary to consider first the interpretation to be given to Article 1105(1), then its application to the facts of the present case.

(i) *The scope and interpretation of Article 1105(1)*

89. Article 1105 is entitled “Minimum Standard of Treatment”. The relevant provision here is paragraph 1, which provides as follows:

“(1) Each Party shall accord to investments of investors of another Party treatment in accordance with international law, including fair and equitable treatment and full protection and security.”

90. On 31 July 2001, the Free Trade Commission, acting under NAFTA Article 1131, issued the following interpretation of Article 1105(1):

“B. Minimum Standard of Treatment in Accordance with  
International Law

1. Article 1105(1) prescribes the customary international law minimum standard of treatment of aliens as the minimum standard of treatment to be afforded to investments of investors of another Party.

2. The concepts of ‘fair and equitable treatment’ and ‘full protection and security’ do not require treatment in addition to or beyond that which is required by the customary international law minimum standard of treatment of aliens.

3. A determination that there has been a breach of another provision of the NAFTA, or of a separate international agreement, does not establish that there has been a breach of Article 1105(1).”

91. The FTC’s interpretation has been extensively discussed in subsequent decisions, in particular the *Mondev*<sup>33</sup> and *ADF* cases.<sup>34</sup> The *Mondev* tribunal found that the FTC interpretation:

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<sup>32</sup> Reply, paras. 4.32, 4.39-4.40.

<sup>33</sup> *Mondev International Limited v. United States of America*, Award of 11 October 2002, 6 ICSID Reports 192.

<sup>34</sup> *ADF Group Inc. v. United States of America*, Award of 9 January 2003, 6 ICSID Reports 470.

- resolves any dispute about whether there was such a thing as a minimum standard of treatment of investment in international law in the affirmative;<sup>35</sup>
- makes clear that the standard of treatment is to be found by reference to international law;<sup>36</sup>
- clarifies that Article 1105 refers to a standard existing under customary law, not standards under other treaties of the NAFTA Parties or other provisions within NAFTA;<sup>37</sup>
- clarifies that the terms “fair and equitable treatment” and “full protection and security” are references to existing elements of customary international law and are not “additive”, that is, they do not add novel elements to that standard;<sup>38</sup> and
- incorporates current international customary law, at least as it stood at the time that NAFTA came into force in 1994, rather than any earlier version of the standard of treatment.<sup>39</sup>

92. This last point was expanded by the tribunal in *ADF*: it recorded the view of the United States, accepted by Canada and Mexico, that the customary international law in Article 1105(1) is not static and that the minimum standard of treatment does evolve, going onto say that “both customary international law and the minimum standard of treatment of aliens it incorporates, are constantly in a process of development.”<sup>40</sup>

93. Both the *Mondev* and *ADF* tribunals rejected any suggestion that the standard of treatment of a foreign investment set by NAFTA is confined to the kind of outrageous treatment referred to in the *Neer* case, i.e. to treatment amounting to an “outrage, to bad faith, to wilful neglect of duty, or to an insufficiency of governmental

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<sup>35</sup> *Mondev International Limited v. United States of America*, Award of 11 October 2002, 6 ICSID Reports 192, 216 (para. 98), 223 (para. 120). See also *ADF*, 527 (para. 178).

<sup>36</sup> *Mondev International Limited v. United States of America*, 216 (para. 98).

<sup>37</sup> *Ibid.*, 223 (para. 121).

<sup>38</sup> *Ibid.*, 223 (para. 122).

<sup>39</sup> *Ibid.*, 224 (para. 125).

<sup>40</sup> *ADF Group Inc. v. United States of America*, Award of 9 January 2003, 6 ICSID Reports 470, 527-8 (para. 179).

action so far short of international standards that every reasonable and impartial man would readily recognize its insufficiency”<sup>41</sup>.

94. The discussion of Article 1105 by the tribunal in *S.D. Myers*, even though before the FTC interpretation, may also be noted. The tribunal considered that a breach of Article 1105 occurs

“only when it is shown that an investor has been treated in such an unjust or arbitrary manner that the treatment rises to the level that is unacceptable from the international perspective. That determination must be made in the light of the high measure of deference that international law generally extends to the right of domestic authorities to regulate matters within their own borders. The determination must also take into account any specific rules of international law that are applicable to the case.”<sup>42</sup>

95. In the context of denial of justice arising from decisions of domestic courts, the *Mondev* tribunal formulated the test of the applicable “customary international law minimum standard” under Article 1105(1) in the following terms:

“The test is not whether a particular result is surprising, but whether the shock or surprise occasioned to an impartial tribunal leads, on reflection, to justified concerns as to the judicial propriety of the outcome, bearing in mind on the one hand that international tribunals are not courts of appeal, and on the other hand that Chapter 11 of NAFTA (like other treaties for the protection of investments) is intended to provide a real measure of protection. In the end the question is whether, at an international level and having regard to generally accepted standards of the administration of justice, a tribunal can conclude in the light of all the available facts that the impugned decision was clearly improper and discreditable, with the result that the investment has been subjected to unfair and inequitable treatment.”<sup>43</sup>

96. The *ADF* tribunal, citing *Mondev v. United States*, said of Article 1105 as interpreted by the FTC<sup>44</sup> that “any general requirement to accord ‘fair and equitable treatment’ and ‘full protection and security’ must be disciplined by being based on State

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<sup>41</sup> *USA (L.F. Neer) v. United Mexican States*, 1927, AJIL 555, at 556, cited in *Mondev*, 221 (para. 114).

<sup>42</sup> *S.D. Myers, Inc. v. Government of Canada*, Partial Award, 13 November 2000, para. 263. The majority (Arbitrator Chiasson dissenting) considered that the facts which supported a finding of breach of Article 1102 also established a breach of Article 1105, para. 266.

<sup>43</sup> *Mondev v. United States*, 225-6 (para. 127).

<sup>44</sup> *Ibid.*, 528-31 (paras. 180, 183-4).

practice and judicial or arbitral caselaw or other sources of customary or general international law.”<sup>45</sup> Considering the “general customary international law standard of treatment”, the Tribunal found that:

- the argument that the government procurement provisions were unfair was unconvincing. Performance requirements in governmental procurement were common to all three NAFTA Parties as well as to other States. Thus “the US measures cannot be characterized as idiosyncratic or aberrant and arbitrary”;<sup>46</sup>
- the actions of a government authority in refusing to follow and apply earlier case-law was not in the circumstances of the case “grossly unfair or unreasonable”, nor were ADF’s assumptions about the applicability of that case-law induced by the misrepresentations by authorised officials of government;<sup>47</sup>
- the government agency in question had not acted *ultra vires*, but, in any case, showing an act is *ultra vires* under the internal law of a state “by itself does not necessarily render the measures grossly unfair or inequitable under the customary international law standard of treatment embodied in Article 1105(1)... something more than simple illegality or lack of authority under the domestic law of a State is necessary”;<sup>48</sup>
- the investor’s claim that the United States had breached its duty under customary international law to perform its obligations in good faith in breach of Article 1105 added “only negligible assistance in the task of determining or giving content to a standard of fair and equitable treatment.”<sup>49</sup> However the Tribunal noted in this respect that the investor had not tried to show government actions refusing the request for a waiver of the procurement requirements were “flawed by arbitrariness”. There was no evidence that other companies had been granted the same waivers. The investor did not allege that the contract specifications were tailored so that only a specific US company could comply; nor did the investor show that extraordinary costs or other burdens had been imposed that were not also imposed on other contractors involved in the same project.

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<sup>45</sup> Ibid., 531 (para. 184).

<sup>46</sup> Ibid., 531 (para. 188).

<sup>47</sup> Ibid., 531-2 (para. 189).

<sup>48</sup> Ibid., 532-3 (para. 190).

<sup>49</sup> Ibid., 533 (para. 191).

97. The content of Article 1105 in light of the FTC interpretation was also discussed in *Loewen v. United States* in the specific context of denial of justice.<sup>50</sup> The tribunal said:

“Neither State practice, the decisions of international tribunals nor the opinion of commentators support the view that bad faith or malicious intention is an essential element of unfair and inequitable treatment or denial of justice amounting to a breach of international justice. Manifest injustice in the sense of a lack of due process leading to an outcome which offends a sense of judicial propriety is enough, even if one applies the Interpretation according to its terms.”<sup>51</sup>

The *Loewen* Tribunal also noted that discriminatory violations of municipal law would amount to a manifest injustice according to international law.<sup>52</sup> However, the tribunal held that, where the minimum standards of international law in question in a particular case are raised in respect of a claim of judicial action—that is, a denial of justice—what matters is the *system* of justice and not any individual decision in the course of proceedings. The system must be tried and have failed, and thus in this context the notion of exhaustion of local remedies is incorporated into the substantive standard and is not only a procedural prerequisite to an international claim.<sup>53</sup> For this reason, although the *Loewen* tribunal found that the first instance trial and its verdict were “clearly improper and discreditable” and a breach of the minimum standards of fair and equitable treatment, that did not dispose of the case.<sup>54</sup>

98. The search here is for the Article 1105 standard of review, and it is not necessary to consider the specific results reached in the cases discussed above. But as this survey shows, despite certain differences of emphasis a general standard for Article 1105 is emerging. Taken together, the *S.D. Myers*, *Mondev*, *ADF* and *Loewen* cases suggest that the minimum standard of treatment of fair and equitable treatment is infringed by conduct attributable to the State and harmful to the claimant if the conduct is arbitrary,

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<sup>50</sup> *The Loewen Group, Inc. and Raymond L. Loewen v. United States of America*, Award of 26 June 2003 (Case No. ARB(AF)/98/3). For the Tribunal’s discussion of the Article 1105 and the FTC interpretation see *ibid.*, paras. 124-8.

<sup>51</sup> *Ibid.*, para. 132.

<sup>52</sup> *Ibid.*, para. 135.

<sup>53</sup> *Ibid.*, para. 168.

<sup>54</sup> *Ibid.*, para. 137.

grossly unfair, unjust or idiosyncratic, is discriminatory and exposes the claimant to sectional or racial prejudice, or involves a lack of due process leading to an outcome which offends judicial propriety—as might be the case with a manifest failure of natural justice in judicial proceedings or a complete lack of transparency and candour in an administrative process. In applying this standard it is relevant that the treatment is in breach of representations made by the host State which were reasonably relied on by the claimant.

99. Evidently the standard is to some extent a flexible one which must be adapted to the circumstances of each case. Accordingly it is to the facts of the present case that the Tribunal turns.

(ii) *The allegations of breach of Article 1105(1)*

100. The Claimant asserted that the failure of Acaverde's enterprise arose from a combination of conduct of local, provincial and federal authorities, together with the failure of Mexican courts and tribunals to provide it any relief. In the first place the Tribunal will consider separately the conduct of each of the various Mexican authorities concerned. Subsequently it will deal with the claim that there was collusion or conspiracy between these authorities.

101. Before turning to the specific facts, the Tribunal notes that an important part of the background to the case was the Mexican financial crisis, which started in December 1994 with a substantial devaluation of the currency and continued for several years. During that period the value of the peso was approximately halved, the rate of inflation reached 38%, and federal revenues to the States and municipalities were greatly affected.<sup>55</sup> The effects on the City were numerous: tourist numbers declined, its financial obligations under the Concession Agreement (which were indexed to inflation) were substantially increased<sup>56</sup> and the federal revenues it received were substantially reduced.

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<sup>55</sup> See William A. Lovett, "Lessons from the Recent Peso Crisis in Mexico", (1996) 4 *Tulane JICL* 143.

<sup>56</sup> The monthly fee increased from NP1 million to NP1.6 million in January 1996.



(a) The conduct of Banobras

102. The only executive entity at federal level of whose conduct Waste Management complained was the development bank, Banobras.<sup>57</sup> Assuming, for the sake of argument, that Banobras' conduct was attributable to Mexico for NAFTA purposes (see above, paragraph 75), nonetheless the Tribunal finds that it did not constitute a breach of Article 1105. Prior to the conclusion of the Line of Credit Agreement in June 1995, Banobras, which had not been a party to the initial negotiations for the Concession Agreement, was in no way obliged to grant the line of credit. Its regional director explained that "lines of credit... guaranteed by the share of the States and Municipalities in federal tax revenue" were not common; in Guerrero, this was the only example and would not be repeated.<sup>58</sup> When it was approached by the City to grant the line of credit, Banobras insisted on various changes to the Concession Agreement. It was within its rights to do so, and the changes were accepted, albeit reluctantly, by Acaverde as a condition of its investment. Whatever hopes Acaverde may have entertained of having a significant part of its income guaranteed by the federal development bank, the fact is that the eventual guarantee was a more limited one, expressed to cover "temporary liquidity problems which the City of Acapulco might experience". On its face it "was not an alternative source [or] mechanism... for the regular payment, to Acaverde, of monthly payments for its services".<sup>59</sup> It was also limited in amount to NP6 million. In other words, it does not appear that Banobras had any obligation to make payments to Acaverde beyond that figure, unless the line of credit was replenished by the City or Banobras was able to divert federal funds in Guerrero's hands in order to replenish the line of credit.

103. It is not necessary for the Tribunal to determine whether, after the Line of Credit Agreement had been concluded, Banobras in all respects complied with its terms. The Agreement provided its own mechanism for determining that question. But it is clear that Banobras did comply at least to some extent, making payments to Acaverde totalling nearly NP5 million. It appears that this amount had not been reimbursed to Banobras by the City at the time Acaverde withdrew from providing services in October 1997. At the same time Banobras discussed with the parties possible changes to their arrangements

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<sup>57</sup> See e.g., Claimant's Memorial, para. 1.1.

<sup>58</sup> Statement of Mr. Mario Alcaraz Alarcón, para. 4.

<sup>59</sup> Ibid., para. 7.

which might be sustainable given the sharp drop in federal revenues to Guerrero and the City and the underlying crisis in public finances. Its role here was that of a concerned intermediary, and the failure of those discussions was not its fault.<sup>60</sup>

104. For these reasons, the Tribunal rejects the claim that Mexico was in breach of Article 1105(1) by reason of the conduct of Banobras.

105. There is a separate issue whether the Mexican courts denied justice to the Claimant through their decisions in the cases brought against Banobras. This is discussed in paragraphs 118-132 below.

(b) The conduct of Guerrero

106. Representatives of the State of Guerrero attended a number of meetings discussing a settlement of the problem, for example in June 1996. According to one witness, State officials offered help with payments to avoid drawing on the line of credit. But the City was unable to pay the share envisaged by these proposals, and the discussions did not reach any conclusion.<sup>61</sup>

107. Although the Claimant asserted that representatives of Guerrero were implicated in the continuing breach of the Concession Agreement, Guerrero was neither a party to the Agreement nor a guarantor. This situation was not affected by the legal requirement that the legislature of Guerrero approve the Concession Agreement, which it did on 15 December 1994. Overall the Tribunal has not been provided with any evidence that supports any specific charge against Guerrero in terms of Article 1105(1) of NAFTA.

(c) The conduct of the City

108. The position with respect to the City is more complex, and there is certainly a case to answer with respect to Article 1105(1).

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<sup>60</sup> See e.g. the letter from the State Representative, Mr. Alcaraz Alarcón to his superior in the Banobras head office, 10 October 1996.

<sup>61</sup> Second Statement of Mr. Alcaraz Alarcón, paras. 4-5.

109. On the information before the Tribunal it is clear that the City failed in a number of respects to fulfil its contractual obligations to Claimant under the Concession Agreement. It did so, most obviously, with respect to the monthly payments, which immediately fell into arrears. In addition Acaverde credibly alleged breaches of the agreement, for example with respect to inadequate enforcement of the 1995 Ordinance and the provision of land for the proposed permanent waste disposal site.

110. On the other hand there are a number of countervailing factors. The City did make at least some attempts to enforce the 1995 Ordinance. It defended proceedings brought against it by local residents challenging the Concession Agreement and the 1995 Ordinance. It made at least some attempts to encourage local residents and business groups to contract with Acaverde. Contrary to the Claimant's allegations, it did bring at least some proceedings against the "pirates" and even against its own employees caught moonlighting in the concession area. It made at least some attempts, through the deployment of inspectors, to enforce the Cleaning Services Ordinance. And some steps were taken, in conjunction with Acaverde, to identify a location for the permanent waste disposal site and to obtain secure title over it. For example, the City brought non-contentious proceedings before an Agrarian Court in Guerrero to give an agreement made with the holders of customary title over the land the status of an order of the Court; on 8 April 1996 the Court granted the order accordingly.<sup>62</sup>

111. Against this background of breaches of contract and allegations of non-performance, two facts are evident. The first is that the Concession Agreement was unpopular with a significant proportion of the residents of the concession area, many of whom were not permanently resident in Acapulco but maintained holiday apartments there. Even the permanent residents were not used to paying separately for waste disposal services. Moreover this problem—acknowledged as a potential difficulty by the Claimant from the outset—was exacerbated by the initial, rather heavy-handed approach of the Claimant in issuing immediate invoices to all area residents, accompanied by threats of legal action in the event of non-payment. As the Tribunal has noted (see paragraph 44 above), the obligation to pay for waste collection services was contingent upon the conclusion of a service agreement, and did not arise under the Cleaning Services

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<sup>62</sup> The land in question was *ejido* land (a form of customary or communal title). The agreement of 5 August 1995 conferred rights of exclusive use of 56 hectares of land for 25 years for use as a sanitary landfill by Acaverde.

Ordinance itself. The Claimant's apparent assumption to the contrary at the early stages of the introduction of the Concession stirred up substantial opposition, leading to public protests and a series of *amparo* actions against the City by residents and business groups. The City defended these actions, not always successfully; for example, confiscated vehicles belonging to several "pirate" collectors had to be released. At least some of the cases of non-compliance with the Concession Agreement of which Claimant complains were the result of these cases and of interim or final orders obtained against the City.

112. The second fact is that the financial plans of the City, and thus of the Claimant, were severely affected by the Mexican financial crisis, which lasted well into 1996 and severely affected the City's capacity to perform its obligations. The City was reduced to offering certain land holdings either to Acaverde in lieu of payment or to Banobras as security for extension of the line of credit.<sup>63</sup> Understandably, neither of them was prepared to accept this, but it is further evidence of the reality of severe financial difficulties.

113. The Tribunal notes that Acaverde itself responded to these early setbacks. It sought to persuade its potential customers to enter into contracts, so that by the end of the period of operations rather more than 50% of residents and enterprises had done so, although in many cases it was necessary to offer substantial discounts (up to 40-50%) on the published rates. It addressed operational complaints and difficulties. It showed flexibility in discussions with the City on a range of matters.<sup>64</sup> It took the initiative in creating a temporary land-fill which appears to have complied with applicable standards, unlike the two existing land-fills.<sup>65</sup> But the fact remains that the weaknesses of the original business plan could not be overcome at a time of financial stringency.

114. The Tribunal does not suggest that financial stringency or public resistance are, as such, excuses for breaches of contractual commitments on the part of a municipality. But NAFTA Chapter 11 is not a forum for the resolution of contractual disputes, and as investment tribunals have repeatedly said, "Investment Treaties are not

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<sup>63</sup> See Mayor Almazán's letter to Banobras, 26 August 1996 and the reply of 4 September 1996.

<sup>64</sup> E.g., letter of Mr. Proto to the Secretary-General of the City, 24 April 1996.

<sup>65</sup> Statement of Mr. D. Harich, paras. 4, 10.

insurance policies against bad business judgments”.<sup>66</sup> The question is whether, having regard to the conduct of the parties concerned and the general circumstances, losses were caused to Waste Management by the City in circumstances amounting to a breach of the minimum standard of treatment embodied in Article 1105, a standard which the Tribunal has summarised in paragraph 98 above.

115. In the Tribunal’s view the evidence before it does not support the conclusion that the City acted in a wholly arbitrary way or in a way that was grossly unfair. It performed part of its contractual obligations, but it was in a situation of genuine difficulty, for the reasons explained above. It sought alternative solutions to the problems both parties faced, without finding them. The most important default was its failure to pay; the Tribunal will discuss in a subsequent section whether such failure, persisted in, could have amounted to a breach of NAFTA Article 1110 because it was tantamount to expropriation, either of the enterprise as a whole or at least of the sums remaining unpaid.<sup>67</sup> For present purposes it is sufficient to say that even the persistent non-payment of debts by a municipality is not to be equated with a violation of Article 1105, provided that it does not amount to an outright and unjustified repudiation of the transaction and provided that some remedy is open to the creditor to address the problem. In the present case the failure to pay can be explained, albeit not excused, by the financial crisis which meant that at key points the City could hardly pay its own payroll. There is no evidence that it was motivated by sectoral or local prejudice.

116. The importance of a remedy, agreed on between the parties, for breaches of the Concession Agreement bears emphasis.<sup>68</sup> It is true that in a general sense the exhaustion of local remedies is a procedural prerequisite for the bringing of an international claim, one which is dispensed with by NAFTA Chapter 11. But the availability of local remedies to an investor faced with contractual breaches is nonetheless relevant to the question whether a standard such as Article 1105(1) have been complied with by the State. Were it not so, Chapter 11 would become a mechanism of equal resort

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<sup>66</sup> *Maffezini v. Spain*, Award, 13 November 2000, 5 ICSID Reports 419, 432 (para. 64), cited in para. 29 of *CMS Gas Transmission Company v. Argentina*, Decision of the Tribunal on Objections to Jurisdiction, 17 July 2003, 42 ILM 788 (2003). See also *Eudoro A. Olguín v. Republic of Paraguay*, ICSID Case No. ARB/98/5, Award, 26 July 2001, 6 ICSID Reports 164, paras. 72-75.

<sup>67</sup> See below, paras. 155-176.

<sup>68</sup> For the terms of Article 17 of the Concession Agreement see para. 53 above.

for debt collection and analogous purposes in respect of all public (including municipal) contracts, which does not seem to be its purpose.

117. For these reasons the Tribunal is not satisfied that the City's breaches of contract rose to the level of breaches of Article 1105(1) of NAFTA.

(d) The Mexican legal proceedings

118. But even if the conduct of the City or Banobras in itself did not violate the Article 1105 standard, the question remains whether the situation presented by their conduct was adequately responded to by the Mexican courts. Both the Concession Agreement and the Line of Credit Agreement made provision for dispute settlement, referring to local arbitration and proceedings before the federal courts of Mexico City respectively. The Claimant tried both avenues, eventually discontinuing the arbitration proceedings and failing in the federal court. It is thus necessary to ask to what extent the decisions of the federal courts or of CANACO either compounded the situation, or constituted a distinct denial of justice, so as to entail a breach of Article 1105(1).<sup>69</sup>

119. Before turning to the relevant legal principles, the course of the three proceedings needs to be described in more detail.

*The arbitration proceedings*

120. By notice of 3 December 1997, Acaverde notified the City that it was commencing arbitration proceedings under Article 17 of the Concession Agreement. On 9 January 1998 the Permanent Commission of Commercial Arbitration of the National Chamber of Commerce (CANACO) was notified. On 4 March 1998 the City objected to the Claimant's notice on procedural grounds, but it subsequently appointed its arbitrator after CANACO had threatened to make a default appointment if it did not. The two party-appointed arbitrators having failed to agree, on 8 September 1998 CANACO was requested to appoint a Chairman of the Tribunal, which it did. On 25 November 1998 the City objected to the jurisdiction of the Tribunal on the ground, *inter alia*, that the Concession Agreement was an administrative act governed by public law and therefore

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<sup>69</sup> Cf. *Azinian, Davitian & Baca v. United Mexican States*, Award of 1 November 1999, 5 ICSID Reports 269, 289 (para. 97).

necessarily subject to the jurisdiction of the contentious administrative courts; it also denied the Claimant's case on the merits.

121. Subsequently the City commenced court proceedings seeking to block the arbitration, using the same arguments.

122. In the light of the City's resistance to the arbitration, CANACO requested an advance of payment of NP2.5 million from each party as a condition of continuing the arbitration. (At then-current exchange rates this was equivalent to approximately US\$275,000.) The City refused to pay this amount, and thus if the arbitration was to proceed it would have had to be wholly funded by Acaverde. On 7 July 1999, counsel for Acaverde wrote to CANACO stating that unspecified "actions of the said Permanent Commission of Arbitration in the above mentioned arbitration trial, as well as the position taken by the Municipality of Acapulco, State of Guerrero, have prevented the continuation of such arbitration procedure". The file was duly returned on 14 September 1999.

123. CANACO is not a State organ, and in any event its sole role was to facilitate the arbitration. Evidence of collusion between CANACO and the City with respect to the conduct of the arbitration or of discrimination against Acaverde on account of its foreign ownership would have been very material, but there is no such evidence before the Tribunal.<sup>70</sup> Although the deposit sought was very large by local standards, the claim was large and the case threatened to be complex. On the evidence presented to the Tribunal, CANACO apparently behaved in a proper and impartial way. For example it rejected a preliminary jurisdictional submission made by the City's lawyers on the grounds that the question of jurisdiction was a matter for the tribunal.<sup>71</sup> Proceedings before the Mexican courts to resolve the issue of arbitrability were never concluded, but it may be inferred from the decisions both of the federal and State courts that they would have enforced the arbitration clause against the City: at any rate the Claimant has not

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<sup>70</sup> The Claimant asserts that CANACO imposed the requirement for deposit of costs "because it was concerned about its own liability in the nullification lawsuit if the arbitration continued". Whether or not its concerns were justified, they were still those of CANACO as a private entity, and there is no sufficient evidence that the judicial process was dilatory or gave unfair advantages to state entities in seeking to avoid domestic arbitration clauses to which they had agreed.

<sup>71</sup> Order of Permanent Arbitration Commission, National Chamber of Commerce of Mexico City, 18 June 1998.

demonstrated the contrary. In the circumstances the Tribunal finds that the discontinuance of the arbitration, a decision made by the Claimant on financial grounds, did not implicate the Respondent in any internationally wrongful act.

*The federal court proceedings*

124. In addition, in January 1997 Acaverde brought proceedings in the Mexican federal court against Banobras under the Line of Credit Agreement in respect of the unpaid invoices of 1996. Subsequently, in July 1998 it brought further proceedings against Banobras in respect of the 1997 invoices. Although Acaverde was not a party to the Line of Credit Agreement, under Mexican law it was entitled to sue as a beneficiary of that Agreement, and its standing to do so was upheld by the courts.

125. In the first proceeding against Banobras, Acaverde claimed more than NP15 million by way of principal plus damages and costs.<sup>72</sup> Guerrero and the City intervened as third parties at Banobras' suit, even though Acaverde made no affirmative claim against them in the proceedings. A challenge to Acaverde's standing having failed, the Tribunal dismissed Acaverde's claim on the ground that it had not proved it had strictly complied with the requirements of the Line of Credit Agreement in terms of demands for payment made on Banobras.<sup>73</sup> Acaverde appealed from this decision. On 11 March 1999, the Federal Tribunal dismissed the appeal, in part relying on the grounds given by the trial court, in part because, at the time the demand was made, Banobras had received from the City notice of a dispute about provision of services by Acaverde.<sup>74</sup> According to the appeal court this was "enough to prove that non-payment of the invoices presented was due to non-performance by Claimant, who is now dissatisfied, and not due to the Municipality's lack of liquidity".<sup>75</sup> An application for *amparo*<sup>76</sup> (a constitutional action) failed on the basis that although the lower court had misinterpreted the Line of Credit Agreement Acaverde had failed to prove the indebtedness.<sup>77</sup>

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<sup>72</sup> H. Juzgado Primero de Distrito en Materia Civil en el Distrito Federal. Juicio Ordinario Mercantil, expediente 12/97, *Acaverde, S. A. de C. V. v. Banco Nacional de Obral y Servicios Públicos, Sociedad Nacional de Crédito*.

<sup>73</sup> Decision of the First Civil District Court of the Federal District, 7 January 1999.

<sup>74</sup> H. Segundo Tribunal Unitario del Primer Circuito. Toca Civil 16/99-II.

<sup>75</sup> Decision of 11 March 1999.

<sup>76</sup> H. Sexto Tribunal Colegiado en Materia Civil del Primer Circuito. Amparo Directo D. C. 5026/99.

<sup>77</sup> Decision of 6 October 1999.



126. The second action,<sup>78</sup> in which Acaverde claimed NP22 million owing in respect of the January-October 1997 invoices, was dismissed on the basis that Banobras, having been notified of the dispute between Acaverde and the City, was entitled not to pay under the Line of Credit until that dispute was resolved.<sup>79</sup> Acaverde's appeal.<sup>80</sup> was dismissed on procedural grounds, on the basis that the dispute related to the Concession Agreement and that Acaverde should first have arbitrated its dispute with the City under Article 17 of the Concession Agreement. The dismissal was stated to be without prejudice to the rights of the Claimant in the proper forum.<sup>81</sup> Again Acaverde brought a constitutional action by way of *amparo* in respect of this decision.<sup>82</sup> It argued that the lower court, in applying the provisions of a 1996 amendment to the Code of Civil Procedure and the Code of Commerce, violated Articles 14 and 16 of the Mexican Constitution which prohibit the retrospective application of laws. The Line of Credit Agreement having been concluded in 1995, Acaverde argued, the 1996 amendment should not have been applied to it. The *amparo* application was rejected by a decision of 20 May 1999. The Court did not accept the City's argument that the application was inadmissible, but it denied the *amparo* claim on the basis that Acaverde had commenced the proceedings relying on the provisions of the law then in force, including the 1996 amendment. The Claimant having failed to challenge a ruling of the lower court to that affect had thereby consented to it: "if... Appellant submitted to the application of legislation currently in force and voluntarily consented to continuing the proceedings thereunder, it is not legally possible to change that on the grounds of that constituting a retroactive application of the Law where the application thereof was consented to from the beginning".

127. The proceedings in the two cases are summarised in Table 1 on the following page.

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<sup>78</sup> H. Juzgado Segundo de Distrito en Materia Civil en el Distrito Federal. Juicio Ordinario Mercantil, expediente 88/98. *Acaverde, S. A. de C. V. v. Banco Nacional de Obras y Servicios Públicos, Sociedad Nacional de Crédito. Institución de Banca de Desarrollo.*

<sup>79</sup> Decision of 12 January 1999.

<sup>80</sup> H. Primer Tribunal Unitario del Primer Circuito. Toca Civil 24/99-I.

<sup>81</sup> Interlocutory Decision, 18 February 1999.

<sup>82</sup> H. Séptimo Tribunal Colegiado en Materia Civil del Primer Circuito. Amparo Directo D. C. 2870/99.

**Table 1****Mexican Judicial Proceedings brought by Acaverde against Banobras**

	<u>First Proceeding</u>	<u>Second Proceeding</u>
Commenced	31 January 1997	11 August 1998
Subject matter	May-December 1996 invoices	January-October 1997 invoices
Amount claimed	Approx NP15 million	Approx NP22 million
First instance decision	<p><b>File 12/97, 7 January 1999</b></p> <p>Claimant's standing upheld but claim dismissed on the grounds that: (a) the Claimant did not prove that the City's non-payment was due to Council's lack of liquidity; (b) the invoices were not submitted in the form required by Line of Credit Agreement, demonstrating the City's acceptance thereof.</p>	<p><b>File 89/98, 12 January 1999</b></p> <p>Interlocutory order dismissing claim on the basis that the dispute related to the Concession Agreement and Acaverde should first have arbitrated its dispute with the City under Article 17 of the Concession Agreement. Case Dismissed without prejudice to the rights of the Claimant in the proper forum.</p>
Appeal	<p><b>Appeal file 16/99-II, 11 March 1999</b></p> <p>Rejected:</p> <p>(a) the Line of Credit can only be used in the event of the debtor's lack of liquidity;</p> <p>(b) Claimant had failed to prove City's receipt and acceptance of invoices;</p> <p>(c) on 13 September 1996 Banobras received formal notice of a dispute between City and Acaverde, establishing that non-payment was due to a dispute about performance, not to City's lack of liquidity</p>	<p><b>Appeal file 24/99-I, 18 February 1999</b></p> <p>Rejected on the ground that it was incorrectly filed.</p> <p>Appeal for reversal rejected on 25 February 1999 on the basis that Acaverde had not invoked the correct remedy of a motion for reconsideration.</p>
Amparo	<p><b>Amparo file 5026/99, 6 October 1999</b></p> <p>Rejected: Although the lower court erred in interpreting the Line of Credit Agreement, Acaverde did not prove City's receipt and acceptance of invoices, its tender of unstamped photocopies not being sufficient for this purpose, in accordance with prior case-law.</p>	<p><b>Amparo file DC 2870/99, 20 May 1999</b></p> <p>Rejected: The Claimant was entitled to invoke Articles 14 and 16 of the Constitution concerning non-retroactivity of the law in relation to the procedural reforms of 1996 (after the Line of Credit Agreement was concluded), but the Claimant had accepted the relevant provisions by conduct in commencing and continuing the suit.</p>

(e) Was there a denial of justice?

128. In asking whether these proceedings involved a denial of justice in terms of Article 1105, two points are fundamental. First, these proceedings were against Banobras

yet the underlying dispute was between the parties to the Concession Agreement, Acaverde and the City. That dispute could not be settled in federal proceedings against a federal agency unless Banobras was a guarantor of the whole of the City's indebtedness under the Concession Agreement. But—and this is the second point—such was not the case. Banobras had quite properly insisted on limiting its obligations under the Line of Credit and Acaverde had accepted that limitation.<sup>83</sup> It is true that Banobras could have sought replenishment of the Line of Credit by diverting federal revenues destined for the City which were in the hands of Guerrero. But in the context of the Mexican financial crisis this was hardly a realistic option, and in any event, it does not appear that Acaverde had any right under the Line of Credit that this be done. Thus the federal proceedings were in any event incapable of resolving Acaverde's most important grievances.

129. Turning to the actual reasons given by the federal courts, the Tribunal would observe that it is not a further court of appeal, nor is Chapter 11 of NAFTA a novel form of *amparo* in respect of the decisions of the federal courts of NAFTA parties. Certain of the decisions appear to have been founded on rather technical grounds, but the notion that the third party beneficiary of a line of credit or guarantee should strictly prove its entitlement is not a parochial or unusual one. Nor was it unreasonable, given the limitations of the Line of Credit Agreement, for the court in the second proceedings to insist that Acaverde comply with the dispute settlement procedure contained in the Concession Agreement, notice of the dispute with the City having been given to Banobras.

130. In any event, and however these cases might have been decided in different legal systems, the Tribunal does not discern in the decisions of the federal courts any denial of justice as that concept has been explained by NAFTA tribunals, notably in the

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<sup>83</sup> See above, para. 51.

*Azinian*,<sup>84</sup> *Mondev*,<sup>85</sup> *ADF*<sup>86</sup> and *Loewen* cases.<sup>87</sup> The Mexican court decisions were not, either *ex facie* or on closer examination, evidently arbitrary, unjust or idiosyncratic. There is no trace of discrimination on account of the foreign ownership of Acaverde, and no evident failure of due process. The decisions were reasoned and were promptly arrived at. Acaverde won on key procedural points, and the dismissal in the second proceedings, in particular, was without prejudice to Acaverde's rights in the appropriate forum.

131. The Claimant argues that litigation strategy adopted by the City itself amounted to a denial of justice and hence a breach of Article 1105. But the City was a litigant, and there is no evidence that it was acting in collusion either with CANACO or the federal courts. It is not unusual for litigants to be difficult and obstructive, and there is nothing here comparable to the abusive remarks of counsel in the *Loewen* case which were tolerated and even condoned by the trial judge, producing a denial of justice.<sup>88</sup> The point is that a *litigant* cannot commit a denial of justice unless its improper strategies are endorsed and acted on by the court, or unless the law gives it some extraordinary privilege which leads to a lack of due process. There is no evidence of either circumstance in the present case.

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<sup>84</sup> In *Azinian* the tribunal also addressed whether the Claimants could have successfully pursued a denial of justice claim. It said: "A denial of justice could be pleaded if the relevant courts refuse to entertain a suit, if they subject it to undue delay, or if they administer justice in a seriously inadequate way.... There is a fourth type of denial of justice, namely the clear and malicious misapplication of the law [which] ... overlaps with the notion of 'pretence of form' to mask a violation of international law." However, in the view of the tribunal, the findings of the Mexican courts could not "possibly be said" to be in any way a denial of justice, *Azinian, Davitian & Baca v. United Mexican States*, Award of 1 November 1999, 5 ICSID Reports 269, 290 (paras. 102-103).

<sup>85</sup> *Mondev International Limited v. United States of America*, Award of 11 October 2002, 6 ICSID Reports 192.

<sup>86</sup> The *ADF* Tribunal, rejecting the investor's submission that a federal administrative body had acted *ultra vires* in its interpretation of the measures in question, the Tribunal said, "...even had the investor made out a *prima facie* basis for its claim, the Tribunal has no authority to review the legal validity and standing of the US measures... under *US internal administrative law*. We do not sit as a court with appellate jurisdiction.... The Tribunal would emphasize, too, that even if the US measures were somehow shown or admitted to be *ultra vires* under the internal law of the United States, that by itself does not necessarily render the measures grossly unfair or inequitable under the customary international law standard of treatment embodied in Article 1105(1).... [S]omething more than simple illegality or lack of authority under the domestic law of a State is necessary to render and act or measure inconsistent with the customary international law requirements of Article 1105(1)...", *ADF Group Inc. v. United States of America*, Award of 9 January 2003, (para. 190). Nor was the authority's refusal to follow prior rulings "grossly unfair or unreasonable" on the facts presented by the investor.

<sup>87</sup> *The Loewen Group, Inc. and Raymond L. Loewen v. United States of America*, Award of 26 June 2003, (ICSID Case No. ARB(AF)/98/3). For the Tribunal's discussion of Article 1105 and the FTC interpretation see *ibid.*, paras. 124-128.

<sup>88</sup> *Ibid.*, paras. 119-123.

132. Of course, as the *Loewen* tribunal said, it is

“the responsibility of the State under international law and, consequently, of the courts of a State, to provide a fair trial of a case to which a foreign investor is a party. It is the responsibility of the courts of a State to ensure that litigation is free from discrimination against a foreign litigant and that the foreign litigant should not become the victim of sectional or local prejudice.”<sup>89</sup>

But neither the decisions themselves nor other evidence before the Tribunal suggest that these proceedings involved discrimination, bias on grounds of sectional or local prejudice, or a clear failure of due process. The CANACO arbitration, which alone held the prospect of complete relief for Acaverde in respect of its claims against the City, was not pursued, and the Tribunal has already held that this fact did not of itself entail a breach of Article 1105. As to the Banobras litigation, Acaverde did exhaust its remedies, but it was not a denial of justice for the federal courts to insist on prior action against the City. This aspect of the claim under Article 1105(1) accordingly fails.

(f) The termination phase

133. On the other hand the relief sought in the Mexican domestic proceedings did not cover the full scope of Claimant’s grievances against the City. Chapter 11 of NAFTA does not require that a party should exhaust local remedies before bringing an international claim: rather it requires a waiver of remaining remedies. There thus remains a question whether conduct attributable to the Respondent, and going beyond the scope of the legal proceedings brought by Acaverde, might constitute a breach of the standard embodied in Article 1105 of NAFTA.

134. Two specific complaints require discussion here. The first concerns the City’s dealings with Setasa, which the Claimant alleged involved a breach of its exclusive rights under the Concession Agreement, if not outright collusion.<sup>90</sup> There is little doubt that Setasa, having been initially involved in discussions with the Claimant,<sup>91</sup> was “waiting in the wings” later that year to take over the operation on a different basis. But there is no evidence that it did so before Acaverde’s withdrawal from the Agreement, and

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<sup>89</sup> *Loewen*, para. 123.

<sup>90</sup> See Claimant’s Memorial, paras. 3.74-3.76.

<sup>91</sup> A 60 day letter of intent was concluded between Sanifill & Setasa on 27 February 1997: see above, para. 66.

in any event whatever civil wrongs may have been committed during the *denouement* of the project, they did not in the Tribunal's opinion either cause or trigger its failure, nor did they independently amount to a breach of the Article 1105 standard.

135. A second and more serious complaint concerns the subsequent attempt by the City to enforce the performance bond given by Acaverde in the amount of NP6 million. This attempt was problematic, especially given the City's own record of non-performance of its obligations under the Concession Agreement. But in fact the City's attempt to collect this money failed, the bond-holder rejecting the claim,<sup>92</sup> and it is not alleged by the Claimant that it suffered any specific losses as a result of this episode.

136. Looking at the matter more generally, the position in this terminal phase can be compared with that in the *ELSI* case, where improper conduct of the local Italian authorities seems to have precipitated the collapse of a failing enterprise, leading to a fire-sale of assets and consequent losses to the investor. A Chamber of the Court held that such conduct did not amount to a breach of the applicable FCN treaty;<sup>93</sup> whether it would have amounted to a breach of NAFTA the Tribunal does not need to inquire. For the key difference here is that there was no actual requisition or any equivalent act triggering the departure of Acaverde. The Claimant was not prevented (as the parent company in the *ELSI* case was arguably prevented) from seeking to conduct an orderly withdrawal from Acapulco. Attempts at a financial settlement or sale of the enterprise failed, but this was not a result of any internationally wrongful act of the Respondent State.

(g) The allegation of conspiracy

137. Thus far the Tribunal has considered the various items of conduct complained of by the Claimant separately and serially. But the Claimant also, in effect, alleged that the various Mexican agencies conspired together to frustrate the concession, and that the sum of this conduct was greater than its various component parts in terms of causing a violation of Article 1105.<sup>94</sup>

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<sup>92</sup> See Statement of J. Herrera, para. 21.

<sup>93</sup> *Case Concerning Elettronica Sicula S.P.A. (ELSI) (United States of America v. Italy)*, 1989 ICJ Reports 15.

<sup>94</sup> See e.g., Claimant's Memorial, para. 3.65.

138. The Tribunal has no doubt that a deliberate conspiracy—that is to say, a conscious combination of various agencies of government without justification to defeat the purposes of an investment agreement—would constitute a breach of Article 1105(1). A basic obligation of the State under Article 1105(1) is to act in good faith and form, and not deliberately to set out to destroy or frustrate the investment by improper means.

139. But such an allegation needs to be proved, and the Claimant has not proved it. For example, the State Delegate of Banobras was said to be responsible for soliciting the City's letter of 11 September 1996 with a view to avoiding payment to Acaverde. He denied this in evidence before the Tribunal,<sup>95</sup> and the Tribunal accepts his denial. But in any event, as already noted, Banobras had no obligation to Acaverde to garnishee funds payable to the City in order to replenish the line of credit. There was a substantial reduction in federal funds being channelled through Guerrero, and in the absence of replenishment the line of credit was nearly exhausted. As the Tribunal has already found, the refusal of Banobras to go further, whether or not it was a breach of contract, was not in itself a breach of Article 1105(1), nor was it converted into such a breach by the federal court decisions. More generally, there are sufficient reasons to explain the collapse of the concession—attributable far more to the City than to Banobras—and there is no need to resort to conspiracy theories, unsupported by solid evidence. A marginal financial plan, predicated on a much more substantial federal guarantee than was eventually agreed, foundered on the rocks of a deteriorating financial climate and a combination of little and large local difficulties. That is not enough to cross the Article 1105(1) threshold.

*(iii) Conclusions as to Article 1105(1)*

140. For these reasons the Tribunal concludes that the claim under Article 1105(1) must fail.

**(4) The claim for expropriation: NAFTA Article 1110**

141. As noted, the Claimant's principal contention was founded not on Article 1105 but on Article 1110. The Claimant argued that Acaverde's entire enterprise in

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<sup>95</sup> Statement of Mr. Mario Alcaraz Alarcón, para. 22 (“Nobody at Banobras had anything to do with the sending of this letter.”); Second Declaration of Mr. Mario Alcaraz Alarcón, paras. 7-8 (“I deny that there was any type of coordination of the actions taken by the City Council and those taken by the Bank... Neither I nor the personnel of the Banobras office for which I was responsible took part in any discussion of [the cancellation of the concession].”).

Acapulco was expropriated by the City, or at any rate by the combined conduct of the City, Guerrero and Banobras, and that this was a breach of Article 1110 of NAFTA. Although the Claimant did not put it in these terms, it could also be argued that the persistent failure of the City to pay the amounts due under the Concession Agreement was tantamount to an expropriation at least of the amount unpaid. In the Tribunal's view the latter claim is encompassed within the former, and is *infra petita*. It is open to the Tribunal to find a breach of Article 1110 in a case where certain facts are relied on to show the wholesale expropriation of an enterprise but the facts establish the expropriation of certain assets only. Accordingly the Tribunal will consider first the standard set by Article 1110, in particular for conduct tantamount to an expropriation, then whether the enterprise as a whole was subjected to conduct in breach of Article 1110, and finally whether (even if there was no wholesale expropriation of the enterprise as such) the facts establish a partial expropriation.

(i) *The Article 1110 standard*

142. So far as relevant, Article 1110 provides that:

“1. No Party may directly or indirectly nationalize or expropriate an investment of an investor of another Party in its territory or take a measure tantamount to nationalization or expropriation of such an investment ('expropriation'), except:

- (a) for a public purpose;
- (b) on a non-discriminatory basis;
- (c) in accordance with due process of law and Article 1105(1);  
and
- (d) on payment of compensation in accordance with paragraphs 2 through 6.

...

7. This Article does not apply to the issuance of compulsory licenses granted in relation to intellectual property rights, or to the revocation, limitation or creation of intellectual property rights, to the extent that such issuance, revocation, limitation or creation is consistent with Chapter Seventeen (Intellectual Property).

8. For purposes of this Article and for greater certainty, a non-discriminatory measure of general application shall not be considered a measure tantamount to an expropriation of a debt security or loan covered by this Chapter solely on the ground that the measure imposes costs on the debtor that cause it to default on the debt.”



143. It may be noted that Article 1110(1) distinguishes between direct or indirect expropriation on the one hand and measures tantamount to an expropriation on the other. An indirect expropriation is still a taking of property. By contrast where a measure tantamount to an expropriation is alleged, there may have been no actual transfer, taking or loss of property by any person or entity, but rather an effect on property which makes formal distinctions of ownership irrelevant. This is of particular significance in the present case, at least as concerns the enterprise of Acaverde as a whole.

144. Evidently the phrase “take a measure tantamount to nationalization or expropriation of such an investment” in Article 1110(1) was intended to add to the meaning of the prohibition, over and above the reference to indirect expropriation. Indeed there is some indication that it was intended to have a broad meaning, otherwise it is difficult to see why Article 1110(8) was necessary. As a matter of international law a “non-discriminatory measure of general application” in relation to a debt security or loan which imposed costs on the debtor causing it to default would not be considered expropriatory or even potentially so. It is true that paragraph (8) is stated to be “for greater certainty”, but if it was necessary even for certainty’s sake to deal with such a case this suggests that the drafters entertained a broad view of what might be “tantamount to an expropriation”.

145. Thus there is some textual basis for the Claimant’s submission that “the modern definition of ‘expropriation’ must be broad enough to encompass every course of sovereign conduct that unfairly destroys a foreign investor’s contractual rights as an asset”.<sup>96</sup> The Claimant relied on a number of decisions in support of this proposition, and a review of these is first called for.

146. *LETCO v. Liberia*<sup>97</sup> concerned a 1970 concession agreement between LETCO and the Liberian government which gave LETCO, a Liberian company owned by French nationals, the exclusive right to harvest, process, transport and market forest products and to conduct other timber operations within an exclusive exploitation area, in

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<sup>96</sup> Reply, para. 4.23.

<sup>97</sup> *Liberian Eastern Timber Corporation [LETCO] v. Government of the Republic of Liberia* (1986) 2 ICSID Reports 343.

return for certain payments and the performance of other contractual obligations.<sup>98</sup> Following an attempt to renegotiate the agreement, the Liberian Forest Development Authority by a letter of 18 February 1980 reduced the concession area by more than half with immediate effect on the grounds of breaches of the concession agreement by LETCO. After unsuccessfully protesting the actions of the Authority, LETCO suspended its operations in March 1983 and commenced ICSID arbitration proceedings under the agreement. Subsequently Liberia annulled the concession agreement, again citing breaches of the agreement by LETCO. The tribunal found that the Authority's letter of February 1980 communicating the withdrawal of over half the concession area was an effective revocation of the agreement which rendered the concession useless to LETCO, and that the revocation was carried out in breach of the notice and cure provisions of the concession agreement.<sup>99</sup> The tribunal examined LETCO's alleged breaches of the agreement (as set out by Liberia in its correspondence with LETCO), and found the alleged breaches were not supported by the facts before it. Before turning to the assessment of compensation due to LETCO for Liberia's breach of contract, the tribunal considered whether Liberia's actions in reducing the concession area could be justified as an act of nationalisation. It found that any such defence would have failed because the confiscation of the concession area was not for a bona fide public purpose, was discriminatory and was not accompanied by appropriate compensation.<sup>100</sup> It should be stressed that LETCO did not base its claim on expropriation or unfair treatment, nor did the tribunal find Liberia responsible under international law for breach of the concession. The tribunal's discussion of expropriation was in the context of addressing a potential defence by Liberia (which did not appear in the proceedings) to the finding of breach of contract. The award of damages was based on the Liberian law of contract.

147. *Sapphire International Petroleums Ltd. v. National Iranian Oil Company*<sup>101</sup> concerned alleged breaches leading to the unlawful termination of an agreement between the claimant and the National Iranian Oil Company (NIOC) under which the parties would form a joint venture to prospect for and exploit oil in a specified geographical area. The

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<sup>98</sup> Ibid., 359.

<sup>99</sup> Ibid., 363.

<sup>100</sup> Ibid., 366-7.

<sup>101</sup> Arbitral Award, 15 March 1963, 35 ILR 136 (1967). The decision was later set aside by an Iranian court: see 9 ILM 1118 (1970).

relationship between the parties broke down after a only a few months. Sapphire repudiated the agreement on the grounds of NIOC's actions which, it concluded, showed that NIOC did not intend to perform its obligations under the agreement, and commenced arbitration proceedings. As in the *LETCO* case, the arbitration took place pursuant to an arbitration clause in the agreement between the parties. The arbitrator held that NIOC had breached the terms of the concession agreement in a manner which entitled Sapphire to terminate the contract and claim damages.<sup>102</sup>

148. The Claimant argues that the "*Sapphire* decision exemplifies State responsibility for undermining the investor-to-government relations on which a long-term economic development agreement is based" and that "the decision holds a State responsible for such conduct even where neither the State nor any State organ terminates the agreement outright".<sup>103</sup> While the arbitrator in *Sapphire* discussed in some depth the relevance of the nature of the contract to his finding as to the substantive law applicable to the dispute,<sup>104</sup> the award rests on a finding of breaches of contract by NIOC, a separate agency which was party to the contract and the defendant in the arbitration.

149. Thus both *LETCO* and *Sapphire* were awards for breach of contract, given by tribunals constituted under the arbitration provisions of those contracts. By contrast the present case concerns a claim that Mexico has breached Article 1110(1) by actions tantamount to expropriation. There is no suggestion that the contracts in the present case were "internationalized". They were contracts between Mexican persons or entities governed by Mexican law and including Mexican dispute settlement provisions. The Claimant relied on statements in the two decisions for the proposition that breach of contract can be characterised as an expropriation. But the two cases are of limited assistance: the statements to that effect, such as they are,<sup>105</sup> were not relevant to the awards of these tribunals.

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<sup>102</sup> 35 ILR 136, 185.

<sup>103</sup> Memorial, para. 5.30.

<sup>104</sup> 35 ILR 136, 170-6. Arbitrator Calvin found that the law of the contract was the rules of law "common to civilized nations" on the basis that the parties had not specified the applicable law in the contract, and the contract was fundamentally different from the ordinary commercial contract envisaged by the rules of private international law because of its long-term and quasi-international character.

<sup>105</sup> The term "expropriation" was not used by the arbitrator in *Sapphire*.

150. Turning to NAFTA itself, the meaning of Article 1110 has been discussed in a series of decisions by NAFTA tribunals.

151. *Pope & Talbot Inc. v. Government of Canada* concerned an alleged regulatory expropriation in terms of the right of access to the United States market. The tribunal held that this right was protected by Article 1105 as part of the “business” in question, but that the Canadian measure was not sufficiently restrictive to amount to a “taking”.<sup>106</sup>

152. The *S.D. Myers* case was also concerned with the distinction between regulation and expropriation, and to that extent is not relevant here. The tribunal defined creeping expropriation as “a lasting removal of the ability of an owner to make use of its economic rights...”.<sup>107</sup> The tribunal accepted that “in legal theory, rights other than property rights may be ‘expropriated’ and that international law makes it appropriate for tribunals to examine the purpose and effect of governmental measures”.<sup>108</sup> The tribunal held that the temporary closure of the border to PCB transports could not be characterised as a measure tantamount to expropriation, rejecting what it characterised as an attempt by the claimant to use the word “tantamount” to extend the meaning of the word “expropriation” beyond the “customary scope of the term... under international law”.<sup>109</sup> It noted that:

“The primary meaning of the word ‘tantamount’ given by the Oxford English Dictionary is ‘equivalent’. Both words require a tribunal to look at the substance of what has occurred and not only at form...”<sup>110</sup>

The tribunal considered that the drafters of the NAFTA intended the phrase “tantamount to expropriation” to cover the concept of “creeping expropriation”.<sup>111</sup> Canada’s actions were

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<sup>106</sup> Interim Award of 26 June 2000, 122 ILR 293, 334-337.

<sup>107</sup> *S.D. Myers, Inc. v. Government of Canada*, Partial Award, 13 November 2000, para. 283, cited in Claimant’s Reply, fn 184; see [http://www.dfait-maecti.gc.ca/tna-nac/disp/SDM\\_archive-en.asp](http://www.dfait-maecti.gc.ca/tna-nac/disp/SDM_archive-en.asp). This was an arbitration conducted under the UNCITRAL Rules.

<sup>108</sup> *Ibid.*, paras. 280-1.

<sup>109</sup> *Ibid.*, para. 285.

<sup>110</sup> *Ibid.*, paras. 285-6, citing *Pope & Talbot, Inc. v. Canada*, Interim Award, 26 June 2000, para. 104.

<sup>111</sup> *S.D. Myers*, para. 286.

not measures “tantamount to expropriation” because Canada realised no benefit from the measure and there was no evidence of a transfer of property or benefit directly to others.<sup>112</sup>

153. *Metalclad Corporation v. United Mexican States* was a claim arising from another municipal concession contract which met fierce local resistance.<sup>113</sup> The claimant alleged that Mexico, through the governments of the State of San Luis Potosi and municipality of Guadalcazar, had breached Articles 1105 and 1110 of the NAFTA by interference in the development and operation of a hazardous waste landfill. Summarising the scope of Article 1110, the tribunal said,

“expropriation under NAFTA includes not only open, deliberate and acknowledged takings of property, such as outright seizure or formal or obligatory transfer of title in favor of the host State, but also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host State.”<sup>114</sup>

The tribunal held that Mexico, by tolerating and acquiescing in the actions of the municipal authorities which prevented the operation of the fully constructed landfill, notwithstanding the approval and endorsement of the federal authorities, was responsible for a measure tantamount to expropriation of Metalclad’s investment in breach of Article 1110. Further, it held, the denial by the municipal authority of a construction permit on grounds which were not open to it and which contradicted earlier federal commitments,<sup>115</sup> and the absence of a timely, orderly and substantiated basis for the denial of the municipal permit amounted to an indirect expropriation.<sup>116</sup> The tribunal also considered that the Ecological Decree, setting aside the area as a reserve and thus preventing the land from being used as provided for in the agreement, was an act tantamount to expropriation and a further ground for finding a breach of Article 1110.<sup>117</sup>

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<sup>112</sup> Ibid., para. 287.

<sup>113</sup> *Metalclad Corporation v. United Mexican States*, Award, 30 August 2000, 5 ICSID Reports 209.

<sup>114</sup> Ibid., 230 (para. 103).

<sup>115</sup> The tribunal found that under federal law the municipal authority had the power to issue or refuse construction permits on construction grounds only, and its denial of the permit on ecological grounds was *ultra vires*: *ibid.*, 228 and 230 (paras. 92, 106).

<sup>116</sup> Ibid., 230 (paras. 106-7)

<sup>117</sup> Ibid., 231 (paras. 109, 111).

154. Mexico sought judicial review of the *Metalclad* award in the Supreme Court of British Columbia on various grounds.<sup>118</sup> The Supreme Court upheld Mexico's argument that the tribunal's finding under Article 1105 was in excess of jurisdiction because the tribunal used NAFTA's transparency provisions (extraneous to Chapter 11) as a basis for the interpretation and application of Article 1105.<sup>119</sup> As the tribunal had also based its Article 1110 finding of expropriation, at least in part, on Mexico's failure to act in a transparent manner, this finding was also outside the scope of the submission to arbitration.<sup>120</sup> However, the Supreme Court found that the tribunal's decision that the Ecological Decree was an expropriation was within jurisdiction and not patently unreasonable and that there were no grounds to set it aside.<sup>121</sup> Tysoe J. commented that the tribunal's definition of expropriation for the purposes of Article 1110 was "extremely broad", but held that this was not a reviewable issue under the relevant Canadian legislation.<sup>122</sup>

155. In the present case, for reasons that will appear, the Tribunal does not need to reach final conclusions on the meaning of the phrase "measures tantamount to... expropriation" in Article 1110. Each case has to be looked at it in light of the factual situation and the basis for the measures in question. There is no issue in the present case of "regulatory taking"; rather the question is whether the combined conduct of Mexican public entities had an effect equivalent to the taking of the enterprise, in whole or substantial part. In considering this question it is necessary to distinguish between the measures affecting Acaverde as a whole and those concerning particular contractual rights under the Concession Agreement.

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<sup>118</sup> *United Mexican States v. Metalclad Corporation*, decision of 2 May 2001, 2001 BCSC 664, 5 ICSID Reports 236.

<sup>119</sup> *Ibid.*, 5 ICSID Reports 236, 253 (para. 66).

<sup>120</sup> *Ibid.*, 255 (paras. 78-9).

<sup>121</sup> *Ibid.*, 259-60 (paras. 100, 105).

<sup>122</sup> *Ibid.*, 259 (para. 99)

(ii) *The Article 1110 standard applied to the enterprise*

156. Turning to the impact of the Mexican measures on Acaverde as a whole, the first point is that in the present case there was at no stage any expropriation of physical assets. The assets of Acaverde were sold off in an apparently orderly way at about the time it withdrew from operations under the Concession Agreement.<sup>123</sup>

157. Nor was there any direct or indirect expropriation of the enterprise, Acaverde, as such. As the Tribunal has already held, the reason Waste Management withdrew from Acapulco was not because the enterprise had been seized, or because its activity as a whole had been blocked, for example by the seizure of key items of its property, but because—as a result of contractual defaults, changes of circumstances and the fragility of the underlying business plan—the operation was persistently uneconomic.

158. Thus for present purposes the question is whether there was any conduct tantamount to an expropriation which might trigger NAFTA Article 1110. The Claimant contends that the City's refusal to pay on approved invoices and Banobras' refusal to make payments under the Line of Credit Agreement were confiscatory in effect, and that Acaverde's rights under the concession were rendered valueless by the combination of (a) the City's failure to enforce the exclusivity provisions of the Concession, (b) its frustrating the construction, building and operation of the landfill, and (c) its campaign of obstruction (in cahoots with Guerrero and Banobras) in the face of Acaverde's attempts to resolve the dispute. In short the Claimant argues that these actions and refusals to acts by the City, Guerrero and Banobras taken together resulted in a "creeping" expropriation of the Claimant's investment, in breach of Article 1110.<sup>124</sup>

159. In answering this question it is not necessary for the present Tribunal to resolve the differences in interpretation which arose in the *Metalclad* case as between the NAFTA tribunal and the British Columbia Supreme Court.<sup>125</sup> Leaving aside any question of the breadth of the definition of expropriation given by the *Metalclad* tribunal (at least when considered in isolation from the facts of that case), the present Tribunal does not

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<sup>123</sup> Mr. Rodney Proto, transcript, 7 April 2003, 194.

<sup>124</sup> Memorial, para. 5.8; Reply, para. 4.23.

<sup>125</sup> See paragraphs 153-154 above.

regard the conduct of Mexico in the present case as tantamount to expropriation of the enterprise as such, within the meaning attributed to that term in *Metalclad*. Acaverde at all times had the control and use of its property. It was able to service its customers and earn collection fees from them. It is true that the City failed to make available the promised land for the disposal site—but a failure by a State to provide its own land to an enterprise for some purpose is not converted into an expropriation of the enterprise just because the failure involves a breach of contract. It is also true that the City’s breaches (not remedied by Guerrero and remedied only to a limited extent by Banobras) had the effect of depriving Acaverde of “the reasonably-to-be-expected economic benefit” of the project so far as the monthly fees due from the City were concerned. But that will be true of any serious breach of contract: the loss of benefits or expectations is not a sufficient criterion for an expropriation, even if it is a necessary one.

160. In the Tribunal’s view, an enterprise is not expropriated just because its debts are not paid or other contractual obligations towards it are breached. There was no outright repudiation of the transaction in the present case, and if the City entered into the Concession Agreement on the basis of an over-optimistic assessment of the possibilities, so did Acaverde. It is not the function of Article 1110 to compensate for failed business ventures, absent arbitrary intervention by the State amounting to a virtual taking or sterilising of the enterprise.

161. The nearest the Claimant came to showing an outright repudiation of the enterprise by Mexico was the Mayor’s statement, shortly after the Concession Agreement came into force, to the effect that “the obligation to contract Acaverde’s services will be eliminated in order to remove what was previously interpreted as an imposition”.<sup>126</sup> This of course related only to one aspect of the concession arrangements, although an important aspect. But even if a unilateral and unjustified change in the exclusivity obligation could have amounted to an expropriation, no legislative change was in fact made. The Claimant argued that this statement “effectively repealed the law” but the Tribunal does not agree. The Mayor was not purporting to exercise legislative authority or unilaterally to vary the contract. He was not intervening by taking some extra-legal action, as the Mayor of Palermo did when he intervened in the *ELSI* case. He was saying what ought to be done,

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<sup>126</sup> See paragraph 56 above for the statement and its context.



in his view, to allay public concerns, concerns which did in fact exist at the time. Individual statements of this kind made by local political figures in the heat of public debate may or may not be wise or appropriate, but they are not tantamount to expropriation unless they are acted on in such a way as to negate the rights concerned without any remedy. In fact no action was taken of the kind threatened at the time or later. Even if it had been taken, the Claimant had remedies available to it, under the Concession Agreement and otherwise.

162. For these reasons the Tribunal does not accept that there was an expropriation of Acaverde in this case, or any measure tantamount to the expropriation of Acaverde as an enterprise.

*(iii) Was there conduct tantamount to an expropriation of Acaverde's contractual rights?*

163. This conclusion does not however exhaust the Claimant's case, for the reasons given in paragraph 141 above. Even if the enterprise of Acaverde was not subjected to conduct in breach of Article 1110 when considered as a whole, it is arguable that the persistent refusal or inability of the City to pay sums due under the Concession Agreement involved an expropriation, or at least measures tantamount to an expropriation, of the sums due. As another NAFTA tribunal confirmed in the *Mondev* case, "the protection afforded by the prohibition against expropriation or equivalent treatment in Article 1110 can extend to intangible property interests".<sup>127</sup> The Claimant alleged that the City's failure to pay, persisted in over many months, was a virtual expropriation of its contractual rights amounting to a breach of Article 1110.

164. This issue was raised but not resolved in the *Azinian* case.<sup>128</sup> There the claimants argued that the fundamental non-performance by the city council of a waste management contract with its Mexican subsidiary was a violation of Article 1110, relying on a "wealth of authority treating the repudiation of concession agreements as an

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<sup>127</sup> *Mondev International Limited v. United States of America*, Award of 11 October 2002, 6 ICSID Reports 192, 216 (para. 98).

<sup>128</sup> *Azinian, Davitian & Baca v. United Mexican States*, Award of 1 November 1998, 5 ICSID Reports 269.

expropriation of contractual rights”.<sup>129</sup> The tribunal, having emphasised that proof of a breach of contract did not equate to a breach of NAFTA Chapter 11, responded to this argument in the following terms:

“Labelling is... no substitute for analysis. The words ‘confiscatory,’ ‘destroy contractual rights as an asset,’ or ‘repudiation’ may serve as a way to describe breaches which are to be treated as extraordinary, and therefore as acts of expropriation, but they certainly do not indicate on what basis the critical distinction between expropriation and an ordinary breach of contract is to be made. The egregiousness of any breach is in the eye of the beholder—and that is not satisfactory for present purposes.”<sup>130</sup>

The Tribunal noted however that the repudiation by the council in that case took the form of the actual rescission of the contract for cause, which cause was upheld by the Mexican courts in proceedings not alleged to involve a denial of justice. In the absence of a denial of justice, the Mexican contract had no further existence as a source of rights.<sup>131</sup> That being so, the issue of breach of contract as conduct tantamount to expropriation did not arise: it was “unnecessary to consider issues relating to performance of the Concession Contract”.<sup>132</sup>

165. In the present case, by contrast, the City at no stage purported to invalidate or terminate the Concession Agreement. As the Tribunal has held, it did attempt to perform its obligations in a number of respects. At the same time it is undeniable (and the Respondent hardly sought to deny) that the City was in breach of the Agreement for much of its duration, especially as concerns its failure to pay the monthly fee due. Thus the present case does raise the question whether a persistent and serious breach of a contract by a State organ can constitute expropriation of the right in question, or at least conduct tantamount to expropriation of that right, for the purposes of Article 1110.

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<sup>129</sup> Ibid., 288 (para. 89).

<sup>130</sup> Ibid., 288 (para. 90).

<sup>131</sup> The tribunal stressed that the claimants’ failure to plead denial of justice in respect of the decisions of the Mexican courts was fatal: “if there is no complaint against a determination by a competent court that a contract governed by Mexican law was invalid under Mexican law, there is by definition no contract to be expropriated”: *ibid.*, 290 (para. 100).

<sup>132</sup> *Ibid.*

166. The Claimant relied on several earlier cases as authority for the proposition that contractual non-performance, and in particular the refusal to pay a debt, can constitute an expropriation.

167. *George W. Cook v. United Mexican States*<sup>133</sup> was a decision of the United States-Mexican Claims Commission established under the Convention of 8 September 1923.<sup>134</sup> This was a claim for postal money orders issued in 1913 and 1914 which were not paid by the Mexican postal authorities on presentation. The Commission found for the claimant, dismissing Mexico's submission that the action was time-barred because the right to collect on money orders expired two years after issue. Cook had presented the orders for payment within the two year period, the authorities had refused to pay them, contrary to the governing provisions of Mexican law, and now Mexico could not rely on its own default as a defence to the claim. Commissioner Nielsen, in a statement with which the other two commissioners concurred, said that: "[b]y the failure of the Mexican authorities to pay the money orders in question in conformity with the existing Mexican law when payment was due... Cook was wrongfully deprived at the time of property in the amount [of the postal orders]."<sup>135</sup> It may be noted that the Commission had jurisdiction over the whole class of claims by nationals of one State against the Government of the other State, to be decided "in accordance with the principles of international law, justice and equity". According to Article V of the Convention:

"The High Contracting Parties, being desirous of effecting an equitable settlement of the claims of their respective citizens, thereby affording them just and adequate compensation for their losses or damages, agree that no claim shall be disallowed or rejected by the Commission by the application of the general principle of international law that the legal remedies must be exhausted as a condition precedent to the validity or allowance of any claim."

Thus the Commission's jurisdiction was not dependent upon the qualification of the conduct as expropriatory; nonetheless the Commission did characterise it in those terms.

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<sup>133</sup> *George W. Cook v. United Mexican States*, Opinion of 3 June 1927, 22 *AJIL* 189. See also A.H. Feller, *The Mexican Claims Commissions 1923-1934* (New York, Macmillan, 1935) 179-80.

<sup>134</sup> *United States Treaty Series*, No. 678; 118 *British & Foreign State Papers* 1103.

<sup>135</sup> 22 *AJIL* 189, 191.

168. In the Tribunal's view, the outright refusal by a State to honour a money order or similar instrument payable under its own law may well constitute either an actual expropriation or at least a measure tantamount to an expropriation of the value of the order. There was no suggestion that Cook as the beneficiary of the money order was not entitled to be paid. Like other instruments of similar character the money order was not just an ordinary contract; it was an instrument representing a certain value which the State was *ex facie* committed to pay under its own law.

169. The *Cook* case was, however, relied on in *Singer Sewing Machine Co. v. The Republic of Turkey*<sup>136</sup> for the broader proposition that a government's failure to pay a debt due under a contract is an expropriation of the amount owed—and correspondingly the *Singer* case was relied on by the Claimant before this Tribunal. In that case the American-Turkish Claims Committee held that the Turkish Government's failure to pay for sewing machines it had agreed to purchase could be viewed as either a confiscation of the purchase price of the commodities or the destruction or confiscation of property rights in a contract. According to Nielsen's report, the Committee stated that:

“It cannot be said that the law of nations embraces any ‘Law of Contracts’ such as is found in the domestic jurisprudence of nations. International law does not prescribe rules relative to the forms and legal effect of contracts, but that law may be considered to be concerned with the action authorities of a government may take with respect to contractual rights. It is believed that in the ultimate determination of responsibility under international law, application can properly be given to principles of law with respect to confiscation, and that the confiscation of the property of an alien is violative of international law. If a government agrees to pay money for commodities and fails to make payment, the view may be taken that the purchase price of the commodities has been confiscated, or that the commodities have been confiscated, or that property rights in a contract have been destroyed or confiscated.”<sup>137</sup>

170. The United States-Turkish Exchange of Notes of 24 December 1923, pursuant to which the decision was made, was not limited to claims for expropriation, or indeed to claims for breaches of international law in any sense. The Exchange of Notes provided only that the Committee...

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<sup>136</sup> Reported in F.K. Nielsen, ed., *The American-Turkish Claims Settlement Commission. Opinions and Report* (Washington, Government Printing Office, 1937), 490, cited in Claimant's Memorial, paras. 5.46-5.47.

<sup>137</sup> Nielsen, 491.

“will proceed, with a view to determining the solutions which should be given them, to the examination of the claims presented by either Government within a period of six months from its constitution. The dossiers of the claims must contain the documents establishing the nature, the origin, and the justification of each claim.”<sup>138</sup>

Thus the Committee’s dictum quoted above was not necessary for the purposes of its decision. Moreover it was, in the present Tribunal’s view, far too wide. Taken literally that dictum would appear to eliminate the distinction between breach of contract and breach of treaty entirely.

171. Subsequent authorities have sought to make a distinction between mere failure or refusal to comply with a contract, on the one hand, and conduct which crosses the threshold of taking or expropriation, on the other hand. The Tribunal is sympathetic to the view expressed in *Azinian* that such a distinction is not adequately made by the addition of adjectives (“egregious”, “gross”, “flagrant” or whatever).<sup>139</sup> But *some* distinction must be made: if certain cases of contractual non-performance may amount to expropriation, it must be possible to say, in principle, which ones, otherwise the distinction between contractual and treaty claims disappears.

172. On analysis it appears that the cases fall into a number of groups. First and perhaps best known are the cases where a whole enterprise is terminated or frustrated because its functioning is simply halted by decree or executive act, usually accompanied by other conduct.<sup>140</sup> This was so in many of the oil cases,<sup>141</sup> and in many cases before the Iran-United States Claims Tribunal.<sup>142</sup>

173. Secondly, there are cases where there has been an acknowledged taking of property, and associated contractual rights are affected in consequence. In such cases the bundle of rights requiring to be compensated includes all the associated contractual and

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<sup>138</sup> Text in CI Bevens, *Treaties and other International Agreements of the United States of America 1776-1949* (1974) vol. 11, 1105.

<sup>139</sup> See above, para. 164.

<sup>140</sup> Thus in the *Rudloff* case, the council unilaterally terminated the contract and destroyed the building the Claimant was constructing on the land in question: (1905) 9 RIAA 255, 259.

<sup>141</sup> E.g., *Libyan American Oil Company v. Government of the Libyan Arab Republic*, (1977) 62 ILR 141, 189-90. See also *Revere Copper & Brass, Inc. v. Overseas Private Investment Corporation* (1978) 56 ILR 258.

<sup>142</sup> See the cases reviewed by GH Aldrich, *The Jurisprudence of the Iran-United States Claims Tribunal* (Oxford, Clarendon Press, 1996) ch. 5.

other incorporeal rights,<sup>143</sup> unless these are severable and retain their value in the hands of the claimant notwithstanding the seizure of the related property.

174. Thirdly, there is the much smaller group of cases where the only right affected is incorporeal; these come closest to the present claim of contractual non-performance. *Cook* was such a case, and (if it is properly classified as an instance of expropriation, which is doubtful) so was *Singer Sewing Machine Co. v. The Republic of Turkey*. In such cases, simply to assert that “property rights are created under and by virtue of a contract” is not sufficient.<sup>144</sup> The mere non-performance of a contractual obligation is not to be equated with a taking of property, nor (unless accompanied by other elements) is it tantamount to expropriation. Any private party can fail to perform its contracts, whereas nationalization and expropriation are inherently governmental acts, as is envisaged by the use of the term “measure” in Article 1110(1). It is true that, having regard to the inclusive definition of “measure”,<sup>145</sup> one could envisage conduct tantamount to an expropriation which consisted of acts and omissions not specifically or exclusively governmental. All the same, the normal response by an investor faced with a breach of contract by its governmental counter-party (the breach not taking the form of an exercise of governmental prerogative, such as a legislative decree) is to sue in the appropriate court to remedy the breach. It is only where such access is legally or practically foreclosed that the breach could amount to an definitive denial of the right (i.e., the effective taking of the chose in action) and the protection of Article 1110 be called into play.

175. The Tribunal concludes that it is one thing to expropriate a right under a contract and another to fail to comply with the contract. Non-compliance by a government with contractual obligations is not the same thing as, or equivalent or tantamount to, an expropriation. In the present case the Claimant did not lose its contractual rights, which it was free to pursue before the contractually chosen forum. The law of breach of contract is not secreted in the interstices of Article 1110 of NAFTA. Rather it is necessary to show

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<sup>143</sup> See, e.g., *Starrett Housing Corporation v. Government of the Islamic Republic of Iran* (1987) 16 Iran-US CTR 112, 230-1 (paras. 361-2).

<sup>144</sup> See *Shufeldt Claim*, (1930) 2 RIAA 1083, 1097. This was a case of legislative invalidation of a concession agreement 6 years after its inception.

<sup>145</sup> Article 201 defines “measure” as including “any law, regulation, procedure, requirement or practice”.

an effective repudiation of the right, unredressed by any remedies available to the Claimant, which has the effect of preventing its exercise entirely or to a substantial extent.

176. In the present case, in the Tribunal's view, this has not been shown. The question here is not one of final refusal to pay (combined with effective obstruction and denial of legal remedies); it is one of neglect and failure at the contractual level in the context of a marginal enterprise. That does not pass the test for an expropriatory taking of contractual rights as it emerges from the decisions analysed above.

*(iv) Conclusion as to Article 1110*

177. In the Tribunal's view, it is not the function of the international law of expropriation as reflected in Article 1110 to eliminate the normal commercial risks of a foreign investor,<sup>146</sup> or to place on Mexico the burden of compensating for the failure of a business plan which was, in the circumstances, founded on too narrow a client base and dependent for its success on unsustainable assumptions about customer uptake and contractual performance. A failing enterprise is not expropriated just because debts are not paid or other contractual obligations are not fulfilled. The position may be different if the available legal avenues for redress are blocked or are evidently futile in the face of governmental intransigence. But this was not the case here. The Claimant's decision not to proceed with the CANACO arbitration may have been understandable, but taking into account all the circumstances it did not implicate Mexico in a breach of Article 1110 any more than of Article 1105.<sup>147</sup>

178. For all these reasons, in the Tribunal's view, there was nothing which could be properly described as an expropriation by Mexico of Waste Management's property, assets or investment, or a measure tantamount to such expropriation, within the meaning of NAFTA Article 1110. The Claimant's case on Article 1110, like that on Article 1105, must fail.

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<sup>146</sup> Cf. *Marvin Feldman v. Mexico*, ICSID Case No. ARB(AF)/99/1, Award of 16 December 2002, para. 111.

<sup>147</sup> See above, para. 118-132 for an analysis of the remedies sought by Acaverde in the context of Article 1105.

#### D. THE ISSUE OF COSTS

179. Turning to the question of the costs and expenses of the proceeding, no question arises as to the costs of the first proceeding, which were dealt with by the first Tribunal.<sup>148</sup>

180. In its decision of 26 June 2002, this Tribunal reserved the question of costs on Mexico's preliminary objection, as to which the Claimant was successful.

181. As is now unfortunately common, there were a significant number of interlocutory issues raised by both parties during the proceedings.

182. As to the merits, in the Tribunal's view the proceedings were expeditiously and efficiently conducted by the representatives of both parties.

183. There is no rule in international arbitration that costs follow the event. Equally, however, the Tribunal does not accept that there is any practice in investment arbitration (as there may be, at least *de facto*, in the International Court and in interstate arbitration) that each party should pay its own costs. In the end the question of costs is a matter within the discretion of the Tribunal, having regard both to the outcome of the proceedings and to other relevant factors.

184. In circumstances where the conduct of the City is by no means beyond criticism, the Tribunal concludes that a fair outcome would be an order that each party bear its own legal costs and expenses, and that the costs and expenses of the Tribunal be borne equally between them.

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<sup>148</sup> *Waste Management, Inc. v. United Mexican States*, Award, 2 June 2000, 5 ICSID Reports 443, 461-2.



**AWARD**

For the foregoing reasons, the Tribunal unanimously DECIDES:

- (a) That the claim is admissible under Chapter 11 of NAFTA;
- (b) That the conduct of the Respondent which is the subject of the claim did not involve any breach of Article 1105 or 1110 of NAFTA;
- (c) That Waste Management's claim is accordingly dismissed in its entirety;
- (d) That each Party shall bear its own costs and half of the costs and expenses of these proceedings.

Done at Washington, D.C. in English and Spanish, both versions being equally authoritative.

Professor James Crawford  
President of the Tribunal

Mr. Benjamin R. Civiletti  
Member

Mr. Eduardo Magallón Gómez  
Member

Date of dispatch to the parties: July 14, 2006

INTERNATIONAL CENTRE FOR SETTLEMENT  
OF INVESTMENT DISPUTES  
WASHINGTON, D.C.

IN THE PROCEEDING BETWEEN

AZURIX CORP.  
(CLAIMANT)

AND

THE ARGENTINE REPUBLIC  
(RESPONDENT)

ICSID CASE No. ARB/01/12

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AWARD

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*Members of the Tribunal*

Dr. Andrés Rigo Sureda, President  
The Honorable Marc Lalonde P.C., O.C., Q.C., Arbitrator  
Dr. Daniel Hugo Martins, Arbitrator

*Secretary of the Tribunal*

Ms. Claudia Frutos-Peterson

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## **AWARD**

### **I. Introduction**

1. The Claimant, Azurix Corp., is a corporation incorporated in the State of Delaware of the United States of America (hereinafter “Azurix” or “the Claimant”). It is represented in this proceeding by:

Mr. Doak Bishop  
King & Spalding  
1100 Louisiana, Suite 4000  
Houston, TX 77002  
United States of America

Mr. Guido Santiago Tawil  
M&M Bomchil  
Suipacha 268, Piso 12  
C1008AAF Buenos Aires  
Argentina

2. The Respondent is the Argentine Republic (hereinafter “Argentina” or “the Respondent”), represented in this proceeding by:

Mr. Osvaldo César Guglielmino  
Procurador del Tesoro de la Nación  
Procuración del Tesoro de la Nación Argentina  
Posadas 1641  
CP 1112 Buenos Aires  
Argentina

## **II. Procedural background**

3. On September 19, 2001, Azurix filed a request for arbitration against the Argentina Republic, with the International Centre for Settlement of Investment Disputes (hereinafter the "Centre"). Azurix claims that Argentina has violated obligations owed to Azurix under the 1991 Treaty Concerning the Reciprocal Encouragement and Protection of Investment between the Argentine Republic and the United States of America (hereinafter "the BIT"), international law and Argentine law in respect of Azurix's investment in a utility which distributes drinking water and treats and disposes of sewerage water in the Argentine Province of Buenos Aires. Azurix alleges such breaches were made by Argentina both directly through its own omissions and through the actions and omissions of its political subdivisions and instrumentalities.

4. On October 23, 2001, the Secretary-General of the Centre registered Azurix's request for arbitration, pursuant to Article 36(3) of the ICSID Convention on the Settlement of Investment Disputes between States and National of other States (hereinafter "the Convention").

5. On November 12, 2001, the parties agreed that the Arbitral Tribunal would consist of three arbitrators, one to be appointed by each party and the third presiding arbitrator to be appointed by the Chairman of the Administrative Council of the Centre. Accordingly, the Claimant appointed Professor Elihu Lauterpacht, C.B.E. Q.C., a British national, and the Respondent appointed Dr. Daniel H. Martins, an Uruguayan national. Dr. Andrés Rigo Sureda, a Spanish national, was appointed President after consultation with the parties.

6. The Tribunal was deemed to have been constituted on April 8, 2002 and the proceeding to have commenced. On the same date, the parties were notified that Ms. Claudia Frutos-Peterson, Counsel, ICSID, would serve as Secretary of the Arbitral Tribunal.

7. In accordance with Arbitration Rule 13, the Tribunal held its first session with the parties in Washington D.C. on May 16, 2002. Mr. R. Doak Bishop of King & Spalding represented the Claimant at the first session, and Mr. Hernán Cruchaga and Ms. Andrea G. Gualde of the Procuración del Tesoro de la Nación, Buenos Aires, acting

on instruction from the then Procurador del Tesoro de la Nación, Dr. Rubén Miguel Citara, represented the Respondent at the first session.

8. At the first session, the parties agreed that the Tribunal had been properly constituted and that they had no objection to any of the members of the Tribunal, and it was noted that the proceedings would be conducted under the ICSID Arbitration Rules in force since September 26, 1984 (hereinafter “the Arbitration Rules”). In respect of the pleadings to be filed by the parties, their number, sequence and timing, it was announced after consultation with the parties that the Claimant would file its Memorial within 150 days of the date of the first session, the Respondent would file its Counter-Memorial within 150 days of the date of receipt of the Memorial, the Claimant’s Reply would be filed within 60 days of the date of receipt of the Counter-Memorial, and the Respondent’s Rejoinder would be filed within a further 60 days of its receipt of the Reply. It was further noted by the Tribunal that, in accordance with the Arbitration Rules, the Respondent had the right to raise any objections it might have to jurisdiction no later than the expiration of the time limit fixed for filing its Counter-Memorial. If such objections to jurisdiction were made by the Respondent and rejected by the Tribunal, it was agreed that the above timetable would be resumed following the resumption of proceedings on the merits.

9. In accordance with the timetable decided during the first session, Azurix filed its Memorial on the merits on October 15, 2002, claiming that Argentina had breached the BIT by expropriating its investment by measures tantamount to expropriation without prompt, adequate and effective compensation (Article IV(1)), by failing to accord to it fair and equitable treatment, full protection and security, and treatment required by international law (Article II(2)(a)), by taking arbitrary measures that impaired Azurix’s use and enjoyment of its investment (Article II(2)(b)), by failing to observe obligations Argentina entered into with regard to Azurix’s investment (Article II(2)(c)), and by failing to provide transparency concerning the regulations, administrative practices and procedures and adjudicatory decisions that affect Azurix’s investment (Article II(7)). In addition, Azurix requested orders for the payment of compensation for all damages suffered and the adoption by Argentina of all necessary measures to avoid further damages to Azurix’s investment. Azurix expressly reserved its right to request a



decision on provisional measures under Article 47 of the ICSID Convention and Arbitration Rule 39.

10. On March 7, 2003, Argentina filed a Memorial on jurisdiction raising two objections to the Tribunal's jurisdiction. The first was that Azurix agreed to submit this dispute to the courts of the city of La Plata and waived any other jurisdiction and forum; the second was that Azurix had already made a forum selection under Article VII of the BIT by submitting the dispute to Argentine courts. On March 12, 2002 the Tribunal suspended the proceeding on the merits pursuant to Arbitration Rule 41(3), and set dates for filing pleadings on jurisdiction. Accordingly, Azurix filed its Counter-Memorial on jurisdiction on May 13, 2003.

11. Azurix filed a request for provisional measures on July 15, 2003 (dated July 14, 2003), subsequently supplemented by two letters dated July 21 and 28, 2003. The request sought a provisional measure recommending that Argentina refrain from incurring by itself or through any of its political subdivisions in any action or omission capable of aggravating or extending the dispute, taking into account especially the reorganization of Azurix's Argentine subsidiary, Azurix Buenos Aires S.A. (hereinafter "ABA"), or any other measure having the same effect.

12. At the request of the Tribunal, Argentina filed observations on Azurix's request for provisional measures on July 24, 2003, seeking dismissal of the request for provisional measures together with costs and requesting that the Tribunal request the Claimant to produce an original copy of the Decision of the Appeals Chamber of the Province of Buenos Aires.

13. The Tribunal, in a decision of August 6, 2003, rejected Azurix's request for provisional measures, considering that, in the circumstances of the case and at that stage of proceedings, it was not in a position to recommend the specific measure requested or to propose others with the same objective. The Tribunal did, however, invite the parties to abstain from adopting measures of any character which could aggravate or extend the controversy submitted to arbitration, and took note of statements made by Argentina affirming that the Province of Buenos Aires (hereinafter "the Province") recognizes that the receivables for services rendered by ABA before

March 7, 2002 belong to ABA, and that those collected or to be collected in the future have been or will be deposited in a special banking account, and that the situation described in Azurix's request would not affect the enforceability or execution of any award rendered on the merits. The Tribunal postponed its decision on costs in respect of the provisional measures request to a later stage of the proceedings and considered it unnecessary to request the Claimant to furnish the Tribunal with the Decision of the Appeals Chamber.

14. Argentina filed its Reply on jurisdiction on August 4, 2003

15. Azurix filed a Rejoinder on jurisdiction on August 29, 2003.

16. The hearing on jurisdiction took place in London on September 9 and 10, 2003. The parties were represented by Messrs. R. Doak Bishop, Guido Santiago Tawil, Ignacio Minorini Lima and Craig S. Miles, on behalf of the Claimant. Messrs. Carlos Ignacio Suárez Anzorena, and Jorge Barraguirre, and Ms. Beatriz Pallarés, from the Procuración del Tesoro de la Nación, and Mr. Osvaldo Siseles, from the Secretaría Legal y Administrativa del Ministerio de Economía y Producción, represented the Respondent. On December 8, 2003 the Tribunal issued its Decision on Jurisdiction, which is part of this Award, declaring that the dispute was within the jurisdiction of the Centre and the competence of the Tribunal.

17. During the hearing on jurisdiction, the Respondent had requested an extension of 90 days to file its Counter-Memorial on the merits should the Tribunal find that it had jurisdiction. On December 8, 2003, the Tribunal issued Procedural Order No. 1 establishing the schedule for the further procedures on the merits. According to that schedule, the Respondent was granted an extension of 50 days and its Counter-Memorial on the merits was due within 60 days from the date of that Procedural Order; the Claimant was to file its Reply within 60 days from its receipt of the Respondent's Counter-Memorial, and the Respondent was to file its Rejoinder within 60 days from its receipt of the Claimant's Reply.

18. On February 9, 2004, the Respondent filed its Counter-Memorial on the merits. In the Counter-Memorial, Argentina requested the Tribunal to order the Claimant to produce all reports, analysis and other documentation related to the Claimant's

participation in the privatization of the water supply and sewerage services of the Province and the Claimant's IPO. The Respondent also requested, if considered appropriate by the Tribunal, that the Tribunal ask the United States Congress to furnish the reports related to ENRON's scandal and its relationship to Azurix.

19. On February 20, 2004, it was agreed that the hearing on the merits would take place in Paris from October 4 to 8, 2004 and, if necessary, extend it to October 11-12.

20. On March 8, 2004, the Tribunal invited Azurix to comment on Argentina's evidence request in the Counter-Memorial. Azurix objected to the request on March 15, 2004 and requested the Tribunal that, in case it would agree to Argentina's request, Argentina be invited in turn to produce all documentation related to AGOSBA's services, their privatization, the original setting of the tariffs, all documents of the Privatization Commission, the ORAB, and the files related to ABA, AGOSBA and ABSA. The Respondent commented on Azurix's objection on March 29, 2004 and manifested its willingness to request the Province to produce evidence that the Tribunal considered relevant under Arbitration Rule 34.

21. On March 29, 2004, the parties agreed to extend by three weeks the schedule for the presentation of the Reply and the Rejoinder.

22. On April 19, 2004, the Tribunal issued Procedural Order No. 2 inviting the Respondent to request the Province to furnish the documentation filed with the Province for participating in the bidding process (Envelop No. 1 –the technical offer- and Envelop No. 2 –the economic offer) ("Envelops No. 1 and No. 2"), and postponed consideration of the production of the remainder of the evidence requested until the Tribunal had an opportunity to review the Reply, which was due by May 7, 2004.

23. The Respondent furnished the documentation requested under Procedural Order No. 2 on May 17, 2004. At the same time, the Respondent requested that the Tribunal do not distribute such documentation until Azurix had furnished its own copies of Envelops No. 1 and No. 2. At this point, the Respondent alleged certain irregularities in Circulars 51(b) and 52(a) and pointed out changes in the Concession Agreement which were not part of the draft agreement included in the bidding documents.

24. On May 24, 2004, the Tribunal issued Procedural Order No. 3 requesting Azurix to furnish the Tribunal its own copies of Envelops No. 1 and No. 2 and withheld the documentation received from the Respondent.

25. Azurix, instead of presenting its own copies of Envelops No. 1 and No. 2, sought copies directly from the Province allegedly for convenience's sake. On May 31, 2004, the Respondent objected that, by seeking the documents from the Province, Azurix had not complied with Procedural Order No. 3, withdrew its request related to the production of Envelops No. 1 and No. 2, informed the Tribunal on irregularities it had detected in Envelop No. 2 and requested that the Tribunal charge to the Claimant the costs related to this procedural incident.

26. On July 24, 2004, the Respondent requested an extension of 10 days to file its Rejoinder. The extension was granted on August 10, 2004.

27. On July 29, 2004, the Tribunal issued procedural Order No. 4 rejecting the request for production of evidence formulated in the communication of the Respondent of July 22, 2004 because of its general nature and failure to justify it.

28. On August 3, 2004, the Secretariat notified the parties that Professor Lauterpacht had resigned as an arbitrator for health reasons, and suspended the proceedings in accordance with Arbitration Rule 10(2). On the same date, the Secretariat notified the parties that the Tribunal had consented to Professor Lauterpacht's resignation in accordance with Arbitration Rule 8(2). On August 4, 2004, Mr. Marc Lalonde, a Canadian national, was appointed as an arbitrator by the Claimant in replacement of Professor Lauterpacht. On August 10, 2004, the Tribunal was reconstituted and the proceedings were resumed.

29. On August 16, 2004, the Tribunal issued Procedural Order No. 5 rejecting a further Respondent's request, dated August 2, 2004, for production of evidence because it considered that it was not adequately justified even if more precise than the request of July 22, 2004. On the same date, Argentina notified the appointment of Mr. Osvaldo César Guglielmino as the Procurador del Tesoro de la Nación Argentina.

30. On August 17, 2004, the Respondent filed its Rejoinder on the Merits.

31. On August 23, 2004, the Respondent requested the Tribunal to reconsider Procedural Order No. 5. The Claimant reiterated its objections to the Respondent's request on August 26, 2004. The Tribunal, after considering anew the Respondent's request and having then had the opportunity to review the Rejoinder, issued Procedural Order No. 6, requesting the Claimant to submit, not later than September 17, 2004, the study prepared by Hytsa Estudios y Proyectos, S.A. ("Hytsa") referred to in paragraph 35 of the Rejoinder, and the Respondent to submit by the same date the bid evaluation reports related to each stage of the bidding for the Concession.

32. As previously decided, the hearing on the merits was held, from October 4-13, 2004, at the World Bank's office in Paris, France. Present at the hearing were:

Members of the Tribunal

Dr. Andrés Rigo Sureda, President

The Hon. Marc Lalonde, P.C, O.C., Q.C., Arbitrator

Dr. Daniel H. Martins, Arbitrator

ICSID Secretariat

Ms. Claudia Frutos-Peterson, Secretary of the Tribunal

On behalf of the Claimant

Mr. R. Doak Bishop (King & Spalding, Houston, Texas)

Mr. John P. Crespo (King & Spalding, Houston, Texas)

Mr. Craig S. Miles (King & Spalding, Houston, Texas)

Ms. Zhennia Silverman (King & Spalding, Houston, Texas)

Ms. Carol Tamez (King & Spalding, Houston, Texas)

Mr. Guido Santiago Tawil (M & M Bomchil, Buenos Aires, Argentina)

Mr. Francisco Gutiérrez (M & M Bomchil, Buenos Aires, Argentina)

Mr. Federico Campolieti (M & M Bomchil, Buenos Aires, Argentina)

Also attending on behalf of the Claimant

Mr. Steve Dowd (Azurix Corp.)

Mr. Lou Stoler (Azurix Corp.)

On behalf of the Respondent

Mr. Osvaldo César Guglielmino (Procurador, Procuración del Tesoro de la Nación, Buenos Aires, Argentina)

Mr. Raúl Vinuesa (Procuración del Tesoro de la Nación, Buenos Aires, Argentina)

Mr. Gabriel Bottini (Procuración del Tesoro de la Nación, Buenos Aires, Argentina)

Mr. Juan José Galeano (Procuración del Tesoro de la Nación, Buenos Aires, Argentina)

Mr. Ignacio Pérez Cortés (Procuración del Tesoro de la Nación, Buenos Aires, Argentina)

Ms. María Soledad Vallejos Meana (Procuración del Tesoro de la Nación, Buenos Aires, Argentina)

Also attending on behalf of the Respondent

Ms. Guillermina Cinti (Provincia de Buenos Aires)

Mr. Roberto Salaberren (Provincia de Buenos Aires)

Mr. Juan Carlos Schefer (Provincia de Buenos Aires)

33. On November 29, 2004, the Respondent filed an application to disqualify the President of the Tribunal under Article 57 of the ICSID Convention. In accordance with Arbitration Rule 9(6), the proceedings were suspended. Pursuant to Article 58 of the Convention, the co-arbitrators issued a Decision dated February 25, 2005 on the Challenge to the President of the Tribunal declining the Respondent's disqualification proposal, which was notified to the parties on March 11, 2005.

34. On March 14, 2005, the proceedings were resumed in accordance with Arbitration Rule 9(6).

35. On March 15, 2005, the Centre transmitted to the Tribunal the parties' Post- Hearing Briefs of November 29, 2004.

36. The Tribunal met in Washington, DC from September 7 to 9, 2005 to discuss a draft of this award, and decided to request Azurix to explain, not later than September 28, 2005, certain discrepancies in the amounts in the financial statements of ABA for fiscal years 2000 and 2001. Azurix furnished its explanation on September 27, 2005 and the Tribunal invited the Respondent to comment on it by October 17, 2005. The Respondent sent comments on October 14, 2005.

37. On April 17, 2006, the Tribunal declared the proceedings closed pursuant to Arbitration Rule 38. By letter of June 13, 2006 the Tribunal extended by a further 30 days the period by which the award would be drawn up, in accordance with ICSID Arbitration Rule 46.

### **III. Background to the Dispute**

38. In 1996 the Province started the privatization of the services of Administración General de Obras Sanitarias de la Provincia de Buenos Aires ("AGOSBA"), the Province owned and operated company which provided potable water and sewerage services in the Province. The Province passed Law 11.820 ("the Law") to create the regulatory framework for privatization of AGOSBA's services. The future operator of the water services would be granted a concession which would be overseen and regulated by a new regulatory authority established for the purpose - Organismo Regulador de Aguas Bonaerense ("ORAB"). The concessionaire was required to be a company incorporated in Argentina. The Province engaged Schroeders Argentina S.A. ("Schroeders") as adviser for the privatization of AGOSBA and requested Schroeders to distribute an information statement to potential investors. Schroeders sent the information statement to ENRON Corporation ("ENRON") inviting this company to participate in the bidding. ENRON requested from a consulting company, Hytsa Estudios y Proyectos S.A. ("Hytsa") a preliminary report on the information furnished by the Province in the Data Room on AGOSBA and its operations.

39. The privatization process was conducted by the Privatization Commission, which tendered the concession on the international market on the basis of the Law and of a set of contract documents prepared in accordance with the Law by ORAB, including the Bidding Terms and Conditions and a draft Concession Agreement.

40. A bid offer was made by two companies of the Azurix group of companies established for this specific purpose: Azurix AGOSBA S.R.L. ("AAS") and Operadora de Buenos Aires S.R.L. ("OBA"). AAS and OBA are indirect subsidiary companies of Azurix. AAS is registered in Argentina and is 0.1% owned by Azurix and 99.9% owned by Azurix Argentina Holdings Inc. (a company incorporated in Delaware), which in turn is 100% owned by Azurix. OBA, also registered in Argentina, is 100% owned by Azurix Agosba Holdings Limited which is registered in the Cayman Islands. Azurix owns 100% of the shares in Azurix Agosba Holdings Limited.

41. Having successfully won their bid, AAS and OBA incorporated Azurix Buenos Aires S.A. ("ABA") in Argentina to act as concessionaire. On June 30, 1999, ABA (also referred to as "the Concessionaire") made a "canon payment" of 438,555,554 Argentine pesos ("the Canon") to the Province. On payment of the canon, ABA, AGOSBA and the Province executed a concession agreement ("the Concession Agreement") which granted ABA a 30-year concession for the distribution of potable water, and the treatment and disposal of sewerage in the Province ("the Concession"). Handover of the service took place on July 1, 1999.

42. Azurix declared to know and accepted the bidding conditions and committed itself to undertake all measures necessary to ensure that OBA would fulfill the obligations set forth in the bidding conditions and the Concession Agreement as operator of the Concession during the first 12 years of operation. Similarly, Azurix accepted to be jointly responsible for the obligations of AAS and that during the first six years of the Concession there would be no change in the control of AAS.

43. The Claimant contends that its investment in Argentina has been expropriated by measures of the Respondent tantamount to expropriation and that the Respondent has, in addition, violated its obligations, under the BIT, of fair and equitable treatment, non-discrimination and full protection and security; that such measures are



actions or omissions of the Province or its instrumentalities that resulted in the non application of the tariff regime of the Concession for political reasons; that the Province did not complete certain works that were to remedy historical problems and were to be transferred to the Concessionaire upon completion; that the lack of support for the concession regime prevented ABA from obtaining financing for its Five Year Plan; that in 2001, the Province denied that the canon was recoverable through tariffs; and that “political concerns were always privileged over the financial integrity of the Concession”,<sup>1</sup> and “[w]ith no hope of recovering its investments in the politicized regulatory scheme, ABA gave notice of termination of the Concession and was forced to file for bankruptcy”.<sup>2</sup>

44. The Respondent has disputed the allegations of the Claimant. For the Respondent, the dispute is a contractual dispute and the difficulties encountered by the Concessionaire in the Province were of its own making. In particular, the Respondent has argued that the case presented by the Claimant is intimately linked to Enron’s business practices and its bankruptcy; that the price paid for the Concession was excessive and opportunistic and related to the forthcoming IPO of Azurix at the time Azurix bid for the Concession through AAS and OBA and that the Concessionaire did not comply with the Concession Agreement, in particular its investment obligations, and the actions of the Province, including the termination of the Concession Agreement by the Province, were justified.

45. Before proceeding to examine the facts and the parties’ allegations, the Tribunal will make the following preliminary observations concerning the responsibility of the Respondent for actions or omissions of the Province, the scope of the jurisdiction of the Tribunal, the Claimant’s ENRON relationship, allegations of corruption, Argentina’s economic crisis and the law applicable to the merits of the dispute.

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<sup>1</sup> Memorial, p.7.

<sup>2</sup> Ibid.

#### **IV. Preliminary Observations**

##### **1. Responsibility of the Respondent for Actions and Omissions of the Province**

###### **(a) Positions of the Parties**

46. The Claimant alleges that Argentina is responsible for the actions of the Province under the BIT and customary international law. Indeed, the definition of investment covers investments made in the territories of the parties to the BIT, and the BIT in its preamble refers to the territory of each of the parties in reference to its reach. Furthermore, Article XIII makes the BIT explicitly applicable to the political subdivisions of the parties. The Claimant also refers to the responsibility of the State for acts of its organs under customary international law and cites, as best evidence, Articles 4 and 7 of the Draft Articles on Responsibility of States for Internationally Wrongful Acts of the International Law Commission (“ILC”) (“Draft Articles”).

47. The Claimant also notes the decision on the merits in *Compañía de Aguas del Aconquija S.A. and Vivendi Universal v. Argentine Republic* (“*Vivendi*”) where the tribunal stated that: “It is well established that actions of a political subdivision of [a] federal state, such as the Province of Tucumán in the federal state of the Argentine Republic, are attributable to the central government.”<sup>3</sup> The Annulment Committee confirmed that statement: “in the case of a claim based on a treaty, international rules of attribution apply, with the result that the state of Argentina is internationally responsible for the acts of its provincial authorities.”<sup>4</sup>

48. The Respondent has not disputed that the BIT applies to the Province or the responsibility of the central State for acts of provincial authorities under customary international law. The Respondent has based its counter-argument on the fact that the Claimant’s allegations are in all instances based on breaches of obligations contractually assumed by the Province. Hence, according to the Respondent, the Tribunal does not need to reach the stage of whether the BIT imposes absolute

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<sup>3</sup> *Compañía de Aguas del Aconquija, S.A. & Vivendi Universal v. Argentine Republic*, (ICSID Case No. ARB/97/3), Award of Tribunal of November 21, 2000. para. 49.

<sup>4</sup> *Compañía de Aguas del Aconquija, S.A. & Vivendi Universal v. Argentine Republic*, (ICSID Case No. ARB/97/3), Decisión on Annulment, July 3, 2002. para. 96

responsibility on the central government for actions of a political subdivision because the Claimant has failed to allege facts that are attributable to the Argentine Republic under the BIT.

49. The Respondent considers that the Claimant takes for granted the highly debatable proposition that contractual breaches result in a violation of the BIT. The Respondent then refers, among others, to statements in the Annulment Decision in *Vivendi II* to the effect that: “As to the relation between breach of contract and breach of treaty in the present case, it must be stressed that Articles 3 and 5 of the BIT do not relate directly to breach of a municipal contract. Rather they set an independent standard”, and “A state may breach a treaty without breaching a contract, and *vice versa*, and this is certainly true of these provisions of the BIT... It may be that “mere” breaches of contract, unaccompanied by bad faith or other aggravating circumstances, will rarely amount to a breach of the fair and equitable treatment standard ...” From these statements, the Respondent concludes that “a claimant in similar cases may not invoke as events or facts giving rise to international responsibility the same facts that constitute a breach of contract ... international rules are ‘independent rules’. Therefore, a State’s international responsibility may not be asserted by disguising mere contractual breaches.” The Respondent concludes by recalling that to address the conflicts of a contractual nature raised by the Claimant, both ABA and Azurix have waived their right to submit them to any other jurisdiction other than the administrative courts of the city of La Plata.<sup>5</sup>

**(b) Considerations of the Tribunal**

50. The responsibility of States for acts of its organs and political subdivisions is well accepted under international law. The Draft Articles, as pointed out by the Claimant, are the best evidence of such acceptance and as such have been often referred to by international arbitral tribunals in investor-State arbitration. Moreover, Article XIII of the BIT states clearly: “This Treaty shall apply to the political subdivisions of the Parties.” This is not in dispute between the parties. The issue is whether the acts upon which Azurix has based its claim can be attributed to the Respondent. The

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<sup>5</sup> Counter-Memorial, paras. 932-937.

Respondent contends that such attribution is not feasible because all the acts are contractual breaches by the Province. This is a different matter to which the Tribunal will now turn.

## **2. Scope of the Jurisdiction of the Tribunal**

51. The Tribunal recalls that its decision on jurisdiction is based on the finding that the Claimant had shown a *prima facie* claim against the Respondent for breach of obligations owed by Argentina to the Claimant under the BIT. In that decision, the Tribunal noted that:

“The investment dispute which the Claimant has put before this Tribunal invokes obligations owed by the Respondent to Claimant under the BIT and it is based on a different cause of action from a claim under the Contract Documents. Even if the dispute as presented by the Claimant may involve the interpretation or analysis of facts related to performance under the Concession Agreement, the Tribunal considers that, to the extent that such issues are relevant to a breach of the obligations of the Respondent under the BIT, they cannot *per se* transform the dispute under the BIT into a contractual dispute”.<sup>6</sup>

52. The Tribunal also recalls that Azurix and the Respondent have no contractual relationship. The Concession Agreement is a contract between the Province and ABA, and Azurix made certain commitments and undertook certain guarantees to the Province at the time of the bidding for and signature of the Concession Agreement. None of the allegations made by the Claimant refer to breaches of the Province in relation to Azurix itself. The obligations undertaken by the Province in the Concession Agreement were undertaken in favor of ABA not Azurix. As the Respondent itself has asserted, Argentina is not party to the Concession Agreement, and ABA is not party to these proceedings. Therefore, the underlying premise of Article II(2c) of the BIT – that a party to the BIT has entered into an obligation with regard to an investment – is in-existent. Neither the Respondent nor the Province, as a political subdivision of the Respondent, has entered into a contractual relationship with Azurix itself.

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<sup>6</sup> Decision on Jurisdiction, para. 76.

53. The Tribunal, in evaluating the facts and the allegations of the parties, is mindful that its task is to determine whether the alleged actions or omissions of the Respondent and the Province, as its political subdivision, amount to a breach of the BIT itself. For this purpose, and since the allegations of the Claimant are based on disputes related to the Concession Agreement, the Tribunal will need to determine the extent to which the Province was acting in the exercise of its sovereign authority, as a political subdivision of the Respondent, or as a party to a contract. As stated by the tribunal in the case of *Consortium FRCC c. Royaume du Maroc*, a State may perform a contract badly, but this will not result in a breach of treaty provisions, “unless it be proved that the state or its emanation has gone beyond its role as a mere party to the contract, and has exercised the specific functions of a sovereign.”<sup>7</sup> It should be noted, however, that this was not just any contract as between two private parties. It was a Concession Agreement embodying the tariff regime of the Concession and the actions taken by the Province were taken in its capacity as a public authority and by issuing resolutions through its regulator and decrees, actions which can hardly be treated as those of “a mere party to the contract.”

54. As noted earlier, Argentina has questioned the ability of a claimant to invoke as events or facts giving rise to international responsibility the same facts that constitute a breach of contract. The Tribunal has no doubt that the same events may give rise to claims under a contract or a treaty, “even if these two claims would coincide they would remain analytically distinct, and necessarily require different enquiries.”<sup>8</sup> To evoke the language of the Annulment Committee in *Vivendi II*, the Tribunal is faced with a claim that it is not “simply reducible to so many civil or administrative law claims concerning so many individual acts alleged to violate the Concession Contract or the administrative law of Argentina”, but with a claim that “these acts taken together, or some of them, amounted to a breach” of the BIT.<sup>9</sup> This is the nature of the claim in

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<sup>7</sup> *Consortium FRCC v. Royaume du Maroc* (ICSID Case. No. ARB/00/6), Sentence arbitrale, para. 65. See also *Impregilo S.p.A. v. Islamic Republic of Pakistan* (ICSID Case No ARB/03/3), Decision on jurisdiction (*Impregilo*), para. 260.

<sup>8</sup> *Ibid.*, para. 258.

<sup>9</sup> Decision of Annulment Committee, para. 112.

respect of which the Tribunal held that it had jurisdiction and which the Tribunal is obliged to consider and decide.

### **3. The ENRON relationship**

55. Argentina has placed substantial emphasis on the fact that Azurix was a subsidiary of ENRON and has alleged that Azurix followed the aggressive and dubious practices of ENRON in its bidding for and subsequent operation of the Concession. For purposes of the dispute before this Tribunal and based on the documentation submitted by the parties, the Tribunal considers that nothing has been proven that relates the case before this Tribunal to ENRON's case. The proven facts are that ENRON was invited by the Province to bid for the Concession and ENRON declined in 2001 to guarantee a loan of Banco de la Nación Argentina to ABA under the program of the National Sanitation Works Agency ("ENOHSA") financed by the Inter-American Development Bank ("IDB").

### **4. Corruption**

56. In 2002, at the time Argentina was preparing the Rejoinder on jurisdiction, it realized that Section 12.1.1 of the Concession Agreement was added after the award of the Concession. ABA's exemption of fines during the first six months of the Concession for failure to meet the Concession's performance standards was also added after the award of the Concession. The Tribunal was informed by Argentina that an investigation of this matter had been initiated by the office of the Procurador del Tesoro. During the hearing on the merits, and as a reaction to insinuations of corruption during the examination by Argentina of a witness presented by Argentina, counsel for the Claimant asked the witness whether to his knowledge there had been any corruption in connection with the award of the Concession. The witness replied that he was not aware of any improper conduct, and the Procurador General present at the hearing confirmed that the investigation was continuing but that no evidence of improper conduct had surfaced. No further information has been transmitted to the Tribunal.

## **5. Argentina's Economic Crisis**

57. Argentina has pleaded that the institutional, social and economic crisis that it endured in the period 1998-2002 was the worst in its history.<sup>10</sup> On the other hand, the Claimant has alleged that the Respondent deliberately confuses the economic recession starting in 1998 with the economic and political crisis that began in 2001. According to the Claimant, the recession and economic crisis took place after termination of the Concession Agreement, are irrelevant for the purposes of this arbitration and cannot justify the Province's breaches of the Concession Agreement. The Claimant further observes that Argentina does not claim any justification based on the recession and only notes it as a background fact.<sup>11</sup> The Tribunal notes that the parties have not argued that the actions of the Province, ABA or Azurix had been influenced by the economic crisis. The crisis may provide context to the dispute, but none of the parties has pleaded that the economic crisis was the cause of the actions taken by the Province, ABA or Azurix.

### **V. Applicable law**

#### **1. Positions of the parties**

58. The Claimant has argued that Article 42 of the Convention, in its first sentence, directs the Tribunal to look first to the rules of law agreed by the parties. Since the parties have not agreed to the governing law, the Tribunal should apply the BIT as *lex specialis* between the parties, and international law. The BIT expressly requires Argentina to comply with international law, and the BIT and international law have been incorporated by Argentina in its domestic law.<sup>12</sup>

59. The Claimant refers, among others, to Professor Weil's opinion that: "the existence of a Bilateral Investment Treaty raises the question of compliance with the rights and obligations contained therein to the level of a matter under international law, with respect not only to relations between the States party to the treaty *but also to relations between the host State and the investor.*" According to the Claimant, the BIT

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<sup>10</sup> Counter-Memorial, para. 851, pp.243-245.

<sup>11</sup> Reply, pp. 193-194.

<sup>12</sup> Memorial, p. 149.

requires “the Argentine Republic to afford U.S. investors like Azurix treatment no less favorable than that required by international law, both with respect to investment generally, and in particular with respect to expropriations or measures tantamount to expropriation of an investment.”

60. The Claimant also relies on the statement of the Annulment Committee in *Vivendi II* on the law applicable to the determination of whether a breach of the BIT has occurred, “In such a case, the inquiry which the ICSID tribunal is required to undertake is one governed by the ICSID Convention, by the BIT and by applicable international law. Such an inquiry is neither in principle determined, nor precluded, by any issue of municipal law, including any municipal law agreement of the parties.”<sup>13</sup>

61. The Claimant adds that international law also applies under the second sentence of Article 42(1) of the Convention. The Claimant relies here again on the authority of Professor Weil,

“no matter how domestic and international law are combined, under the second sentence of Article 42(1), international law always gains the upper hand and ultimately prevails. It prevails indirectly through the application of domestic law where the latter is deemed consistent with international law or incorporates it. It prevails directly where domestic law is deemed deficient or contrary to international law. Thus, under the second sentence of Article 42(1), international law has the last word in all circumstances: international law is fully applicable and to classify its role as ‘only’ ‘supplemental and corrective’ seems a distinction without a difference.”<sup>14</sup>

62. The Respondent draws a different conclusion from the fact that the parties have not agreed on the applicable law. In such a case, the Tribunal shall apply “the law of the Contracting State party to the dispute, including its rules on the conflicts of laws, and such rules of international law as may be applicable.” (Article 42(1) of the Convention). In accordance with this article, the dispute is basically governed by Argentine law, which is also applicable to contractual matters and provincial

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<sup>13</sup> Ibid., p. 151.

<sup>14</sup> Ibid., 155-156.



administrative law underlying the claim. However, the Respondent admits that the BIT is “the point of reference for establishing the merits of the Argentine Republic’s obligations in connection with Azurix’s investment. Non-contractual international law is relevant to the extent that the Treaty refers to it, or to the extent relevant to interpretation of the contract, or to the extent included in Argentine law.”<sup>15</sup>

63. In its Reply, the Claimant concurs in that the BIT is the point of reference to judge the merits and reaffirms that the BIT is the *lex specialis* between the parties. The Claimant is unsure about the meaning of “non-contractual international law” and affirms that all relevant international law may be applicable. The Claimant adds that customary international law provides a floor or minimum standard of treatment for foreign investment while the terms of the BIT may provide a higher standard.<sup>16</sup>

64. In its Rejoinder, the Respondent reaffirms its considerations in the Counter-Memorial whereby, pursuant to Article 42 of the Convention, “the dispute is basically governed by Argentine law which is also applicable to contractual matters and by the provincial administrative law underlying Azurix’s claim.”<sup>17</sup>

## **2. Considerations of the Tribunal**

65. The Tribunal notes first the agreement of the parties with the statement that the BIT is the point of reference for judging the merits of Azurix’s claim. The Tribunal further notes that, according to the Argentine Constitution, the Constitution and treaties entered into with other States are the supreme law of the nation, and treaties have primacy over domestic laws.<sup>18</sup>

66. Article 42(1) has been the subject of controversy on the respective roles of municipal law and international law. It is clear from the second sentence of Article 42(1) that both legal orders have a role to play, which role will depend on the nature of the dispute and may vary depending on which element of the dispute is considered. The Annulment Committee in *Wena v. Egypt* considered that “The law of the host State can indeed be applied in conjunction with international law if this is justified. So too

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<sup>15</sup> Counter-Memorial, p. 47.

<sup>16</sup> Reply, paras. 18-20.

<sup>17</sup> Rejoinder, para. 21.

<sup>18</sup> Section 31 and Section 75(22).

international law can be applied by itself if the appropriate rule is found in this other ambit.”<sup>19</sup>

67. Azurix’s claim has been advanced under the BIT and, as stated by the Annulment Committee in *Vivendi II*, the Tribunal’s inquiry is governed by the ICSID Convention, by the BIT and by applicable international law. While the Tribunal’s inquiry will be guided by this statement, this does not mean that the law of Argentina should be disregarded. On the contrary, the law of Argentina should be helpful in the carrying out of the Tribunal’s inquiry into the alleged breaches of the Concession Agreement to which Argentina’s law applies, but it is only an element of the inquiry because of the treaty nature of the claims under consideration.

68. Before the Tribunal considers the meaning of each of the standards allegedly breached by the Respondent, and because this discussion is closely related to the conflicting views of the parties on the facts of the dispute and their implications, the Tribunal will now consider at length the facts and then each of the standards of treatment of the BIT supposedly breached by the Respondent. In considering the allegations of the parties under each of the factual situations, the Tribunal will assess to which extent the established facts evidence actions on the part of the Province in the exercise of its public authority or as a party to a contract. The Tribunal will follow the order in which the facts have been presented in the memorials taking into account the witness statements, the documentation submitted, expert opinions and the written and oral arguments made by the parties.

## **VI. The Facts**

### **1. The Takeover of the Concession**

#### **(a) Positions of the Parties**

69. The Claimant has alleged that on the day of the transfer of the Concession, July 1, 1999, no representatives of the Province or AGOSBA were present to ensure an orderly and safe transfer. According to the Claimant, critical documents were burnt in the facility located at the Plaza San Martín, and in nearly all branches

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<sup>19</sup> *Wena Hotels Limited v. Arab Republic of Egypt*, (ICSID Case No. ARB/98/4). *Ad hoc* Committee Decision on Application for Annulment, dated February 5, 2002, 41 ILM (2002) p. 941.

tools and equipment to operate the Concession were missing. The Claimant alleges also to have found certain anomalies in the customer database, – i.e. the archives of large account customers were missing and so were the methodology for calculating VAT amounts, interest calculation, whether or not a property was a vacant lot, the due date of installments, etc. According to the Claimant, ABA communicated the specific deficiencies of the database to the MOSP and ORAB in October 1999 after it received an inadequate response from AGOSBA, and did not receive an “effective response” from either.<sup>20</sup>

70. The Respondent has pointed out that Claimant alleged no difficulties at the takeover of the Concession in the request for arbitration, in the grounds for the termination of the Concession Agreement adduced by the Claimant or in the discussions on the Memorandum of Understanding (MOU). According to the Respondent, the execution of the Concession Agreement took place in the presence of all the relevant provincial authorities, the Concession area is very large and it was not possible for officials to be present physically at all locations, and the Bidding Conditions provided a remedy in Article 15.1.3 for such a situation. ABA never notified the Province of any conflict or negligence by the Province in connection with the takeover.

71. The Respondent affirms that all necessary information was made available to the bidders as part of the privatization related documentation and drawings and maps were made available to ABA on July 2, 1999 and that, in accordance with Section 2.4 of the Terms of Reference, Azurix acknowledged full access to all information and waived any claim to insufficient or non-delivery of information. The Respondent also points out that no claim was ever made in connection with defective equipment or tools and considers that the allegations of the Claimant in respect of the database are inadmissible. The Respondent refers in this respect to a communication of ABA to AGOSBA in terms that show deference and gratitude rather than offense for lack of cooperation. According to the Respondent, the database may have contained

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<sup>20</sup> Memorial, pp. 25-29.

errors and defects but they were known to all bidders. The Respondent concludes by affirming that the takeover took place in a “context of mutual cooperation.”<sup>21</sup>

72. In its Reply, the Claimant alleges that the Respondent relies on formalisms. It disputes the meaning given by the Respondent to Article 15.1.1, since this section could only be invoked if the ‘legal’ transfer was not made. Equally, the Claimant considers misplaced the reference to Section 2.4, since this Section presumes good faith in the Province’s discharge of its duties and cannot be invoked when insufficient information was not received because of obstruction and sabotage by provincial employees.<sup>22</sup> The Claimant contests the affirmation that no complaints were ever made. In fact, numerous complaints were filed with the Privatization Commission, the ORAB, the Provincial Governor and Argentine federal officials.<sup>23</sup>

73. The Claimant admits in its Reply that 12,700 maps were received on July 2, 1999, but that they were in total disarray and ABA had to engage the services of Halcrow to digitalize and organize the documentation. The maps were old, outdated and failed to describe the current state of the Concession. In contrast, ABA’s employees were approached by former AGOSBA staff to offer them digitalized updated maps of the Concession, that, according to them, could substantially reduce the number of network expansions required under the Concession Agreement.<sup>24</sup>

74. The Respondent in the Rejoinder reaffirms its understanding of Article 15.1.3 of the Bidding Conditions and disputes that it only applies to the “legal” transfer. The takeover was a defined term in the Concession Agreement: “The act whereby the Concessionaire assumes the provision of service according to Chapter 15.”<sup>25</sup> The Respondent confirms that all documentation, including blueprints, maps and the users’ database, was provided to the Concessionaire. ABA had the obligation under the Concession Agreement to digitalize the maps, and, if the Concessionaire employed Halcrow for this purpose, it was to fulfill an obligation not because the Province did not

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<sup>21</sup> Counter-Memorial, paras. 167-194.

<sup>22</sup> Reply, paras. 76-77.

<sup>23</sup> Ibid., para. 68.

<sup>24</sup> Ibid., paras. 70-72.

<sup>25</sup> Rejoinder, paras. 148-152.

comply with providing the pertinent information.<sup>26</sup> The Respondent finds that none of the evidence provided by the Claimant shows that ABA voiced any complaints during the six-month period following the takeover. ABA did not even mention it at the time of submitting its First Five-Year Plan proposal.<sup>27</sup>

75. The Respondent concludes by alleging that the evidence shows that the conflict identified as “takeover” was created by Azurix for these proceedings and that ABA and Azurix raised concerns about facts related to the takeover before provincial and federal authorities when their officers were warned about possible international arbitration proceedings.<sup>28</sup>

**(b) Considerations of the Tribunal**

76. The Tribunal considers that the Claimant has failed to prove that the irregularities that may have occurred had the serious consequences that the Claimant has alleged and that can be attributable to the Province. The item with most serious implications would seem to be the destruction and removal of documentation, in particular of Concession’s maps. As admitted in the Reply, these maps were supplied by AGOSBA to ABA and ABA had the obligation to digitalize them. It would appear that the maps that the former employees had digitalized were more current than those furnished to ABA by the Province but no evidence has been furnished to the Tribunal showing that the alleged up to date maps offered by former employees of AGOSBA had been updated while in the service of AGOSBA and removed before the handover of the Concession, or that they were ever in the possession or control of the Province.

**2. Measures related to the tariff regime**

77. The measures under this heading include the elimination of zoning coefficients, the valuation applicable to non-metered customers whose property had undergone construction changes, the so-called Valuations 2000, and the RPI. The Tribunal will consider them in that order.

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<sup>26</sup> Ibid., para. 170.

<sup>27</sup> Ibid., para. 185.

<sup>28</sup> Ibid., para. 186.

**(a) Zoning Coefficients**

**(i) Positions of the parties**

78. On April 9, 1999, the Privatization Commission issued Information Communiqué No.12 on zoning coefficients. This communiqué attached a list of coefficients that “will apply for the correction of fiscal valuation of property and allow for determining the billing ranges as per Sanitary Rates in each district to which AGOSBA provides services according to provisions of Act 10.474 Section 7”. The communiqué added: “Please note that the tariff scheme that shall apply to the Concession shall be the one contained in Annex Ñ, which does not contemplate any zoning coefficients.”

79. The Privatization Commission was asked the following question on Communiqué No. 12:

“Question No. 160: Annex Ñ Concession Contract. The information communiqué No. 12 leaves evidence that the tariff system, which will rule the concession, will be the one included in Annex Ñ, which does not contemplate zoning coefficients. Is it correct to assume that the new billing could surpass the one determined in the last billing previous to the taking over due to the fact that it was affected by such adjustment?”

80. On April 23, 1999, the Privatization Commission replied:

“It is clarified that as regards the tariff system, it is governed by what is established in Annex Ñ of the Concession Agreement and the tariffs set not only for metered system but also for the non-metered system in Section 4 of the aforesaid Annex should be especially taken into account.”

81. The Claimant concludes from this exchange that it was reaffirmed that Annex Ñ would govern the application of the non-metered tariff regime and that water bills would be increased for those persons who previously benefited from zoning coefficients.<sup>29</sup>

82. According to Circular 59(A) of June 25, 1999, AGOSBA issued the first billing cycle after the transfer of the Concession so that the new Concessionaire would

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<sup>29</sup> Memorial, p. 33.

have sufficient time to prepare. When ABA sent the bills for its first billing cycle (the second billing cycle after the transfer) without applying the zoning coefficients, consumers reacted badly to the resulting price increase. This event happened during the presidential campaign in which the governor of the Province, Mr. Duhalde, was running for president of the country.

83. On August 4, 1999, the ORAB issued Resolution 1/99. According to this resolution, ABA was precluded from billing amounts in excess of those amounts billed by AGOSBA for non-metered service prior to the granting of the Concession, and it ordered ABA to credit those amounts that exceeded AGOSBA's final billing for non-metered service during the month of August. ORAB based Resolution 1/99 on Article 4a-1 of Title II of Annex Ñ which states: "The tariff that results due to the application of the scale shall not exceed the one determined by the final billing prior to the Taking of Possession, for the same real estate, i.e., provided no building developments have been recorded."

84. ABA appealed administratively Resolution 1/99. ABA argued that Resolution 1/99 equated the terms tariff and bill, that a bill increase is not necessarily a tariff increase, that it did not change the tariff; and that it had simply eliminated the zone coefficient and, while the bills were higher, the tariff remain unchanged. The ORAB rejected the appeal by Resolution 2/00 of January 19/00 and dismissed ABA's interpretation of Annex Ñ as inconsistent with the regulatory framework promulgated by the Law.

85. The Claimant alleges that the action taken by the ORAB was politically motivated under pressure of the Government of the Province which was concerned that higher water bills would damage the chances of Mr. Duhalde in the presidential race. According to the Claimant, the press reported statements by the Minister of Public Works (MOSP) to the effect that the bills issued by ABA were incorrect and that consumers should not pay them until the issue was clarified (testimony of Mr. Castillo quoted in the Memorial p. 33). The Claimant further alleges that the Minister of MOSP

“wanted to ease and postpone the solution in any way” till after the presidential election.<sup>30</sup>

86. The Claimant maintains that the action taken by ABA was correct and permitted under the Concession Agreement. The Claimant bases its position on the interpretation provided by Circular 27(A) and on the different meanings of the terms bill and tariff. Tariff is “a public document that includes a description of the company services, rates and charges, as well as the governing rules, regulation and practice in relation to those services”.<sup>31</sup> It is inappropriate to use tariff as a synonym of rates or prices, “the tariff is nothing else that a list of prices or rates”.<sup>32</sup> According to the Claimant, the ORAB contravened the Law by not providing a well-founded decision in dismissing the appeal of ABA as required by Chapter III, article 13-II of the Law.

87. The Respondent argues that the position of the Claimant has no basis on the Contract or on the Communiqué or the Circular. The Respondent first recalls that the non-metered system was a temporary system that should have been replaced 100% by a metered system by year five of the Concession, and that the Communiqué is not part of the contractual documentation of the Concession. In rejecting the understanding by the Claimant of the Communiqué and the Circular, the Respondent explains that, according to article 4 of Annex Ñ, the Concessionaire needed to follow two criteria for billing purposes: first, the bill should be the result of multiplying the presumed consumption by the price per cubic meter established on the basis of the valuation of the building concerned, and second, the resulting bill should not exceed that of the last bill prior to the takeover of the Concession. Thus, if the bill resulting from applying the values in the table included in article 4 exceeded the bill before the takeover, then the consumer should be charged only what had been charged then. The exceptions were only for new customers that, by definition, would not have received a bill prior to the Concession takeover, and in the case of construction variations which would affect the fiscal valuation of the building.

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<sup>30</sup> Testimony of Mr. Guaragna quoted in the Memorial, p. 34.

<sup>31</sup> L. Goodman, *The Process of Ratemaking*, Virginia: Public Utilities Reports, Inc. (1999) p. 45 quoted in the Memorial, p. 37.

<sup>32</sup> Villegas Basavilbaso, *Derecho Administrativo*, vol. 3, p. 178, quoted by M. Marienhoff in *Tratado de Derecho Administrativo*, 1981, vol. II p. 133 (Exhibit 33 to the Memorial).



88. The Respondent expresses its inability to understand how the Claimant can rely on the distinction between tariffs and rates to justify its position. The Respondent agrees with the definition of tariffs and rates provided by the Claimant and affirms that the Province never maintained that these concepts were the same or were used indistinctly.<sup>33</sup> The Respondent cannot follow how a bill for a building for a non-metered service may be increased without at the same time increasing the tariffs.<sup>34</sup>

89. The Respondent considers that it was always clear that Annex Ñ did not contemplate zoning coefficients and the clarification in Communiqué No.12 would have been unnecessary. This does not mean that bills for the first month of the Concession could be increased; the function of article 4 (a-1) was to avoid this effect.<sup>35</sup> Equally irrelevant, for purposes of the Claimant's interpretation, is Circular 27(A). This circular replied to the question by simply referring to the provisions of Annex Ñ, in particular what is provided in article 4.<sup>36</sup> According to the Respondent, once the appeal of Resolution 1/99 was rejected, the decision of the ORAB became administratively firm and unassailable under the administrative law of the Province.<sup>37</sup>

**(ii) Considerations of the Tribunal**

90. Both parties agree that zoning coefficients are not included in Annex Ñ. They also agree on the meaning of the terms tariff, bills and rates. Communiqué No.12 was issued by the Privatization Commission at its own initiative, so it may have considered it necessary to point out that Annex Ñ did not include zoning coefficients. When applied to a bill, coefficients had the effect of reducing it. Hence the follow up question to the Privatization Commission - question No. 160 - specifically asking whether "Is it correct to assume that the new billing could surpass the one determined in the last billing previous to the taking over due to the fact that it was affected by such adjustment?" The Commission replied – item No. 20 of Circular 27(A) - by referring generally to the tariff regime in Annex Ñ and stating that "the tariffs set not only for the

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<sup>33</sup> Counter-Memorial, para. 277.

<sup>34</sup> Ibid., para. 280.

<sup>35</sup> Ibid., para. 293.

<sup>36</sup> Ibid., para 297-298.

<sup>37</sup> Ibid., paras. 301-303.

metered system but also for the non-metered system in Section 4 of the aforesaid Annex should be especially taken into account”.

91. This statement evaded the answer to the question asked and left ample room for misunderstanding. The interpretation of paragraph 4(a) by the Claimant is based on the difference between tariffs and bills which is reflected in the terminology of the Concession Agreement. In the key subparagraph of article 4, we read: “the resulting tariff from the application of said scale shall not exceed that determined in the last billing...” The paragraph clearly refers to tariffs and billing as two different matters, what should not be exceeded is the tariff applied in the last billing, not the billing itself. This being the case, the reading by the Claimant of the Concession Agreement and of the information provided by the Privatization Commission would seem reasonable. Indeed, if there is a subsidy resulting from the application of a zoning coefficient and such subsidy ceases to be applicable, the bill will necessarily be higher without any increase in the underlying tariff. To interpret the Contract otherwise, it is to admit that the Information Communiqué No. 12 was openly misleading and Circular 27(a), at best, evasive.

92. To conclude, the ORAB provided an interpretation of the Concession Agreement not in accordance with the concepts of tariff, rates and bills underlying it and with the information provided the bidders at the time they prepared the tenders. The decision of ORAB seems to reflect a concern with the political consequences of the elimination of the coefficients rather than with keeping to the terms of the Concession Agreement.

**(b) Construction Variations: Resolution 7/00**

**(i) Factual background**

93. The Concession Agreement permitted the Concessionaire to re-categorize non-metered customers whose fiscal valuation had changed because of construction improvements. On February 17, 1999, March 8, 1999 and March 24, 1999, the Claimant requested the Privatization Commission for the updated records of property valuations of the *Dirección Provincial de Catastro Territorial* (DPCT). On May 5, 1999, the Commission issued Circular 44(A) stating that the records had not been updated since

1994 except for individual updates “which occurred on a daily basis by customers visiting local branch offices.”<sup>38</sup> Allegedly the Claimant continued to press for the records<sup>39</sup> and on June 23, 1999, the Commission issued Circular 58(A) with a CD containing the valuations of the DPCT.

94. Based on this information, ABA identified about 60,000 non-metered customers whose properties reflected a valuation increase. In January 2000, ABA informed the ORAB that it would re-categorize these customers into a higher tariff scale. On February 8, 2000, the ORAB issued Resolution 7/00 ordering ABA to abstain from re-categorizing these customers until the ORAB would have verified the valuation changes with DPTC. After three weeks, ABA appealed Resolution 7/00.

95. On March 17, 2000, the ORAB, by Resolution 15/00, authorized retroactive increases for construction variations of lands that were paying for the water service as uncultivated land and appeared as built lots in the CD attached to Circular 58(A). In these cases, it was evident that the different valuation was due to construction.

96. On June 26, 2000, the ORAB issued Resolution 54/00 rejecting the appeal of ABA. Resolution 54/00 recalled that, in the presentation made by ABA, it was not evident that the changes in fiscal valuation were due to construction variations and, therefore, the ORAB considered it necessary to conduct a study to determine the rationale of the variations. Resolution 54/00 affirmed that Resolution 7/00 only requested the Concessionaire to abstain from re-categorizing the properties and did not alter the procedure established in the Concession Agreement for the application of the valuations furnished by the Cadastre.<sup>40</sup>

97. The study conducted by the ORAB revealed that 76% of the variations presented by the Concessionaire were due to construction on the properties concerned.<sup>41</sup> On November 22, 2001, after ABA had terminated the Concession, the ORAB issued Resolution 62/01 authorizing the re-categorization of those properties subject to the approval of a business plan to mitigate the impact on users. ABA

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<sup>38</sup> Memorial, p. 42.

<sup>39</sup> Idem.

<sup>40</sup> Counter-Memorial, paras. 321-325.

<sup>41</sup> Ibid., para. 328.

presented the business plan on December 11, 2001. The ORAB requested further information on the plan on December 28, 2001. ABA responded on January 29, 2002. According to the Respondent, the relationship of ABA with the Province and the ORAB and the delivery of the service had deteriorated to such an extent that the ORAB requested the MOSP Undersecretary to include this matter among those to discuss between the Province and ABA.<sup>42</sup> Thereafter, the MOSP Undersecretary advised ABA by letter not to proceed with the re-categorization. According to Azurix and based on press reports, the re-categorization took place once the Concession was transferred to Aguas Bonaerenses.

98. The facts as described have not been contested by the parties.

**(ii) Considerations of the Tribunal**

99. Resolution 7/00 did not refer to the reasons why the ORAB considered it necessary to verify the variations with DPCT. The Resolution ordered ABA to refrain from re-categorization until the ORAB had determined whether the variations were actually construction variations. The ORAB acted on the basis of an internal report of February 8, 2003 that alerted it to the fact that the CD attached to Circular 58(A) did not distinguish between variations in fiscal valuations for construction or other reasons. This simple factual information was not referred to in Resolution 7/00.

100. Construction variations had been the subject of several questions during the bidding process so a clear understanding of what the term meant seems to have been important from the bidders' point of view. According to Annex Ñ, the real estate fiscal valuations to be applied were those furnished by the DPTC. When the information was furnished to the bidders with Circular 58(A), this Circular did not refer to variations in fiscal value. When ABA identified the variations, it had no way to know whether they were caused by construction activity or other reasons. When the ORAB became aware of the issue, it would have seemed appropriate to base its reasoning on this fact, rather than to simply refer to the need to verify the valuation changes, which was understood as a delay tactic by the Concessionaire. The reason for the verification became only apparent when Resolution 15/00 was issued and the appeal was rejected.

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<sup>42</sup> Ibid., para. 332.

101. The ORAB proceeded to identify the previously uncultivated lots with relative speed as compared with the time that it took to verify the other valuation changes. Resolution 15/00 was issued within 5 weeks of Resolution 7/00. On the other hand, Resolution 62/01 was issued more than 21 months after Resolution 7/00. Even if the tariff increases could be applied retroactively and the number of variations to be verified was large, this seems to have been an unduly protracted process. The delay also meant that the application of the new level of tariff would result in larger amounts to be paid retroactively with the consequent negative perception from the consumers' point of view. When the ORAB authorized the re-categorization, a plan to mitigate the impact was required from ABA and, even when such plan had been approved by the provincial authorities, the re-categorization by ABA was not authorized by MOSP.

102. To conclude, the bidders were not provided with accurate information on the variations, and the Province seems to have engaged in a protracted dilatory process; first in identifying the construction variations and then in delaying the re-categorization. As in the case of the zone coefficients, the concern was on the political effect rather than with applying the terms of the Concession Agreement.

**(c) Valuations 2000**

103. The Concession Agreement specified that the 1958 valuations methodology or its equivalent be used to determine the appropriate tariff schedules for non-metered customers. The 1958 valuation was discontinued by the DPCT in early 2000 by law 12.397 of the Province.

**(i) Positions of the Parties**

104. The Claimant argues that the change in property valuation methodology caused a fundamental problem for ABA as it became impossible to apply accurately Valuations 2000 to the existing non-metered tariff scale.<sup>43</sup> The new methodology prevented the application of the tariff regime to new real estate created and to updated valuations for existing real estate that had experienced construction variances.<sup>44</sup> Since the Province did not provide an equivalent methodology, as required by the Concession

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<sup>43</sup> Memorial, p. 50.

<sup>44</sup> Ibid. p. 51.

Agreement, ABA proceeded to prepare an equivalent methodology and presented it to the ORAB on November 22, 2000. According to the Claimant, the ORAB avoided responding on the equivalent methodology proposal notwithstanding persistent communications of ABA, and no determination was ever made by the ORAB.<sup>45</sup>

105. The Respondent argues that it was not the role of ABA to prepare equivalent valuations and that the Concession Agreement was clear that the equivalent valuations had to be determined by the DPCT. Furthermore, the change to Valuations 2000 would have a minimum impact on the Concessionaire since it would only affect construction variations in existing properties and new properties in the Concession area. In any case, the Concession Agreement provided the way to calculate the applicable tariffs when there was inadequate real estate valuation. According to the Respondent, the methodology proposed by ABA was a disguised effort to increase tariffs, a fact that is denied by the Claimant.

106. The Respondent points out that ABA in fact made a proposal to value *ex officio* properties which had no valuation on February 29, 2000. The DPCT informed ABA that it could not decide on this matter because the system in effect did not permit the establishment of a valuation mechanism such as proposed by ABA. However, the ORAB, by Resolution 45/00 of June 13, 2000, permitted ABA and AGBA to carry out *ex officio* valuations as proposed by ABA.<sup>46</sup>

**(ii) Considerations by the Tribunal**

107. The Province proceeded to change the valuation system in the first quarter of 2000, shortly after the Concession was awarded. The bidders were not informed of the upcoming change. When the change occurred no alternative methodology was provided. The complaint of Azurix seems to be more on the lack of a meaningful response by the Province than anything else. Even the arrangement proposed by ABA in February 2000 was put forward at its own initiative, although it was the Province's responsibility to provide alternative methodologies as explained by the Respondent. Irrespective of the merits of ABA's proposal and whether it meant a raise

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<sup>45</sup> Reply, paras. 173-190.

<sup>46</sup> Counter-Memorial, paras. 345-371.

on applicable tariffs to the properties affected by the valuations, this tariff conflict could have been avoided by simply instructing the Concessionaire on what to do at the time the new law was issued and as part of its implementation. It seems that the administration of the Province was not very pro-active in search of solutions to a problem that the Province itself had created.

**(d) Retail Price Index (RPI) issue**

**(i) Background**

108. The Concession Agreement provides for extraordinary revisions of the tariffs on account of, *inter alia*, variations in cost indices. According to Article 12.3.5.1, the concept of such revisions is as follows: "These revisions shall be carried out where the Concessionaire or the Regulatory Entity alleges an increment or fall in the Concession cost indexes when its absolute value exceeds three per cent (3%), in accordance with the provisions set out in clause 12.3.5.2." Article 12.3.5.2 sets forth the formula for the calculation of the percentage cost index variation. For this purpose, the formula uses as a basis 50% of the change in the Consumer Price Index of the United States and 50% of the change in the Producer Price Index, Industrial Commodities, also of the United States.

109. ABA requested the commencement of the procedures for the tariff review foreseen in Article 12.3.5.3 of the Concession Agreement on December 20, 2000 based on a 6.659% increase in the RPI. On January 3, 2001, the ORAB regulatory department noted in a letter to the Board of the ORAB that ABA had met the formal regulatory requirements of said article and was authorized to seek an RPI review.<sup>47</sup> On January 30, 2001, Mr. Pievani, the head of the economic regulation area of the ORAB, sent a further report to the ORAB president confirming the 6.659% RPI increase but considering the request inadmissible based on consequences related to the provision of the service and to the users, in particular, he referred to the Bahía Blanca incident, which is considered later in this award. On February 8, 2001, the President of the ORAB notified the MOSP Undersecretary of ABA's request and recommended the denial of the tariff review. On February 27, 2001, the MOSP instructed the ORAB to solicit from ABA

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<sup>47</sup> Exhibit 70 to the Memorial.

a detailed cost study justifying the impact of the variance of prices on ABA's cost structure, to conduct its own cost study and to condition the review and ultimate submission of the request to the Executive Branch on ABA's presentation of the cost study. On March 9, 2001, the ORAB notified ABA of the need to present a cost study.

110. ABA responded to the cost study request in a note to the ORAB, dated March 18, 2001, requesting ORAB to clarify the procedural or contractual framework on which ORAB based its request.<sup>48</sup> The ORAB reiterated the request for a cost study within five days on April 5, 2001. On April 16, 2001, ABA responded by explaining "the economic and financial principles behind the RPI adjustment as an integral element of price cap regulation and price controls, and the importance of the regulator's objectivity to insure the transparency of the regulatory process".<sup>49</sup> On May 14, 2001, ABA sent the ORAB a more comprehensive analysis of the economic and financial principles underlying inflationary adjustments and a discussion of the automatic and objective nature of the inflationary review process.<sup>50</sup>

111. On May 30, 2001, the ORAB sent a letter to the MOSP Undersecretary informing him of ABA's concerns with the handling of the RPI request by the Province and requesting the advice of the provincial Organismos de Asesoramiento y Control (Asesoría General de Gobierno, Contaduría General and Fiscalía de Estado). After these organs had expressed their opinion, the ORAB issued, on October 24, 2001 (after ABA had terminated the Concession Agreement) Resolution 53/01 whereby it summoned ABA "to furnish the ORAB with a study on costs that warrant the incidence of such indexes on tariffs in order to verify the admissibility of an extraordinary tariff revision" within ten days under the penalty of the tariff revision request be disallowed. Since ABA did not provide the cost study requested, the ORAB issued Resolution 23/02 on March 26, 2002 (after the Province had taken over the Concession) dismissing the request.

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<sup>48</sup> Memorial, p. 61.

<sup>49</sup> Ibid., p. 62.

<sup>50</sup> Ibid., p. 63.



**(ii) Positions of the Parties**

112. The controversy on the RPI is related to the extent that the review had an automatic character under the Concession Agreement. The Claimant argues that such review was automatic once the correctness of the elements underlying the percentage calculation had been verified, that this was an essential element of price-cap regulation and that there was no need to present a cost study. Such study was required only for the extraordinary tariff review foreseen elsewhere in the Concession Agreement. The Claimant notes that it was notified of the need of a cost study nearly three months after it filed its RPI request when in accordance to the contract the review of ORAB was to be completed within 30 days, and that the cost study was mandated by the MOSP Undersecretary but it did not figure in the ORAB's early evaluation of the review, nor in the separate report of Mr. Pievani. The Claimant alleges that the protracted process outlined by the Regulatory Group in the ORAB and the addition of a cost study were politically motivated and that there is no basis for them in the Concession Agreement. Furthermore, the public hearings do not have the role in the case of the RPI review attributed to them by the Respondent. Their objective is to provide transparency in the process of tariff reviews. According to the Claimant, the last paragraph of Article 12.3.5.3 proves that, once the revision is considered pertinent, the percentage of variation in the RPI had to be applied to the tariffs established in US dollars.

113. The Respondent has alleged that the procedure for the extraordinary tariffs reviews was common to all such reviews, and that there was no automatic raise of tariffs simply by the fact that a review had been triggered by a certain level of inflation. The steps required to be undertaken for such review were followed by the ORAB without the cooperation due by ABA to the regulatory organ of the Province and without any political motivation on the part of the Province which at all times followed the provisions of the Law and the Concession Agreement. The function of the public hearing goes beyond that attributed to it by the Claimant and it is the same for all tariff reviews. The ultimate decision to approve a tariff review request was the function of the provincial Governor.

**(iii) Considerations of the Tribunal**

114. As in the other controversies under the generic heading of tariff conflicts, the issues are based to a large extent on the interpretation of the Concession Agreement, in particular, Article 12. This Article has the following structure: General Principles (12.3.1), Procedure (12.3.2), Automatically Unacceptable Assumptions for Increases in the Tariffs and Prices (12.3.3), Ordinary Five-Year Reviews (12.3.4), Extraordinary Reviews based on Variations in the Indices of Costs (12.3.5), and General Extraordinary Reviews (12.3.6).

115. One of the general principles applicable to all revisions (“modificaciones”) is that revisions of the tariffs and prices can compensate only the costs arising from the delivery of the Service provided that there is compliance with the terms of the Agreement. The procedure to be followed is common for all revisions and includes, *inter alia*, the requirements that the revisions be based “on prior analyses and technical, economic, financial and legal reports, and on proof of the facts and actions that justify the revision”, and that there be an evaluation of the consequences that may result from the revision in respect of the delivery of the service and of the users. In addition, the proposed revisions shall be debated in a public hearing before the executive approves or rejects proposed revisions.

116. In the specific context of the revisions for reason of variations in the cost indices, Article 12.3.5.3 entitled “Verification of Revision Admissibility” provides that, once it is established that a variation is above the percentage set forth in Article 12.3.5.1, the procedure moves on to “the verification stage” where the ORAB is required to verify the existence of the elements that justify the revision in accordance with the general principles of Article 12.3.1 and the provisions of Article 12.3.5. Once the verification is completed, the ORAB shall determine whether the revision is justified and the modification to be introduced to the existing tariffs and prices. If the ORAB finds the revision justified, then a public hearing on the proposed revision should take place. The conclusions of the ORAB and the minutes of the hearing are sent to the executive which decides whether to agree to the revision or reject it.

117. It is evident from a reading of the contractual provisions that the Concession Agreement applies the same procedure to all reviews, therefore, a review for variations in cost indices is not more or less automatic than an ordinary five-year review. The elements that trigger the review are objective and whether a review should or should not take place could be seen as automatic once the correctness of the calculations have been verified, but this is the first step in the process. The ORAB then had to decide on the appropriateness of any revisions taking into account the general principles in Article 12.3.1, one of which is that modifications may only compensate for actual costs in the delivery of the service, and the consequences that the modification may have for service delivery and the users. The fact that the revision would be the subject of a public hearing and that the executive may or may not approve it show that a cost indices variation revision was not assured, under the terms of the Concession Agreement, to produce the result of simply transferring the variation in the costs indices to the tariffs and prices.

118. The parties have also argued whether the cost study requested from ABA by the ORAB was appropriate. The Claimant has placed special emphasis on the political motivation of the request since it was not in the original assessment of the ORAB. Given that under the terms of the Concession Agreement the ORAB was obliged to evaluate whether the modification based on variation in the cost indices was justified in terms of the general principle that modifications should reflect the costs of the service, the request would seem to be legitimate.

119. In interpreting the Concession Agreement and as affirmed by the parties and required by the Agreement itself, it is necessary to proceed with a harmonious reading of all the relevant provisions. While the last paragraph of Article 12 would seem to indicate that once the review is considered justified then the price index increase shall be applied to the tariffs retroactively as calculated, this provision cannot be read in such a manner as to contradict the general principle established in Article 12.3.1. The Tribunal is not convinced that the position taken by the Province would have changed the economic equilibrium of the Concession, as Azurix has claimed, as long as the principle to reflect actual cost variations due to inflation had been respected. In any case, this point is speculative since the review was never completed.

### **3. The Works in Circular 31(A)**

120. The Privatization Commission issued Circular 31(A) on April 23, 1999 on the subject of works under execution. This circular lists works in progress for purposes of Article 15.3.1 of the Concession Agreement and explains that, once the works would have been completed, they would be transferred without charge to the Concessionaire. Each work is listed with the location, a brief description, the amount budgeted and the percentage of completion. It is disputed whether the works were ever completed. ABA either refused to accept them because it considered them defective, or accepted them provisionally, according to ABA, in order to prevent a collapse of the water supply system. We will consider each of these works in the sequence presented by the Claimant in its Memorial and the allegations made by the parties in their respect.

#### **(a) Bahía Blanca: Algae Removal Works**

121. The so-called “Algae removal works at the Paso de las Piedras Dam” in Circular 31(A) consisted of the construction of a micro-filtering plant, refurbishment of certain key aspects of the Patagonia WTP filters, the repair of the system that evenly distributes the incoming water between the two filtration modules at the Patagonia WTP (“the Equipartition system”), the modification of certain elements of the direct filtration system at the Patagonia WTP (“Direct Filtration”), and the construction of a chlorine dioxide dosing facility (“Chlorine Dioxide Dosing System”). The Province retained the responsibility for the operation of the Reservoir and supplying raw water to the Patagonia WTP.

#### **(i) Positions of the Parties**

122. In the Memorial, the Claimant alleges that the Algae Removal Works had serious defects in their design and construction. The Claimant gives as examples that the Micro-Filtration Plant as designed permitted raw untreated water to by-pass microfiltration, the Direct Filtration system was only partially completed and the items installed were never connected, the Equipartition System was only partially completed and did not allow even distribution of water to the filter modules, the Patagonia Filters were not completed, and the Chlorine Dioxide Dosing system was defective in its design and construction and posed operational safety hazards.

123. On August 24, 1999, explains the Claimant, ABA provided the ORAB with a list of necessary short-term corrective measures to be completed prior to ABA taking possession of the Algae Removal Works, including that the water level at the Reservoir was unusually low, the new Micro-Filtering Plant was overloaded, the sand filters at the Patagonia WTP were old and overloaded, and the repairs to the Equipartition system failed to evenly distribute water. ABA also proposed the creation of a technical committee for the operation of the dam and reservoir to define contingency plans for drought periods and determine minimum quality standards to be met by the raw water supplied by the Province.<sup>51</sup>

124. The Claimant alleges that the failure to complete the Algae Removal Works caused an extraordinary algae bloom in the reservoir on April 10-11, 2000 resulting in the water appearing cloudy and hazy and with earth-musty taste and odor. According to the Claimant, the complaints of the consumers were picked up by the press and politicians and it became a major media and political event. The Claimant contends that none of the factors that caused the algae bloom were subject to ABA's control nor could the algae bloom have been foreseen based on the information supplied by the Province. This notwithstanding, observes the Claimant, provincial officials issued statements that caused panic in the population and did not conform with the analyses of the provincial Central Laboratory of the Ministry of Health which had determined that, "although the Bahía Blanca network water is not drinkable from a physical/chemical standpoint, no microbial contamination that could cause infectious diseases was detected."<sup>52</sup>

125. The Claimant points out that, as reported in the press, the Governor invited the citizens not to pay the bills, and that the ORAB ordered ABA to discount the invoices from April 12 until the ORAB deemed the drinking water to meet quality standards. The Claimant alleges that the ORAB took this action bowing to political pressure even if the president of the ORAB had indicated to the press that there were no grounds for a penalty because the quality parameters were in accordance with the

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<sup>51</sup> Memorial, pp. 71-73.

<sup>52</sup> Ibid., Exhibit 104.

standards defined in the bidding terms and conditions.<sup>53</sup> On April 28, 2000, the ORAB, by Resolution 24/00, prevented ABA from invoicing any amounts until the service was normalized. The prohibition was lifted by Resolution 33/00, dated May 8, 2000. On May 18, 2000, at the request of MOSP, the Provincial Domestic Trade Bureau forbade ABA from invoicing and collecting for services until water quality was deemed acceptable to users.

126. The Claimant notes that this action was taken under the Consumer Defense Act which applies to situations not covered by a specific regulatory framework, and disputes the authority of the Provincial Domestic Trade Bureau to issue this measure because the ORAB had exclusive jurisdiction on billing matters. The Claimant also notes that the press reported that the governor was studying the means to remove the ORAB officials responsible for the decision to allow ABA to receive payments when the service was not in good condition and that a lawsuit was filed against these officials.<sup>54</sup> Under such pressure, ABA agreed with the ORAB to extend the service discount from May 5 to May 31, 2000 but stating that it did not accept responsibility for the water problems and reserved the right to seek reimbursement for its damages from the Province. On June 2000, the ORAB issued Resolution 43/00 ordering a 100% discount on invoices for services provided in Bahía Blanca and Punta Alta from April 12 through May 31, 2000.<sup>55</sup>

127. The Committee of Control for Privatized Public Services and Companies, and the Consumer and User Defense Committee of the Provincial Legislature held hearings on the algae incident. According to the Claimant, ABA, MOSP and the ORAB were summoned to appear before said committees. MOSP and the ORAB arranged for a separate meeting closed to the public. In that meeting, the MOSP Minister stated:

“We are aware that, in association with the ORAB, we have forced certain decisions that are of a political nature, particularly by requesting the ORAB to apply a resolution whereby the Concessionaire is to receive no payment for each day in which water supply quality is not as agreed; by doing so, we breached the

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<sup>53</sup> Ibid., p. 82.

<sup>54</sup> Ibid., Exhibit 127.

<sup>55</sup> Ibid., p. 83.

concession agreement, and this was a political decision. We took a step further beyond the general meaning of the agreement itself.”<sup>56</sup>

According to the Claimant, the MOSP Minister also recognized that the problems that occurred had plid causes and the Mayor of Bahía Blanca attributed them to the lack of investments for many years.<sup>57</sup>

128. In the Counter-Memorial, the Respondent recalls that, according to Circular 31(A), 98% of the works had been completed. This percentage reflected the fact that the Micro-Screening Plant of the Paso de las Piedras dam had been refurbished and started up by June 23, 1998, and on December 9, 1998 eight additional filters were released for use.<sup>58</sup> The Respondent points out that Azurix was aware of the condition of the works at the time it submitted the bid for the Concession and ABA had taken over the operation of the service, including algae treatment.<sup>59</sup>

129. The Respondent explains that, under the Concession Agreement, the Concessionaire was responsible for carrying out all tasks to guarantee efficient provision to users, the protection of public health and the rational use of resources, and it was specifically responsible for the quality of unfiltered water and the quality and quantity of drinking water. The Respondent further notes that the Concessionaire was also responsible for the quality of unfiltered and drinking water taken from the Paso de las Piedras dam. The Respondent affirms, based on Article 1 of Exhibit O to the Concession Agreement, that “even when the Province was in charge of the operation and maintenance of the Dique Paso de las Piedras dam, the latter was explicitly exempted from any responsibility regarding the ‘quality and quantity of water delivered’ to the Concessionaire.”<sup>60</sup>

130. The Respondent affirms that ABA infringed the biological parameters for drinking water required in the Concession Agreement. The Respondent points out that the audit report ordered by the ORAB stated that all water coming from superficial sources is susceptible of being treated for human consumption and what varies is the

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<sup>56</sup> Ibid., p. 84, quote from the parliamentary record.

<sup>57</sup> Ibid., p.85.

<sup>58</sup> Counter-Memorial, paras. 605-606.

<sup>59</sup> Ibid., para. 607 and ff.

<sup>60</sup> Ibid., para. 624.

intensity of the required treatment. The same report considered that the Concessionaire managed the crisis in an improvised and imprudent manner and the measures adopted by ABA were not technically suitable to remedy the problem and, hence, the ORAB imposed a fine for not non-compliance with its obligations under the Concession Agreement.<sup>61</sup>

131. The Respondent further notes that a crisis in the drinking water supply is a serious and alarming event for the community and, if the image of ABA deteriorated in the eyes of the users, it was because of the negligent manner in which ABA addressed the problem.<sup>62</sup>

132. In its Reply, Azurix alleges that the Province did not disclose to the bidders information in its possession related to the reservoir situation and points out that Argentina fails to recognize that the April 2000 algae bloom was an extraordinary occurrence that ABA could not predict or avoid on the basis of the information or assets under its management.<sup>63</sup>

133. Azurix contests Argentina's assertion that since the beginning ABA was in charge of algae treatment operations. Azurix recalls that the Algae Removal Works were the exclusive responsibility of the Province, and the works that concerned the Patagonia plant were never completed. Furthermore, ABA could not avoid operating this plant in its existing condition because of its critical importance. Azurix also explains in this context that it needed the ORAB's prior permission for any operation to be carried out in connection with the Algae Removal Works and to access the Micro Filtration Plant facilities. The Claimant notes that this plant was never transferred to ABA and ABA was involved in its operation during the algae crisis in order to take emergency measures.<sup>64</sup>

134. The Claimant disputes the interpretation of the Concession Agreement by the Province and argues that Article 3.6.1 only applied to raw water sources under ABA's management and considers it nonsensical the extension of ABA's obligation to sources exclusively controlled and operated by the Province. In fact, according to the

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<sup>61</sup> Ibid., para. 643 and ff.

<sup>62</sup> Ibid., paras. 650-651.

<sup>63</sup> Reply, para. 318 and ff.

<sup>64</sup> Ibid., para. 326 and ff.



Claimant, none of the action that could have prevented the algae incident was under ABA's control: the Province had exclusive control of the dam and reservoir, could control agricultural run-off into the reservoir, fail to complete the Algae Removal Works and lowered the water level of the reservoir favoring algae blooms.<sup>65</sup>

135. The Claimant explains that the fine imposed by the ORAB on account of the algae incident was imposed after the service had been transferred to the Province more than two years after the algae bloom event and four days before the deadline for filing petitions in ABA's bankruptcy proceedings. The Claimant also points out that the fine was in excess of the amounts permitted under the Concession Agreement. Azurix contests the grounds on which the fine was imposed. Azurix argues that the guidelines values in Table IV of Annex C to the Concession Agreement are only reference values in line with the World Health Organization (WHO)'s recommendations and that the Respondent turns them in strict limits.<sup>66</sup>

136. The Claimant affirms that ABA took all measures required to remedy or mitigate the effects of the situation caused by the Province and that at no time was there any risk to public health, and observes that the Respondent relies exclusively on the audit report prepared by the ORAB to argue that ABA was negligent in dealing with the crisis. Azurix further observes that such report is not reliable given the lack of independence of the ORAB from the Province's political will.<sup>67</sup>

137. The Claimant contests the Respondent's assertion that ABA voluntarily gave a discount to customers and affirms that ABA was forced by the ORAB to apply such discount to the water bills.<sup>68</sup> Furthermore, it is unacceptable to Azurix that public statements by officials with a view "to inciting fear, uncertainty and even violence against ABA" be described by the Respondent as "the free exercise of a democratic society's rights."<sup>69</sup>

138. In the Rejoinder, Argentina reiterates in substance its previous arguments, mainly, that at the time of the bidding for the Concession the Algae Removal Works

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<sup>65</sup> Ibid., para. 335.

<sup>66</sup> Ibid., para. 339 and ff.

<sup>67</sup> Ibid., para. 344-345.

<sup>68</sup> Ibid., paras. 346-347.

<sup>69</sup> Ibid., para. 352.

were 98% completed, that Azurix and ABA were aware of the condition of the works and submitted themselves to Section 2.4 of the Bidding Conditions,<sup>70</sup> that Azurix inspected the works before submitting its offer, that since the beginning of the Concession ABA was in practice responsible for the operation of the Service and the treatment of the algae, that the Concessionaire was responsible for the quantity and quality of raw water from the Paso de las Piedras dam even if the operation and maintenance was under the charge of the Province, that Table IV of Exhibit C to the Concession Agreement required that the drinking water had no phytoplankton and zooplankton, and that failure to meet these biological parameters meant that the ORAB was required to impose a fine.<sup>71</sup>

139. The Respondent alleges that the community unrest was not due to intervention of provincial officials, as claimed by Azurix, on the contrary, these officials were responding to the population concern over the foul smelling and tasting water. The Respondent argues that Azurix has admitted as much by recounting how the problem with the water smell and taste had “gradually attracted the attention of politicians and journalists and became an issue widely covered by the media.”<sup>72</sup>

**(ii) Considerations of the Tribunal**

140. The allegations of the parties relate to their understanding of the Concession Agreement, the causes of the algae incident and the reaction of the provincial authorities.

141. It is a matter of dispute between the parties whether the Concessionaire was responsible for the quantity and quality of the water from a source not under its management. The dispute relates to whether Article 3.6.1 of the Concession Agreement applies to the raw water supplied from the Paso de las Piedras reservoir. The Tribunal notes that this Article does not differentiate between sources of raw water and Annex O specifically exempts the Province from responsibility from the quantity and quality of water supplied from said reservoir.

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<sup>70</sup> This section provides, *inter alia*, that bidders by the fact of submitting a bid recognize that they had sufficient access to information to prepare it correctly and that the bid was based exclusively on their own investigation and evaluation.

<sup>71</sup> Rejoinder, para. 630 and ff.

<sup>72</sup> *Ibid.*, para. 636 and ff. Quote from p. 79 of the Memorial.

142. It is also disputed between the parties whether the Concessionaire breached the biological parameters set forth in Annex C to the Concession Agreement. The Tribunal has difficulty with the Claimant's understanding of the wording of Annex C and the concordant provisions in the Concession Agreement. Article 3.6.2 is very clear in requiring that the Concessionaire meet the parameters established in Annex C and in specifying that in all cases the failure to meet the technical parameters shall be considered a potential risk for the public health.

143. However, the Concession Agreement was based on certain factual assumptions that did not turn out to be correct. It is not contested that the Algae Removal Works were not completed notwithstanding that at the time of bidding for the Concession they were represented to be 98% complete and expected to be completed by April 1999, at least two months before the beginning of the Concession and a full year before the extraordinary algae bloom occurred. The reservoir was kept by the Province only 25% full to permit completion of the works. In turn the low water level contributed to the extraordinary nature of the algae bloom. The works undertaken by the Province had the objective to obtain treated water at the outlet of the Patagonia plant with "levels of the chlorophyll photosynthetic pigment below 1mg/m<sup>3</sup>, irrespective of the species or number of cells, pH, etc. present in the water." This objective was not achieved. The filters installed at the micro-filtering plant were inadequate for filtering algae, a fact on which the ORAB and the consultants of Azurix agreed. The Bahía Blanca Drinking Water Supply Monitoring Report prepared by the ORAB noted that it had not found domestic or international precedents where these micro-filtering systems were used for the primary elimination of this type of plankton organisms.<sup>73</sup> Similarly, the report prepared by the consulting firm JVP employed by ABA concluded that the direct filtration system at Paso de las Piedras was not fit for the treatment of water because of the high concentration of algae/chlorophyll reaching the Patagonia plant due to the properties of the water from the reservoir and the removal capacity of the micro-screens system.<sup>74</sup> Since August 1999, ABA had repeatedly advised the ORAB, to no avail, of the measures necessary for ABA to take possession of the Algae Removal Works. For

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<sup>73</sup> Halcrow Report, p. 32. Exhibit 90 to the Memorial.

<sup>74</sup> Ibid., p.33.

instance, in a letter to the ORAB dated August 24, 1999 (less than two months into the Concession and eight months before the April 2000 incidents) ABA alerted the ORAB that there was an increase in “the algae problem” due to the unusual low level in the reservoir.<sup>75</sup> In the same vein, ECODYMA, the contractor engaged by AGOSBA to carry out the Algae Removal Works, wrote to the General Administrator of Sanitary Works of the Province on July 19, 1999 to bring to her attention that the quality of the water of the reservoir did not meet the standards used as a base for its bid because of the high level of turbidity of the water and the algae bloom in large number and variety.<sup>76</sup>

144. Given this factual situation, the reaction of the provincial authorities shows a total disregard for their own contribution to the algae crisis and a readiness to blame the Concessionaire for situations that were caused by years of disinvestment and to use the incident politically, as admitted by the MOSP Minister in hearings held by commissions of the provincial parliament on the algae incident. It equally shows the willingness of high placed provincial officials, including the Governor, to interfere in the operation of the Concession for political gain whether by forcing ABA not to bill the customers or threatening the staff of the ORAB for lifting the billing interdiction. These actions by the Province are clearly actions taken in use of its public authority and go beyond the contractual rights as a party to the Concession Agreement. The Tribunal understands that governments have to be vigilant and protect the public health of their citizens but the statements and actions of the provincial authorities contributed to the crisis rather than assisted in solving it.

**(b) *Moctezuma***

**(i) *Positions of the Parties***

145. As explained by the Claimant in its Memorial, the works as described in Circular 31(A) included two elements: “Drilling Construction Works” and “Construction of Aqueduct and Injection Pipelines”. These works were only 10% and 25% completed according to Circular 31(A). The drilling component consisted of drilling 16 wells capable of extracting 300 m<sup>3</sup> per hour. Under the drilling contract, AGOSBA had the

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<sup>75</sup> Exhibit 94 to the Memorial.

<sup>76</sup> Exhibit 95 to the Memorial.

right to reject the work performed if the water flow was lower than 50% of the required capacity or the water did not meet sanitary requirements. The aqueduct was intended to transport water from Moctezuma to the cistern in Carlos Casares for delivery to this town and the town of Pehuajó. These works were to be completed in 18 months, by June or early July 2000.

146. According to the Claimant, on March 14, 2000, AGOSBA informed the ORAB that there would be a two-month delay and the works would be completed by September 2000. The dateline was postponed further and the Claimant finds it disconcerting that the ORAB, instead of pressing the Province to fulfill its obligations, informed ABA that “Azurix [sic] cannot assert completion of works as the grounds of non-compliance of the parameters for water quality in such localities.”<sup>77</sup> The completion occurred nearly 18 months after the original completion date and after ABA had terminated the Concession. The Claimant explains that ABA was willing to accept the works provisionally subject to a technical and functional evaluation and that the evaluation performed on January 3, 2002 showed that the works were unsuitable for the purpose and were not accepted by ABA. In particular, the wells could supply only a third to half the agreed water flow.<sup>78</sup>

147. In the Counter-Memorial, Argentina describes a different situation. It refers to the study submitted by ABA to the ORAB in May 2000 where it acknowledges that the wells have been drilled and 13 km. of aqueduct completed. In the same study, ABA recommended to cut the extraction of water by 50% to preserve the geological reserves. The works were completed and ABA was notified on October 2, 2001. ABA accepted the works provisionally on October 10 because it had terminated the Concession on October 5. The civil works were completed by end of August but the electricity connection could not be installed because of flooding in the area. The External Audit of September 2001 presented by ABA to the ORAB states that access to some drillings was not gained because they were in a flooded area. The works were not essential to meet service quality targets because of the 3-year exemption in Annex F of

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<sup>77</sup> Ibid., pp. 89-90.

<sup>78</sup> Ibid., pp. 90-91.

the Concession related to physical and chemical parameters of water quality. ABA was never penalized nor has Azurix claimed any damages on this account.

148. In its Reply, Azurix points out that Argentina has failed to mention that the wells were expected to solve quantity of water issues and not only quality, and that the quality of the water did not comply with the parameters originally provided in the work specifications.<sup>79</sup> The fact that there was no deadline in Circular 31(A) does not mean that this Circular can be considered in isolation of the contracts and specifications for the works in question. The flooding only took place after April 15, 2001, more than eight months after the expiration of the deadline and after the works had been suspended because of lack of payment to the contractor.<sup>80</sup> Azurix maintains that ABA did not even accept the works provisionally but “subject to the conditions mentioned in Note GRP 1882/01, particularly its completion in accordance with the specifications and the contract signed for their execution...”<sup>81</sup> As already pointed out, the ORAB warned ABA that non-completion of the works in Moteczuma could not be used as excuses for non-compliance with water quality parameters. The ORAB also determined that there was decreased pressure in the cities of Pehuajó and Carlos Casares and ordered ABA to solve this issue. ABA had to drill five new wells, implement a pumping scheme to optimize drinking water distribution in Pehuajó, and started the construction of an arsenic treatment plant because the Moctezuma wells failed to meet the standard required in relation to arsenic levels.<sup>82</sup> According to the Claimant, the worst part was the damage to the image of ABA among the customers since the works had been presented by the Province as the solution to the water problems of the previous 40 years and created high expectations among the authorities and local people.

149. Argentina in its Rejoinder claims that the temporary acceptance of the works on October 10, 2001 was linked to the unilateral termination of the Concession 5 days earlier and that the additional works and studies claimed to have been necessary because of the deficient Moctezuma works were already included in the Five-Year Plan presented by ABA to the ORAB in November 1999. No fine was ever imposed on ABA

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<sup>79</sup> Reply, para. 355.

<sup>80</sup> Ibid., paras. 365-366.

<sup>81</sup> Ibid., para. 368.

<sup>82</sup> Ibid., p. 120 footnotes 382 and 383.

related to the alleged consequences of the Moctezuma works on ABA's delivery of services. The only fines were related to the interruption of service because of breakage of the Nueve de Julio aqueduct on May 2 and June 29, 2000 because of improper operating procedures. The breakage happened before the original delivery dates.<sup>83</sup>

**(ii) Considerations by the Tribunal**

150. It is accepted by the parties that the works were late. It is clear from the evidence presented that the works stopped first because the contractor was not paid by the Province and later because of flooding. It is also clear that the quantity of the water that could be extracted from the wells was below expectations. For the Tribunal this is a simple contractual matter not involving the exercise of the provincial public authority.

**(c) Polo Petroquímico ("Polo")**

**(i) Positions of the Parties**

151. AGOSBA had entered into an agreement with Profertil and the Province for the supply of industrial water for a fertilizer plant under construction. The water supply contract was assigned to ABA as part of its takeover of the Concession. To meet the water requirements, the Province had started construction of an aqueduct which was listed as 95% complete in Circular 31(A). Azurix claims that the Province failed to deliver the aqueduct. In a letter of August 25, 1999 to ABA and AGOSBA, Profertil noted the defects "in the construction and design of the Industrial Aqueduct and the inferior quality of the equipment and materials used". In January 2000, ABA informed Profertil that the aqueduct did not meet the requirements to provide the service and it would not be possible to supply Profertil with the quantity and quality of water agreed by the Province. Azurix received the Industrial Aqueduct in March 2000 provisionally and subject to "final acceptance upon the satisfactory result of routine technical evaluation and the Province assuming full responsibility for any service failures not caused by ABA".<sup>84</sup> On August 2000, the Province, Profertil, PBB and Polisur (other industries in the Polo) signed a letter of intent to construct a new pipeline. Azurix considers this fact as an admission that the existing aqueduct was "not fit for its intended purpose". Azurix

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<sup>83</sup> Rejoinder, para. 661.

<sup>84</sup> Memorial, p. 92.

lists a series of steps that it took to minimize the deficiencies of the aqueduct, including the building of a by-pass between the aqueduct and an existing water pipeline, and supplying the companies in the Polo with industrial water while bearing the cost of the raw water paid to the Province.<sup>85</sup>

152. Argentina points out that pursuant to Article 15.4.1 of the Concession Agreement, the contracts signed by OSBA listed in Annex N would be transferred to the Concessionaire. Circular 39(B), item 2, Annex O, established guidelines for the supply of industrial water to the companies in the Polo. The guidelines established the price to be paid to the Province and the responsibility of the Province for the amount of water delivered. The quality of the water should be that of water in its natural state at the Paso de las Piedras dam treated at the micro-screening plant.<sup>86</sup> The President of the ORAB informed ABA about the transfer of the aqueduct on March 28, 2000. In the “Inventory of Fixed Assets” of ABA, the aqueduct was listed as an asset assigned to the Concession with April 15, 2000 as “Date of Origin” and in excellent condition.<sup>87</sup> Argentina argues that ABA tried to generate conflicts with Profértil because it did not consider the contract advantageous, and with the Province to renegotiate the Concession.<sup>88</sup>

153. Azurix in its Reply reaffirms that the poor condition of the work prevented adequate service provision to the industries in the Polo. In addition, the deficient operation of the dam affected the quality of the water to such an extent that ABA could not “invoice the industrial water it delivered in order not to become committed to an operation that it could not guarantee through the Province’s facilities”.<sup>89</sup> Furthermore, the commercial negotiations that ABA may have held with the industries of the Polo are alien to the issues raised by Azurix. There is no doubt that the deficiencies experienced by the aqueduct created a negative image of ABA in the eyes of the industries located in the Polo.<sup>90</sup>

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<sup>85</sup> Ibid., pp. 93-94.

<sup>86</sup> Counter-Memorial, para. 196.

<sup>87</sup> Ibid., para. 698.

<sup>88</sup> Ibid., paras. 699-704.

<sup>89</sup> Reply, para. 384.

<sup>90</sup> Ibid., para. 388.



154. In the Rejoinder, Argentina reaffirms its previous arguments on the assignment of the contract and ABA's acceptance of the aqueduct. If ABA had made investments to ensure the continuity of service, it is because ABA considered it necessary to comply with its obligations. They are not the Province's or Argentina's responsibility.

**(ii) Considerations of the Tribunal**

155. The Tribunal considers that the fact that the Province agreed to build a new aqueduct proves that the one delivered to the Concessionaire was inadequate. The tests conducted by ABA, which have not been disputed by Argentina, provide also evidence of the low level of pressure acceptance by the water pipeline. The letter of August 1999 from Profertil to AGOSBA and ABA speaks by itself and its content has not been refuted by Argentina. However, this is a matter of a contractual nature that does not go beyond the relationship between the parties to the Concession Agreement acting as such.

**(d) Florencio Varela**

**(i) Positions of the Parties**

156. This component of work in progress for which AGOSBA took responsibility consisted of drilling four wells. According to the drilling contract, the wells were to be completed in 180 days from the date of the contract, December 30, 1998. Circular 31(A) stated that the wells were 70% completed, which Azurix disputes. Azurix alleges that the Province failed to deliver the wells and hence it was impossible to keep up with the summer water demands and such failure caused service interruptions. On December 27, 1999, the ORAB ordered ABA "to conform the service to the established service levels within 24 hours". To comply, ABA "took control of the Florencio Varela Extraction Wells on a provisional basis in order to begin providing water service to the local citizens".<sup>91</sup> On December 28, 1999, ABA explained to the ORAB that the Province's failure to complete the wells made it impossible for ABA to comply with its obligations to provide water service. ABA's first Annual Report noted that the drilling ended before

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<sup>91</sup> Memorial, p. 96.

reaching the aquifer “to avoid more complicated works, which rendered said works useless”.<sup>92</sup>

157. According to Argentina, the wells were “practically completed” at the end of July 1999 and the final measurement was carried out. ABA’s Service Report states that the wells were available for service. The wells were included in the inventory of assets on June 15, 1999. The wells needed to be supplemented with the pertinent interconnection pipes. Their installation was the responsibility of the Concessionaire. ABA’s Annual Progress Report on the POES and Service levels for the year July 1999-June 2000 includes at least three of the wells in the actual service provision. In any case, ABA did not suffer any damages nor did the ORAB impose any penalties.<sup>93</sup>

158. In its Reply, Azurix finds that Argentina has failed to address the evidence presented in the Memorial. Azurix notes that it took five months for the ORAB to authorize ABA to assume operation of the Florencio Varela wells, to conduct tests, to adapt them and to complete them in order to address the summer increased demands.<sup>94</sup> Azurix contests the significance of the quoted reports and the measurement statement. According to Azurix, the purpose of the Service Report was “to evaluate the condition of the water system ‘*at the time of ABA’s take over of the Concession*’”.<sup>95</sup> The Report noted that the four wells were not in operation and the equipment was missing. The date of origin in the Fixed Assets Inventory does not have the relevance that Argentina attributes to it. Date of origin is merely a technical term that does not explain why the ORAB did not authorize ABA to take material possession till December 27, 1999. Prior delivery of the wells was essential for the installation of the water pipes. Once ABA obtained the authorization, it immediately proceeded to complete them at its own expense and connect them to the network. Only three wells were put in operation, the fourth could not be used due to construction problems, was abandoned and new drillings had to be made at ABA’s own expense.<sup>96</sup>

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<sup>92</sup> Ibid., p. 97.

<sup>93</sup> Counter-Memorial, paras.706-717.

<sup>94</sup> Reply, para. 390.

<sup>95</sup> Ibid., para. 393. Emphasis in the original.

<sup>96</sup> Ibid., paras. 394-395 and footnote 429.

159. In the Rejoinder Argentina contends that the completion of the works during the first month of the Concession was duly proved by Argentina. Argentina points out that Azurix quoted only partially from the Service Report which stated that “only the ducted well was available. The equipment is missing. The equipment is stored at the ‘Centro’ operating location”.<sup>97</sup> Contrary to Azurix’s allegations, it was not necessary to equip the wells to interconnect them. In any case, no fine was imposed since no fines could be imposed during the first six months of the Concession.<sup>98</sup>

**(ii) Considerations of the Tribunal**

160. From the parties allegations it emerges that Argentina does not contest that ABA was authorized to use the wells on December 27. The inventory of fixed assets showing the wells as an asset added on June 15, 1999 indicates that assets were added before work was completed or were in service. On June 15, the Concession Agreement had not been signed yet and there is no dispute that, on that date, the works were not completed. Argentina claims the works were completed in July and ABA claims never to have accepted them. There is no dispute that only three out of the four original wells went into service and that they produced low water flow. The certificate of measurement of July 20, 1999 simply recorded the fact that the final measurement took place and it is signed by OSBA and the Contractor. Hazen & Sawyer (“H&S”) stated that: “The concessionaire had to unilaterally take over the unfinished wells from AGOSBA and to put them into production before they were formally transferred as stipulated in ABA’s concession contract”.<sup>99</sup> There seems to be a difference of view between simply executing the works and accepting them as works satisfactorily completed under the terms of the civil works contract concerned. ABA considered works completed when accepted in terms of the specifications in the contract, while the Province seems to have been concerned with the physical completion of the works even if they did not meet the contract specifications. The Tribunal concludes from these considerations that that this is a matter in which the Province did not exercise its public authority and acted as any other contractual party.

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<sup>97</sup> Rejoinder, para. 679.

<sup>98</sup> Ibid., para. 686.

<sup>99</sup> Exhibit 163 to the Memorial, pp. 2-11.

#### **4. Rejection of Financing by the Overseas Private Investment Corporation (“OPIC”)**

##### **(a) *Positions of the Parties***

161. Azurix submits that, in the privatization of public water systems, the private investor usually needs to compensate for under-investment in the infrastructure during the previous State-run operation.<sup>100</sup> ABA estimated that it would need \$311 million to comply with the POES goals. ABA contacted OPIC and the Inter-American Development Bank (“IDB”) to obtain \$100 and \$150 million loans, respectively, in the fall of 1999. In April 2000, both institutions expressed interest in providing financing and in May 2000 Azurix submitted formal applications.<sup>101</sup> These institutions engaged H&S to perform a comprehensive due diligence investigation of the Concession and H&S staff visited Argentina in August 2000. During a second visit in October 2000, H&S focused primarily on ascertaining “how the Provincial authorities viewed the ongoing development of the Concession and what role the Province would play in promoting investment security and stability over the course of the Concession”.<sup>102</sup> On September 21, 2001, OPIC rejected formally the application. The letter described the issues identified by their due diligence that required “clear and definitive resolution to ensure the concession’s long-term viability and render it an acceptable credit capable of borrowing funds.”

162. The issues identified by H&S were uncertainty on tariffs, substantial scope of the capital plan required to meet the service goals compared to the level of cash ABA is expecting to generate from forecasted revenues based on tariffs in place, lack of clear definition of roles or responsibilities and unclear commitment of the Province to the Concession given unmet obligations.<sup>103</sup> The letter concluded:

“We understand that since our meeting in Argentina during November 2000, ABA has continued discussions with ORAB and Buenos Aires Provincial government and no significant progress has been made regarding the core issues related to

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<sup>100</sup> Memorial, p. 98.

<sup>101</sup> *Ibid.*, p. 101.

<sup>102</sup> *Ibid.*, p. 103

<sup>103</sup> *Ibid.*, pp. 107-108 and Exhibit 173.

tariff setting and the capital expenditures program. From a creditworthiness perspective, this failure to reach an agreement regarding modifications to the concession to restore a sustainable situation for ABA precludes us from moving forward with potential financing.”

163. According to Azurix, the denial of financing by OPIC made it impossible to obtain long-term financing from other sources. It meant that Azurix would have to fund ABA’s operational expenses itself.<sup>104</sup>

164. In the Counter-Memorial, Argentina alleges that Azurix was always short of funding. Argentina points out that Azurix prepared an IPO to obtain funds that it could not obtain otherwise but that the IPO funds benefited ENRON instead. Furthermore, the World Bank denied funding to Azurix in Ghana because of its totally non-transparent policy. In any case, Azurix was responsible for obtaining funding, and it was its decision where to find it whether using its own capital or becoming indebted to multilateral institutions or other entities.<sup>105</sup>

165. Azurix contests the assertions of Argentina on financing, the link of OPIC financing to the denial of a World Bank loan to Ghana and the lack of resources. Azurix draws attention to the fact that the denial of financing in Ghana took place in March 2000 while OPIC and the IDB expressed interest in providing financing in April and June 2000. The H&S report in January 2001 did not mention the issue and the letter of OPIC sent on September 21, 2001 neither.<sup>106</sup>

166. Argentina points out in its Rejoinder that the conflicts that eventually led OPIC to deny funding were generated by Azurix itself. The notification of Azurix on January 5, 2001 of a dispute under the BIT would have affected the denial of funding by OPIC. Argentina adds another instance of funding denial not mentioned by Azurix. ABA requested a US\$50 million loan from ENOHSA under an IDB-financed program. The loan was denied because the lender requested the guarantee of ENRON or a suitable bank guarantee, which ABA could not provide. ABA was notified on September 21, 2001, the same date as OPIC’s letter, and no reference was made to any conduct or

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<sup>104</sup> Memorial, p. 109.

<sup>105</sup> Counter-Memorial, pp. 162-167.

<sup>106</sup> Reply, para. 284.

omissions by the Province or the Regulatory Agency but to lack of plans, excessive budgets, lack of environmental impact assessments, etc.

**(b) Considerations of the Tribunal**

167. The rejection of the loan by OPIC was very clear and specific in its reasons. The World Bank was not mentioned nor ENRON. The Tribunal has no reason to second guess the management of OPIC in its reasoning for rejecting the request. As regards the ENOHSA loan, ENRON was not prepared to guarantee the loan as required by Banco de la Nación Argentina, the administrator of the program. By September 21, 2001, ABA had already requested the Province to cure its noncompliance with the Concession Agreement. Evidently, each institution had a different choice of reasons for denying funding. For the Tribunal, the significance of the reasons given by OPIC and the due diligence analysis on which they are based stems from the fact that OPIC is unrelated to any of the parties involved and the consultants hired to do the due diligence had no allegiance to any of the parties to this proceeding. The H&S report shows that the lack of funding for ABA could not be attributed to the relationship of Azurix with ENRON or to whichever denial of funding by the World Bank. H&S's assessment noted the politicization of the Concession, the lack of commitment of the provincial authorities to the Concession, and the impact of those two factors on its viability. However, these were not the only reasons adduced by OPIC to reject Azurix's financing request. OPIC's letter also referred to "the substantial scope of the capital plan required to meet the service goals of the concession in terms of both aggressive timing and cost, as compared to the level of cash ABA is expecting to generate from forecasted revenues based on tariffs currently in effect."<sup>107</sup> In other words, the current tariff level was insufficient to sustain the scope of the capital plan.

**5. Memorandum of Understanding (MOU)**

**(a) Positions of the Parties**

168. On January 5, 2001, the Claimant notified Argentina of the existence of a dispute under the BIT. According to the Claimant, at that point the Province renewed its

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<sup>107</sup> Exhibit 173 to the Memorial.

discussions with ABA to remedy the breaches of the Concession Agreement, and on February 15, 2001 the MOSP and ABA signed a Memorandum of Understanding (MOU). The Claimant alleges that:

“the MOU implicitly recognized that the guarantees given by the Privatization Commission (including Circular 52(A) were essential to the attraction of qualified investors. Moreover, it implicitly recognized that the Province, as the granting authority, had the ability to revisit the purpose and goals of the Concession Agreement to optimize intended social purposes. Finally, and importantly, it recognized implicitly that the economic equilibrium of the contract was broken. These principles were incorporated into the MOU under the mutual understanding by ABA and the Province that the economic equilibrium of the Concession needed to be restored.”<sup>108</sup>

169. To implement the goals of the MOU a committee was established (“the MOU Committee”). This committee had to produce an interim report of the negotiations within 30 days and a resolution of the issues outlined in 60 days. During the discussions, the MOSP Undersecretary took the view that the Canon was subject to business risk and he proposed an amortization scheme as a percentage over sales and the remaining unamortized value to be recovered through the re-bidding of subdivided areas of the Concession. According to the Claimant, throughout the discussions “the approach of the MOSP was centered on questioning the privatization process and discarding key assurances that had been provided to ABA”, and the affirmation that the Concession was based on the risk principle.<sup>109</sup> The Claimant alleges that by the end of the negotiating period “the repeated promises that the Province made to cure the outstanding breaches related to the application of the tariff regime remained unfulfilled” and the Province opted for deferring ABA’s rights under the Concession. Thus as told by Mr. Clark, a member of the MOU Committee representing ABA, in his witness statement:

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<sup>108</sup> Memorial, pp.120-121.

<sup>109</sup> Ibid., pp. 123 and 125.

“As a condition to the signing of MOU II, the Province asked Azurix to withdraw its arbitral claim with ICSID and to release the Province from any claims... when ABA stressed the urgent need to increase cash flow, the Province responded that ABA should address this at the first tariff review at the end of the five-year period ... ABA was not in a position to wait until the end of the five-year period, and needed immediate solutions to the threat of its financial collapse.”<sup>110</sup>

170. The Claimant summarizes the MOU process results by affirming that by September 2001 the promises made by the Province to resolve the tariff issues were conditioned to withdrawal of the arbitration claim and the renunciation to recover the Canon, “In essence, after nearly a year of pursuing the rectification of Provincial breaches through the MOU efforts, nothing had changed to make the Concession economically viable. The breaches of the Concession Agreement, which affected the viability of Azurix’s investment, were still uncured.”<sup>111</sup> According to the Claimant, this situation prompted ABA to consider the termination of the Concession Agreement due to the Province’s continuous breaches.

171. From the Respondent’s point of view, the MOU was simply an agreement to create a committee to look into possible negotiating procedures.<sup>112</sup> It was “a negotiating process in which the parties, regardless of the rights to which they are legally entitled or for which they may have a rightful claim, try to reach a sustainable understanding for the Concession Contract within the framework of Law No. 11.820 and the rules and regulations applicable to the service.”<sup>113</sup>

172. The Respondent alleges that no agreement was reached in the context of the MOU negotiations because ABA adopted an unyielding position to be released of its obligations and transfer entrepreneurial risk to the Province. As a result, no proposals were ever submitted to the MOSP as it had been foreseen in Article 2 of the MOU, and

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<sup>110</sup> Ibid., quote in pp. 126-127.

<sup>111</sup> Ibid., p. 127.

<sup>112</sup> Counter-Memorial, para. 494.

<sup>113</sup> Ibid., para. 495.



the quality and expansion targets in the Concession Agreement and in the approved First Five-Year Plan were never modified.<sup>114</sup>

**(b) Considerations of the Tribunal**

173. The MOU was part of a process to revisit certain aspects of the Concession. Its purpose and function was to conduct “the joint analysis of the issues” listed in Section 2 of the MOU. All items listed are couched in terms of work to be done – studies, discussions, preparation of a “regulatory model” - except for the second item – POES goals (Section 2.2) – which in part is drafted as a decision to establish, right there and then, a “priority works” plan to be performed during the current year because “the current critical service condition cannot be resolved by goals based contracts.” (2.2, first paragraph) A detailed plan of works and actions for 2001 was attached as an exhibit to the MOU.

174. The second paragraph of Section 2.2 recognizes the need to revise the goals of the POES in view of Resolution 179/00 of the MOSP and Resolution 59/00 of the ORAB which established sanitary vulnerability, risk and access criteria. The third paragraph of this section entrusts the ORAB with the control and regulation of the service “by following up on the Priority Works Plan.”

175. The MOU was signed by the Minister of Public Works and Services and the General Manager of the Concessionaire in the presence of the Secretary General of FENTOS and the Secretary General of SOSBA and city mayors, all of whom acknowledged the contents by subscribing the exhibit on works and actions for 2001. The signature took place also in presence of members of the provincial Senate and House of Representatives.

176. While the Respondent has played down the importance and significance of the MOU, it seems that it reflected a moment in which the parties were prepared to give serious consideration to the problems that had surfaced during the first year of the Concession. The level of the positions held by the persons who signed it and the context of the signature ceremony show the importance that the parties attached to the

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<sup>114</sup> Ibid., paras. 497-498.

MOU. In particular this is significant for the decision to establish the Priority Works Plan and have it subscribed by the city mayors. At least in this respect, the MOU was more than a simple agreement to establish a committee as has been submitted by the Respondent. The Tribunal will now consider the implications of the MOU for purposes of assessing the performance of the Concessionaire against the POES in 2001.

## **6. The Program for Optimizing and Expanding Service (POES)**

### **(a) *Positions of the Parties***

177. The Respondent points out in its Counter-Memorial that the Claimant had failed to comply with the POES, the core of the Concession. It argues that as part of the POES, the Concessionaire presented a Five-Year Plan proposal with serious shortcomings because from the very beginning it knew that it would not fulfill its obligations. As early as June 2000, ABA tried to reformulate the POES so as not to comply with the Five-Year Plan. The POES obligations were enforceable from the beginning and the MOU did not exempt ABA from complying with them. ABA did not meet the POES goals and investment commitments to such an extent that it prompted the Province to impose fines and terminate the Concession Agreement by fault of the Concessionaire.

178. In response, the Claimant alleges that the Province failed to provide accurate information to the Concessionaire necessary to define the POES goals and delayed approval of these goals for so long that they were no longer relevant. According to the Claimant, the POES goals were superseded by the MOU which recognized that “the economic equilibrium of the concession had been materially altered, and the parties agreed to a finite Priority Work Plan to replace the POES.”<sup>115</sup> Furthermore, the compliance with the POES was subject to certain pre-conditions, such as the proper application of the tariff regime and the cooperation of the Province and the ORAB with the Concessionaire.

179. The Claimant alleges that the provincial authorities failed to provide the Concessionaire with complete and accurate information for purposes of the definition,

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<sup>115</sup> Reply, para. 402.

presentation and subsequent performance of the First Five-Year Plan. The documents promised in Circular 66(A) were not delivered to the extent promised and ABA had to request information on, among others, updated network plans, business documentation, computer center documentation, billing unit records and documents, information and documents related to personnel, debits and credits and technical operating documentation. The documentation requested was never delivered to ABA notwithstanding that it existed: "It was held by former AGOSBA officials – closely connected to the Union - who sought to require ABA to enter into commercial arrangements to acquire the same information that should have been delivered by the Province at the takeover."<sup>116</sup>

180. The Claimant maintains that it presented the Five-Year Plan diligently given the circumstances and that delays in its approval occurred by factors not mentioned by the Respondent such as the request, on February 23, 2000, three months after filing the Five-Year Plan, for information that was in fact in the hands of former officers of AGOSBA to pressure ABA into arrangements with them, or the introduction of the sanitary risk concept that the Province requested that be included by Resolution No. 59/00 of July 21, 2000. According to the Claimant, the introduction of this concept meant that the Concessionaire was instructed to prioritize investment based on new criteria –accessibility, risks and sanitary vulnerability- and “with no consideration to the relevant compensation required to preserve the economic balance of the concession.”<sup>117</sup> The Five-Year Plan was not approved until February 21, 2001 by Resolution 11/01.

181. The First Annual POES Progress Report was approved by the ORAB by Resolution 16/02 on February 19, 2002, 18 months after the submission of the Report. According to the Claimant, “these delays jeopardized the Concessionaire’s performance and evidenced the ORAB’s arbitrary conduct. Furthermore, the lack of certainty and the impossibility to foresee the plan that would be approved by the ORAB or the criteria that

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<sup>116</sup> Ibid., para. 428.

<sup>117</sup> Ibid., para. 445.

would be used to measure compliance with the goals placed ABA in an uncertain situation, which affected its operations.”<sup>118</sup>

182. The Claimant disagrees with Argentina’s argument that the Priority Work Plan included in the MOU was independent from the POES. For the Claimant, this would mean that ABA would have undertaken new investment obligations in addition to those in the POES notwithstanding that the MOU recognized the economic imbalance of the Concession; it was clear that the MOU suspended the goals for the second year of the Concession.<sup>119</sup>

183. According to the Claimant, the Province, not ABA, sought to modify the POES because of a political shift in how the new provincial government viewed the Concession Agreement. Minister Sícara had expressed the intent in February 2001 to change the model from one based on objectives to a model based on investments and a return to a cross-subsidy scheme implementing a social tariff for low income users.<sup>120</sup>

184. The Claimant disagrees with the description of POES non-compliance provided by the Respondent. According to the Claimant, the Respondent carries the evaluation without taking into account the non-application of the tariff regime and the agreement on a Priority Work Plan in the MOU. According to the Claimant, the ORAB could never have evaluated compliance with the POES because it had failed to define the methodology to assess the goals of the POES. The Claimant points out that the evaluation is based on investment amounts rather than goals as required in the Concession Agreement, that the analysis of the expansion goals disregards the setbacks concerning determination of serviced populations, excludes the connections installed within the serviced areas, and that includes, as alleged breaches, goals to be reached in a three or five-year term.<sup>121</sup>

185. The Claimant also alleges discriminatory treatment to the extent that public – ABSA - and private companies – AGBA - were exempted from POES compliance. According to the Claimant, this exemption was due to the

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<sup>118</sup> Ibid., para. 463.

<sup>119</sup> Ibid., para. 474.

<sup>120</sup> Ibid., para. 469.

<sup>121</sup> Ibid., paras. 480 and 482.

unreasonableness of the POES goals when the Province refused for political reasons to apply the tariff regime. The Claimant points out that, in the case of AGBA, the goals for year 2001 were suspended even though the economic crisis did not start until the end of 2001.<sup>122</sup>

186. The Respondent affirms that the MOU did not operate to amend the Concession Agreement or the targets under the POES, “it was merely an attempt by the parties to create a committee to consider the issues and submit a proposal designed to overcome certain difficulties, which was never put together”.<sup>123</sup> The POES was enforceable from the beginning of the Concession. The quantitative and qualitative targets were established in the Concession Agreement and the Five-Year Plans were merely designed to provide additional details, adjustments or updates.<sup>124</sup> The POES and the Five-Year Plans were specific contractual obligations to be discharged in accordance with the terms of the Concession Agreement and were not merely guidelines towards the targets as argued by the Claimant.<sup>125</sup> Compliance with the POES was an exclusive obligation of the Concessionaire and the Province did not hinder or affect negatively compliance of ABA with the POES.

187. The Respondent also contests that the Province discriminated in favor of other companies. AGBA, a private company, had complied with the applicable POES notwithstanding that it had higher targets during the first year of its concession and had only requested, on July 20, 2001, a temporary postponement of the POES deadline for the second year in view of the extraordinary economic crisis of the country. The postponement was not related to the rate system as asserted by the Claimant.<sup>126</sup>

188. As regards ABSA, the Respondent justifies the exemption from the service expansion obligations because it was owned by the Province, the temporary nature of the service transfer, the fact that the Concession had been abandoned, and the deep crisis prevailing at the time.<sup>127</sup>

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<sup>122</sup> Ibid., para. 407.

<sup>123</sup> Rejoinder, para. 327.

<sup>124</sup> Ibid., para. 336.

<sup>125</sup> Ibid., paras. 339-340.

<sup>126</sup> Ibid., paras. 350-375.

<sup>127</sup> Ibid., para. 382.

189. The Respondent contests that the Province had any responsibility for the delayed approval of the First Five-Year Plan. It had provided ABA all the necessary information and the delay was the result of the many requests for postponing the submission deadline. The original deadline of three months from the date of takeover of the Concession was first postponed by two months, and then it was extended by an additional 45 days. As this was not yet enough, two further postponements were granted by ORAB. All together these postponements delayed presentation of the draft Five-Year Plan by nearly nine months. It was submitted on June 12, 2000.

190. According to the Respondent, it was always ABA that attempted to change the POES. When ABA was supposed to submit the Five-Year Plan, in fact it submitted an Emergency Investment Plan and sketched the structure of a plan for the five years, there was a second draft Five-Year Plan, an appeal for reversal of Resolution 10/00, a Supplementary Report to the Five-Year Plan, and a letter to ORAB of July 17, 2001.

191. The Respondent considers that the notions of vulnerability, accessibility and sanitation risk did not modify substantially the POES. Inclusion of these notions was to direct the targets already established to areas that were more intensely exposed to sanitation risks.<sup>128</sup>

192. The Respondent argues that the MOU was only the first step in a process of renegotiation that was never completed because of ABA's desire to walk away from its obligations and transfer all business risks to the Province. The Priority Work Plan never became effective and it could not have amended the Concession Agreement or changed the targets established in the POES for the second year of the Concession.<sup>129</sup>

193. The Respondent affirms that the obligations under the POES were not conditional upon the definition of evaluation criteria regarding performance under the POES, and the achievement of the targets regarding the expansion of drinking water and sewerage works did not call for any regulatory criterion beyond the terms of the Concession Agreement.<sup>130</sup> ABA did not comply with the minimum requirements for region and county during the first two years, the annual renovation and reconditioning of

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<sup>128</sup> Ibid., para. 406.

<sup>129</sup> Ibid., paras. 409-410.

<sup>130</sup> Ibid., paras. 415 and 418.

pipes' target, and the target of maintenance or reconditioning of effluent primary and secondary treatment plants. ABA failed to make sufficient progress in the micro-measurement by year two of the Concession to such an extent as to make it unlikely that the 40% target prescribed in the Concession Agreement could be reached by year five. ABA equally failed to complete the infrastructure works contemplated in Exhibit I to the approved Five-Year Plan. In the second year, ABA prepared the second progress annual report for the POES based exclusively on the Priority Works Plan attached to the MOU and hence failed to reach the targets established in Exhibit F of the Concession Agreement.<sup>131</sup>

**(b) Considerations of the Tribunal**

194. The Priority Works Program was not additional to the POES. It is doubtful that, in its financial condition, ABA would have undertaken new obligations in addition to the POES. The sanitary risk was a new element which would have an effect on the POES and was introduced by the Respondent. It is evident that the MOU was an attempt to solve the problems that had developed and the attempt failed. The POES was never amended and the parties to the Concession Agreement continued to be bound by its original terms, including the tariff regime. However, the failure by the Province to honor the tariff regime contributed significantly to Azurix's inability to implement the POES as planned.

**7. Circular 52(A) and Canon Recovery**

**(a) Introduction**

195. The issue of Canon recovery and the meaning of Circular 52 (A) first emerged during the discussions in 2001 in the context of the MOU as we have already seen. On July 18, 2001, ABA sent a communication to the Province requesting that the Province cure the breaches of the Concession and warning that, if these were not cured, ABA would terminate the Concession. The Province replied on August 29, 2001 denying any wrongdoing and, in particular, denying "ABA's right to recover its investment (including the initial Canon), as expressly stated in Circular 52(A) and Article

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<sup>131</sup> Ibid., paras. 423-449.

12.1.1 of the Concession”.<sup>132</sup> The controversy is linked to the level of risk assumed by the Concessionaire and the principles inspiring the Concession.

**(b) Positions of the Parties**

196. Azurix claims that the Province issued Circular 52(A) in an attempt to attract the highest bids from prospective investors. Azurix maintains that Circular 52(A) assured bidders that the Canon would be considered an investment fully amortizable through tariffs.<sup>133</sup> In this respect, Azurix refers to LECG’s expert report: in which it is stated:

“Although the Province did not issue ex-ante details on regulatory methodology and accounting principles for the tariff reviews, it issued Circular 52(A). In this Circular, the Province indicates very clearly that the initial payment will be treated as an investment. As such, bidders, including Azurix Corp. must have properly assumed that, in the context of a price-cap regime, the canon would be included in the asset base for tariff review purposes, after accounting for its amortization.

This expectation was based on international and Argentine regulatory experience.”<sup>134</sup>

197. Argentina contests the interpretation given by Azurix to Circular 52(A). In its Counter-Memorial, Argentina explains that the fee paid for the Concession is the price to run a monopoly. Argentina considers that this issue was not “a real conflict between ABA and the Province as Law No. 11,820 and the Contract would have never allowed such transfer. The issue was introduced within the framework of negotiations with the Province, in a desperate attempt by Azurix to alter the obligations assumed and the Contract”.<sup>135</sup> Argentina draws attention to Article 12.3.1 of the Concession which provides that the tariffs shall be in force during the term of the Concession and their review may only occur based on events after the takeover of the Concession (Article 12.3.4, 5 and 6 of the Contract and Section 23-II of the Law).

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<sup>132</sup> Counter-Memorial, para. 130.

<sup>133</sup> Memorial, p. 178.

<sup>134</sup> Ibid., p.125.

<sup>135</sup> Counter-Memorial, para. 854.



198. Argentina refers to the expert report of Mr. Chama, one of Argentina's experts, who explains that the bidding process for the Concession sought to select "the economic player that is willing to pay the highest price, usually called 'fee', for the right to exercise the monopoly; and the selection consists simply of determining who is willing to pay the highest price as from a certain rate level, with a rate adjustment system primarily based on service conditions established in the bidding documents and in the regulatory framework governing the service."<sup>136</sup>

199. According to Argentina, the offer of Azurix was opportunistic in the sense that the purpose was the immediate renegotiation of the Concession Agreement to recover the profits renounced in the competitive bidding process. Mr. Chama states that "it could never be argued that the concession fee can be defined as a component of the cost of service and become a factor determining the rates or prices of the service itself".<sup>137</sup> Argentina wonders what would be the point of competing in a bidding process if the concession fee would be subsequently transferred to users.<sup>138</sup> Argentina further argues that the transfer of the concession fee to the tariffs would result in "the absurdity of having different tariffs in different areas depending on the concession fee offered by the winning bidder."<sup>139</sup>

200. Argentina points out that, in the letter of August 29, 2001, the Minister of Public Works of the Province stated that Azurix's representative, after several months of negotiations, requested "an additional condition: to study the mechanisms to adjust the Tariff Regime, aiming at recouping the concession fee paid for taking over the Concession."<sup>140</sup> The Minister adds: "under the Bidding Conditions, payment of the concession fee corresponded to the price that you bid for the concession, assuming the risk that you may not recoup it, considering that if the [C]oncession guaranteed the reimbursement of the price paid plus a rate of return thereon, the business started by

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<sup>136</sup> Ibid., para. 861.

<sup>137</sup> Ibid., para. 864.

<sup>138</sup> Ibid., para. 867.

<sup>139</sup> Ibid., para. 868.

<sup>140</sup> Ibid., para. 875.

Azurix would not be a risky one, as it is stated in Article 12.3.1 of the Concession Contract.”<sup>141</sup>

201. As part of Argentina’s arguments on this issue, Argentina brings to the attention of the Tribunal certain alleged irregularities regarding Circulars 51(B) and 52(A) and Section 12.1.1 of the Contract. According to Argentina, these two circulars were the last circulars issued by the Privatization Committee before bidders presented their economic offer.<sup>142</sup> Circular 51(B) reduced the volume of water that the Concessionaire was to deliver annually free of charge established only the week before, on May 5. The reduction for ABA exceeded 57%. In contrast, the water volumes fell only by 1.48% in Region B, the only Region not awarded to ABA.<sup>143</sup>

202. As regards Article 12.1.1 of the Contract, Argentina draws the attention of the Tribunal to the statement of Azurix in the Memorial whereby the Province, in need of money to balance the budget in 1999, wanted to maximize the Canon and “To this end, it issued Circular 52(A), saying that the Canon would be recognized as an amortizable investment, and thus, included in the tariff rate base. The Province confirmed this by adding Article 12.1.1 to the Contract.”<sup>144</sup> Argentina observes that this section of Article 12 was not in the model contract which was part of the bidding documents and did not establish that the concession fee could be transferred through tariffs. The original Article 12 simply stated a general principle to be taken into account in the determination of the tariff regime. Azurix’s interpretation would make this section contrary to law. The Concession Agreement could not be substantially altered after the bidding process. Amendments to the Concession Agreement were done through letters of amendment, no such letter was used in this case and it might have also been absent in another change also introduced after the award of the contract, i.e. the introduction of a 6-month period of grace for penalties on account of any infringements.<sup>145</sup>

203. Argentina alleges that the Tribunal took Article 12.1.1 of the Concession Agreement into account as a decisive factor in its decision on jurisdiction in disregard of

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<sup>141</sup> Ibid.

<sup>142</sup> Ibid., para.878

<sup>143</sup> Ibid., paras. 878-881.

<sup>144</sup> Ibid., para. 882. Emphasis added by the Respondent.

<sup>145</sup> Ibid., paras. 898-899.

the possible irregularities that affect this section which “could have led the tribunal to error.”<sup>146</sup> Argentina informs that its courts will solve the issues dealing with the inclusion of Article 12.1.1 and considers that, “In any case, the impact on the progress of Azurix’s claim before this Tribunal is evident, as well as the fact that the Tribunal is not competent to decide on the facts described.”<sup>147</sup>

204. Azurix contests that the Canon is only an access fee for the Concession. Circular 52(A) explained that the Canon constitutes an investment to be amortized. According to Azurix, utility investors understand that, when access to other markets is prohibited, canon payments are considered investments to be recovered through regulated tariffs. This is standard regulatory practice in Argentina and the Province. Azurix refers to an internal MOSP report on the MOU process in which Mr. Sícario states: “the proposed scheme accounts for the fact that there is a canon to be amortized by the expiration of the Concession term”.<sup>148</sup> This is in contrast with the statements made by him before the Tribunal as a witness. According to Azurix, the Province simply lacked the political will to allow its recovery in accordance with representations made by the Privatization Commission, the Concession Agreement and Circular 52(A).<sup>149</sup>

205. Azurix dismisses the concept of “unbounded risk” claimed by Argentina. According to Azurix and relying on LECG rebuttal: “The ‘unbounded risk’ concept introduced by Mr. Chama, is deadly off the mark. Were concessions based on the ‘unbounded risk’ concept, no private investor will ever pay anything for the concession.”<sup>150</sup>

206. Azurix also dismisses the unconstitutionality alleged by Argentina if similarly situated customers would pay different prices for public services. This is actually a fact in the Province and Argentina.<sup>151</sup>

207. Azurix also rebuts the notion that Circular 52(A) is only an accounting clarification and points out that Argentina fails to explain how this clarification was to be

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<sup>146</sup> Ibid., para. 900.

<sup>147</sup> Ibid., para. 902.

<sup>148</sup> Reply, 251.

<sup>149</sup> Ibid., para. 252.

<sup>150</sup> Ibid., para. 255.

<sup>151</sup> Ibid., paras. 256-257.

applied or its practical meaning. Furthermore, argues Azurix, Argentina's allegations in respect of the Canon are not consistent with the facts and recognized utility practice. Azurix points out that in the case of another Argentine public utility, Transener, specific provisions like Article 7.8 and Circular 52(A) were not deemed necessary to include the Canon in the tariff rate base.<sup>152</sup>

208. Azurix affirms that it was the behavior of the Province that was opportunistic. The additional capital contributions made by Azurix and exceeding US\$106 million do not indicate behavior of an opportunistic investor seeking additional advantages through a post-bid negotiation. Azurix observes that if the Province, advised by Mr. Chama himself during the bidding process judged Azurix's bid opportunistic or reckless could have rejected the bid and did nothing of the sort.<sup>153</sup> On this point, Azurix concludes that, 'in light of the guarantees offered by the Regulatory Framework, the Concession Agreement and Circular 52(A), the Province should have recognized the implications of accepting Azurix bid. If the Province chose to ignore long-term effects for the benefit of short-term political interests, then it did so under the legal obligation to honor commitments made.'<sup>154</sup>

209. Azurix also contests the supposed irregularities of Circular 52(A) and Article 12.1.1. As Argentina itself admits, this Article merely reiterates what is already contemplated in the Regulatory Framework and the Concession Agreement: "It is Azurix's view that Article 12.1.1 is consistent with Article 28-II(d) of Law 11.820, Article 7.8 of the Concession Agreement and Circular 52(A). They all fit together into a harmonious and systematic whole. Therefore any suggestions that this introduction substantially changed the scope of the Concession Agreement is wrong. It merely clarified it."<sup>155</sup> According to Azurix, by its actions, the Province repudiated Circular 52(A).

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<sup>152</sup> Ibid., paras. 258-263.

<sup>153</sup> Ibid., paras. 266-267.

<sup>154</sup> Ibid., para. 268.

<sup>155</sup> Ibid., para. 272.

210. In the Rejoinder, Argentina refers to statements made by a World Bank expert, Mr. Guasch, to support the allegation of opportunistic behavior of Azurix. According to Mr. Guasch,

“...operators should be held accountable to their bids, and if petitions for renegotiation are turned down, operators ought to feel free to abandon the projects, if they choose to do so (with the corresponding penalties). The appropriate behavior for the government is to uphold the sanctity of the bid and not concede to opportunistic request for renegotiation and, in such cases, allow concessions to fail. Such outcomes would reduce the incidence of renegotiation. That is a key issue in private concessions of infrastructure services –yet one that is often resolved in favor of operators. Thus aggressive bidding and the high incidence of renegotiation should not be surprising.”<sup>156</sup>

211. And again more specifically on the issue of valuation of concession assets:

“What clearly should not be used for the value of the concession in the capital base –from which the operator is allowed to earn a fair rate of return- is the value paid at the bidding stage, regardless of depreciation method. Doing that would take away the efficiency-competitive angle of the auction, by allowing a rate of return on whatever price was paid for the concession.”<sup>157</sup>

212. Argentina considers reasonable that the bidders take into account the return on the investment in order to calculate the concession fee, but it is illogical and unreasonable that the fee be passed through to rates. While every bidder may expect to make reasonable profits above the concession fee, this is not an acquired right.<sup>158</sup>

213. Argentina denies Azurix’s allegation that in the natural gas and electricity sectors the amounts paid as concession fees had been taken into account to determine applicable rates.<sup>159</sup> Furthermore, Argentina considers that the concession fees in these sectors may reflect accurately the value of assets transferred because there are no

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<sup>156</sup> Rejoinder, p. 1.

<sup>157</sup> Ibid., para. 868.

<sup>158</sup> Ibid., paras. 870-871.

<sup>159</sup> Ibid., paras. 877-878.

cross-subsidies or an obligation to expand the grid.<sup>160</sup> Then Argentina refers to the specific example of Transener, an electricity distribution company. In the context of a five-year rate review, Transener argued that the price paid for the concession should be used to determine the asset value for rate-setting purposes. The regulatory agency for the power sector did not accept the argument. In fact, NERA, an expert consulting company in the instant case, advised the regulator that, if the price paid at the time of the privatization:

“constituted the basis of the calculation, then, any amount paid should be recovered through rates (circularity of rates)” and, “if the rates can be calculated on the basis of the value of the company at the time of privatization or, if the rate of return of the company is guaranteed on the bid price, there is nothing to prevent an economic agent from offering a large amount if the implicit regulatory rate of return is higher than its own weighted capital cost.”<sup>161</sup>

214. Argentina refers also to NERA’s advice to defend the concepts of regulatory and accounting amortization advanced in the Counter-Memorial. According to NERA:

“Regulatory amortization is the annual percentage of the asset base that is deducted from the regulatory book value in accordance with the standards established by the regulator. Accounting amortization is the percentage of the asset base that may be written off the accounting books every year in accordance with the standards set by the tax authority and the professional council of economic sciences. These are two different concepts. While regulatory amortization serves the purpose of setting rates, accounting amortization is used to calculate taxes and determine the accounting book value.”<sup>162</sup>

According to Argentina, ENRE, the regulator, took into account these observations.

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<sup>160</sup> Ibid., para. 881.

<sup>161</sup> Ibid., paras. 889-890.

<sup>162</sup> Ibid., para. 261.

215. Argentina considers Article 7.8 of the Contract to be very clear. It consists of three elements: the amortization of assets in service acquired or built by the Concessionaire and the improvements made thereon by the Concessionaire.<sup>163</sup> As regards Article 1.8, Argentina considers that this Article is also clear in showing that the concession fee was not an investment but the price paid to be awarded an area. Argentina refers to Mr. Chama's expert advice and affirms that, for the Concessionaire to earn a reasonable return, Azurix's assessment underlying its Offer would have to have been reasonable and the fee compatible with the financial equilibrium of the Concession. The Concession fee presupposed an appropriate economic offer, otherwise the Concessionaire would offset its deficits derived from ordinary business risks, a compensation expressly prohibited in the Concession Agreement.<sup>164</sup>

216. Argentina points out that, as there was no rule permitting it, there was no submission by ABA to the ORAB requesting the transfer of the concession fee paid onto rates or the increase in rates to cover a part of the concession fee. Argentina alleges that the dispute only arose at the end of the negotiations with the Province in search of an overhaul of the rate system or an excuse to provide grounds for termination.<sup>165</sup> The circulars issued by the Privatization Commission could only introduce clarifications of or amendments to the Terms of Reference provided they were not substantial in nature. If Circular 52(A) would be interpreted as Azurix suggests, it would have introduced a substantial amendment to the rate system contemplated in the Contract. Professor Comadira in his expert opinion states that, in that case, "it would be unreasonable and incompatible with the rest of the provisions of the terms of reference."<sup>166</sup> According to the same expert, the rate system could only be modified after the third year of the Concession (Article 30-II(c)), the rates<sup>167</sup> and prices should have been effective during the term of the Concession (Article 12.3.1), and the values and prices could only be modified by virtue of the procedures and for the reasons disclosed in Article 12.3.2. Therefore, ABA's interpretation of Circular 52(A), "apart from being inconsistent with

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<sup>163</sup> Ibid., para. 911.

<sup>164</sup> Ibid., para. 917.

<sup>165</sup> Ibid., para. 921.

<sup>166</sup> Expert Opinion of Professor Comadira (Comadira), p. 41, quoted in the Rejoinder, para. 928.

<sup>167</sup> It should be pointed out that Article 12.3.1 does not refer to "rates" but to "tariff values."

the harmonic and systematic interpretation of all the clauses of the Terms of Reference, which it may only clarify but never modify substantially under penalty of becoming an absolute nullity, disregards clear legal regulations applicable to the Concession Contract.”<sup>168</sup> Professor Comadira even affirms that:

“A modification of the contracting conditions as the one provided for in the Circular under analysis should have necessarily meant a new call for bids to enable the possible participation of any potential bidders that would have been self excluded under the original conditions. Since that was not the case, the equality guarantee has been clearly violated, thus corrupting the whole procedure.”<sup>169</sup>

217. In addition, Professor Comadira explains that the addition of Article 12.1.1 and its interpretation by Azurix would mean that the essential principle of equality in a bidding process would have been violated, this being “a fundamental principle of the general law and administrative law.” He concludes by inviting the Tribunal to rule this article as manifestly void of absolute and incurable nullity in response to “an ethical or juristic requirement.”<sup>170</sup>

218. According to Argentina, the studies leading to the presentation of the offer could not have taken into “account an interpretation that would have distorted the rate system contemplated in the contract, on the grounds of a nonexistent provision.” Azurix could not have entertained any expectations in this respect.<sup>171</sup>

### **(c) Considerations of the Tribunal**

219. It will be useful to quote first in full the relevant legislative and contractual provisions:

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<sup>168</sup> Comadira, p. 40, quoted in the Rejoinder, para. 930.

<sup>169</sup> Ibid., p. 37, quoted in the Rejoinder, para. 933.

<sup>170</sup> Ibid. p. 44, quoted in the Rejoinder, para. 940.

<sup>171</sup> Rejoinder, paras. 942-943.



Article 28 of the Law:

“Prices and tariffs will tend to reflect the economic cost of providing potable water and sewer services, including the Concessionaire’s margin of profit for and the resulting basic infrastructure costs of the POES.”

Concession Agreement:

Article 12.1.1:

“Determination of the tariff level required under Article 28-II of Law No. 11.820, shall be based on the general principle under which tariff values shall cover the operating, maintenance and amortization costs of the services and allow for a reasonable rate of return on the amounts invested by Concessionaire within an efficient operation and management environment, as well as full achievement of the agreed-upon service expansion and quality goals.”

Article 7.8:

“The Service-related assets acquired or built by the Concessionaire and belonging to it as well as all improvements made thereon shall be capitalized by accounting procedures and shall be depreciated integrally over the term of the Concession or over their Useful Lives, whichever term is shorter; the provisions of the fourth paragraph hereof notwithstanding.

The investments the Concessionaire makes in the assets received by/from the Province upon Take Over shall be considered as acquisition and/or maintenance costs of the Concession in accordance with provisions of clause 1.8 and shall be amortized over the term of the Concession.”

Article 1.8:

“The grant of the Concession shall be in consideration of payment of an initial canon equal to ... by the Concessionaire. Said amount has been paid up by the Concessionaire to the Province upon the signing of the Agreement, and it is equivalent to the amount offered by the Awardee [sic] under the Bidding Process, to be credited as the price for the Concession Area. However, the Concessionaire does hereby undertake to make all necessary investments to

execute the POES and to secure the correct provision of Service under the Agreement, the description of which is detailed in Annex F hereto, the tariffs increments being subject to the guidelines stated in Annex Ñ being subject to compliance with said obligations.”

Circular 52(A):

“It is clarified that the initial royalty which is referred to in Section 1.8 of the Concession Contract constitutes an amortizable investment during the concession period (article 7.8 correlative and concordant of the Concession Contract).”

220. The Tribunal will turn first to the relationship of Circular 52(A) to Article 1.8, second to the meaning of the additional provision 12.1.1 of the Concession Agreement, third to the rationale of the Concession, and fourth to asset depreciation in the asset regime of the Concession Agreement (Article 7.8).

**(i) Circular 52(A): The Canon as an Investment**

221. The parties have discussed the meaning of the term “canon” and whether the Canon is an investment. Article 1.8 of the Contract refers to the Canon as “the consideration” for the granting of the Concession and, in the next sentence, as “the price for the Concession Area.” The following sentence deals with the undertaking related to the POES investments. It starts with the word “however” as a counterpoint to the consideration paid by the Canon, as if to emphasize that the payment of the Canon were not the only contribution to be made by the Concessionaire. This reading of Article 1.8 is reinforced if compared with the terms of Article 28 of the Law. Article 28 sets forth the general principle that: “the prices and tariff will tend to reflect the economic cost of the provision of the services of water supply and sewer services”, and continues by saying: “including a profit margin and the cost arising from the POES related to basic infrastructure.” The economic cost of a service would include, by definition, all costs related to the provision of the service. The specific reference to investments arising out of the POES would seem to be a clarification rather than an exclusion of other investment costs. In case there was any doubt about its meaning at the time of the bidding for the Concession, the Privatization Commission issued Circular 52(A) which

clearly states that “the initial canon...constitutes an investment.” The Tribunal has no reason to doubt the interpretation given by the Privatization Commission. It had the power to issue clarifications of the Bidding Terms and Conditions and all bidders would have been aware of the clarification when they submitted the bid as in the case of any other circular issued by the Privatization Commission. Argentina had argued that Circular 52(A) was issued close to the deadline for the submission of bids and was the last circular issued by the Commission. The evidence provided to the Tribunal shows that Circular 52(A) was not the last circular to be issued by the Commission and that other significant circulars were issued after the date of Circular 52(A). The issue is not so much whether the Canon is an investment but whether being an investment makes it a recoverable investment beyond the given tariff at the time of bidding and as adjusted through the extraordinary reviews.

**(ii) The Addition of Article 12.1.1.**

222. In arguing that Article 12.1.1 of the Concession Agreement is not extraneous to the Concession regime, the Claimant states that: “it is Azurix’s view that Article 12.1.1 is consistent with Article 28-II(d) of Law 11.820, Article 7.8 of the Concession Agreement and Circular 52(A). They all fit together into a harmonious and systematic whole. Therefore, suggestions that this introduction substantially changed the scope of the Concession Agreement are wrong. It merely clarified it.”<sup>172</sup> In support of this statement, the Claimant refers to the expert opinion of Professor Fernández who affirms:

“Section 12.1.1 of the Contract is not a word-by-word reproduction of the section with the same number of the sample agreement attached to the Bidding Terms and Conditions; however, under no means does it imply a modification to the agreed-upon terms since it merely incorporates into the contract the provisions of Section 28(ii) of Law 11.820 and the statement made at the time by means of Circular 52(A), acknowledging that the Canon was an ‘investment to be amortized throughout the term of the concession.’”<sup>173</sup>

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<sup>172</sup> Reply, para. 272.

<sup>173</sup> Legal Opinion of Professor Fernández, para. 56, Reply, Annex 1, para. 271.

223. In the Counter-Memorial, Argentina considered that Article 12.1.1 established a general principle already taken into account in Annex Ñ of the Concession Agreement in order to determine the tariff regime. The resulting rate for the duration of the Concession was “fair and reasonable and allowed a reasonable return.”<sup>174</sup> For Argentina, it was impossible to build Azurix’s interpretation into the terms of Circular 52(A) and Article 12.1.1 of the Concession Agreement without amending substantially the terms of the agreement against the provisions of the Law, which did not permit the passing through of the Canon to the rates.

224. In the Rejoinder, Argentina argued differently and, instead of admitting that Article 12.1.1 established a general principle, it stated that the insertion of Article 12.1.1 is not being supported by any legal provision and that this article could not have been part of the considerations present when Azurix submitted its bid for the Concession.<sup>175</sup>

225. Article 12.1.1 provides that the tariff level required under article 28-II shall be based on the general principle that the tariff values cover the operation, maintenance and amortization costs of the service and permit a reasonable return on the investments of the Concessionaire in the context of an efficient administration and operation and exact fulfillment of the agreed quality and expansion objectives of service. While article 12.1.1 refers to article 28-II of the Law, it introduces a notion, “return on assets”, not present in this article 28, and, conversely, there is no reference to the “profit margin” of Article 28-II in Article 12.1.1. Taking a long term view of the Concession, profit margins and rates of return may come to the same result, but they are different concepts and the concession regime does not contemplate a regime based on rates of return as explained by the Claimant’s own experts and to which we will now turn.

**(iii) Rationale of the Concession**

226. At the time of bidding, the bidders knew the tariff level and that this level could not be changed except as provided in the model contract. These provisions are usual in concession tariff regimes known as price cap regulatory regimes. Both parties

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<sup>174</sup> Reply, para. 887.

<sup>175</sup> Ibid., para. 941.

agree that the tariff regime under the Concession Agreement followed the price cap model.<sup>176</sup> However, the parties' experts draw different implications for purposes of determining whether the Canon was part of the tariff review. The expert report of LECG submitted by the Claimant explains this regime and affirms that:

"The strong incentives for greater efficiency are probably the major innovation of the price cap regulatory regimes, and reflect an essential benefit of the system. A second benefit...is the reduction in regulatory costs as compared to the **traditional rate of return regulation**, which required continuous supervision of investments and costs, thus increasing regulatory costs."<sup>177</sup>

227. This report quotes from a World Bank study:

"For a concessionaire that has paid a transfer to government to operate a business at a predetermined set of prices, these issues [asset valuation and depreciation] could be important. Regulatory disputes could emerge relating to what the concessionaire actually bought with that transfer – **a stream of future earnings or a return on the preexisting and future asset base?** Issues relating to the depreciation profile of both old and new assets therefore assume particular importance and should be signaled by the government during the bidding process.

[...] If the criterion is the largest lump sum offered to run a franchise, however, the outgoing concessionaire could receive the highest bid, **since this bid reflects the value of the assets as they currently exist**. However, this value is based on the future stream of earnings, which is determined by the price set by the regulator throughout the new franchise. If the regulator unreasonably ratchets down prices for the period of the new concession, this effectively expropriates the value of the assets built in the previous concession. Generally, therefore, **new**

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<sup>176</sup> Argentina explains in its Counter-Memorial that there are different ways to regulate utilities, "One is to adjust tariffs based on the actual costs of the service provider and the other way is to fix in advance a fair and reasonable tariff capable of covering the costs of an efficient operator and yielding a reasonable profit. In the latter case, to earn a reasonable profit, the service provider must be efficient." (para. 959). According to Argentina, the privatizations during the nineties followed generally the second model (Counter-Memorial, para. 960).

<sup>177</sup> Exhibit 19A to Memorial, p. 32. Emphasis added by the Tribunal.

**investment** by the concessionaire needs to be transparently treated by the regulator at each review, as part of the process of rolling forward the asset base and charging depreciation on it.”<sup>178</sup>

228. Somehow contradictorily, the LECG report argues for linking the Canon to the tariff review in a price cap regime when the quoted literature explains that in lump sum situations the value of the assets has been calculated by the bidder on the basis of the stream of estimated earnings within the *set level of tariffs* and the periodic adjustments permitted by the Concession Agreement.

229. LECG analyzes what would be the evolution of tariffs if the Canon were not included in the tariff base,

“At the first ordinary rate review the regulator, following standard regulatory practice as well as the regulatory framework and the Concession Contract, would consider the expected investment and operating costs, add the amortization of capital additions for the previous four years, and derive a tariff rate that would provide a normal rate of return only on the additions to the capital following the privatization. The result would be a price that would fall substantially below the long run marginal cost of the system. This is because such rates would remunerate only the capital added since privatization but not the capital already in place when the company started operations. Since, to be able to provide the service efficiently and effectively, both kinds of assets (i.e., that in place prior to privatization and the additional post-privatization) are needed, rates have to remunerate both of them.”<sup>179</sup>

230. LECG concludes,

“Adding the canon to the tariff base provides the right incentives for both consumption and investment. Consumers will be facing the long run cost of providing the system and investors will have incentives to invest.”<sup>180</sup>

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<sup>178</sup> Ibid., pp. 59-60. Emphasis added by the Tribunal.

<sup>179</sup> LECG “An Economic Assessment of Argentina’s Counter-Memorial and of Mr. Chama’s Report”, Exhibit 4 to the Reply, p. 29.

<sup>180</sup> Ibid., p. 30.

231. In its reasoning, LECG ignores the current tariff level at the time that the Concession was granted. That tariff level was already in effect and future adjustments were meant precisely to remunerate the capital added since privatization. LECG's argument assumes that the current tariff would not be taken into account in the calculation of the adjustment, while the Concession Agreement considers it the base from which to start the review. The existing tariff provides the remuneration for the capital invested in the Concession *ab initio*.

232. Paradoxically, LECG itself seems to agree with this conclusion. When discussing the issue of the elimination of monopolistic rents through a competitive bidding process, the report adds a footnote stating that:

“Observe that although the investor bids the expected net present value of future cash flows, the investor makes money on the investment. Indeed, when discounting future cash flows, the investor uses a discount rate. This discount rate is the rate of return the investor gets on the initial investment (the canon) over the life of the concession.”<sup>181</sup>

233. The Tribunal will now analyze asset depreciation in the asset regime of the Concession Agreement.

**(iv) Article 7.8**

234. Article 7.8 on depreciation (“amortización”) is part of Article VII of the Concession Agreement on “Assets” (“Régimen de Bienes”). The first paragraph of this article provides for the capitalization and depreciation of assets over the term of the Concession or their useful lives whichever is shorter, with an exception which we do not need to refer to for purposes of this analysis. The assets to be capitalized and depreciated are those assets, and improvements on them, which are service-related, have been acquired or built by the Concessionaire and belong to the Concessionaire. They need to meet these three conditions. The term “belonging” is a translation of “que sean de su titularidad.” They need to be assets to which the Concessionaire has legal title. Article 7.2 on “Title” distinguishes between the possession of assets received by

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<sup>181</sup> Ibid., p. 31, footnote 53.

the Concessionaire from the Province and assets and movable assets and real property acquired or constructed during the term of the Concession which shall be owned by the Concessionaire. Title to these assets shall be recorded in the Real Property Registry and in the respective registries of movable assets. This is not the case of assets received from the Province.

235. The distinction becomes clearer when Article 7.2 and 7.8 are read together with Article 7.6 on disposition of assets. In the case of disposition of assets “owned by the Province ... the Concessionaire shall act as the Province’s agent.” This distinction then carries over to the second paragraph of Article 7.8 which establishes that, “The investments made by the Concessionaire in the assets received by [sic] [“de” in Spanish, “from” would be the correct translation] the Province upon Take Over shall be considered as acquisition of and/or upkeep costs of the Concession in accordance with provisions of clause 1.8 and shall be depreciated over the term of the Concession.” This paragraph limits the definition of investments to those made in the properties received from the Province without including the properties themselves.

236. The distinction between assets received and those acquired or improvements on the assets received carries over to the requirement for approval of acquisition and disposal of assets and how administrative silence to a request for acquisition or disposal of assets needs to be interpreted. In the case of movable assets owned by the Province, and those owned, whether movable or not, by the Claimant, silence to a request for their disposal shall be understood as approval (Article 7.6.2). On the other hand, silence by the ORAB in the case of non-movable assets registered in the name of the Province shall be understood as rejection of the request (Article 7.6.1).

237. The distinction is particularly relevant when it comes to the termination of the Concession. In the case of termination due to acts of God or *force majeure* (Article 14.2.1), the Province is required to pay the non-amortized value of investments and Service-related assets acquired or built by the Concessionaire in accordance with Article 7.8. Under the terms of this article, the assets received from the Province are not acquired assets. The Concessionaire did not become the owner of the assets transferred by the Province, nor did it ever have registered title to them.



238. The Claimant has argued that the existing assets at the time of the transfer and those acquired later form a unit. The argument is based on Articles 42-II and 43-II of the Law. Article 42-II provides that: “The assets that are covered by this article and which must be included in the Concession Contract are the assets the Concessionaire receives by virtue of the Contract. Also included are assets that the Concessionaire acquires or builds in order to fulfill its obligations under the Concession Contract.” Article 43-II reads as follows: “Assets that are transferred to the Concessionaire are part of a group known as the appropriated unit [‘unidad de afectación’ in Spanish].”

239. The Tribunal considers that the indivisibility of the unit has to be considered in the light of the other provisions on assets in the Concession Agreement and it cannot override the distinctions made between them regarding the ownership of assets, and their administration and disposal.

240. The Tribunal concludes after this analysis of the relevant provisions of the Law and the Concession Agreement that a harmonious interpretation of these provisions does not permit to consider the Canon as if it would be an investment not included in the existing tariff at the time of the transfer. The Tribunal has no doubt that the Canon is an investment, but, for purposes of tariff setting and amortization, the investor, in preparing the bid for the Concession, had to make a calculation of the value of the earnings stream of the Concession, and the price paid for the Concession was the result of this calculation. It is interesting to note, in that regard, that the Claimant seems to be the only bidder to have interpreted Circular 52(A) as it did, the other bidders presenting canons with values at least ten times lower than that submitted by the Claimant.

241. While the principle of amortization may have applied to the initial Canon as a matter of principle, whether it was amortized or not during the duration of the Concession would depend on whether the Concessionaire had estimated correctly the worth of the future earnings of the Concession based on the initial tariff and the discount rate to be applied to this estimate of future earnings. The discount rate used by the Claimant in the preparation of the bid was the rate of return on the Canon as an

“investment”. This seems to be inherent to a price cap concession regime and the terms of the Concession Agreement.

242. To conclude the consideration of the issue of Canon recovery, the Tribunal refers to the statement made by Argentina that the Tribunal may have erred by disregarding the irregularities of Article 12.1.1 in affirming its jurisdiction. According to Argentina, the Tribunal took this Article as a decisive factor in its decision. The Respondent refers specifically to paragraph 62 of the decision on jurisdiction, which reads as follows:

“The Tribunal finds difficulty in following the Respondent’s reasoning on the basis of the definition of investment in Article 1.1(a) of the BIT. First, a concession contract, such as that entered by ABA with the Province, qualifies as an investment for purposes of the BIT given the wide meaning conferred upon this term in the BIT that includes “any right conferred by law or contract.” The Concession Agreement itself refers repeatedly to investments. For instance, in the context of the determination of the tariff level, the Concession Agreement refers to “a reasonable return on the amounts *invested* by the Concessionaire,” [Article 12.1.1] and “the Concessionaire does hereby undertake to make all necessary *investments* to execute... [Article 7.8]”

243. In that paragraph, the Tribunal refers to Article 12.1.1 as an example of references to investments for purposes of the definition of this term under the BIT. The reasoning of the Tribunal would be the same without this example, which is not the only example in the paragraph. The other example, Article 7.8, has not been questioned by the Respondent. It should be apparent from the preceding discussion that what is an investment under the BIT and what is a recoverable investment under the Concession Agreement are different matters, and that whether an investment is or is not recoverable may be irrelevant for purposes of it being considered an investment under the BIT.

## **8. Termination**

### **(a) Introduction**

244. As has already been noted, ABA requested the Province to cure its breaches of the Concession Agreement on July 18, 2001. The Province replied on August 29, 2001 denying any wrongdoing; in particular, the letter denied the right of the Concessionaire to recover its investment, including the initial Canon. On October 5, 2001, ABA terminated the Concession Agreement. On November 1, 2001, the Province issued an Executive Order rejecting the termination of the Concession Agreement and ordering ABA to cease and desist from claiming that it had terminated the Concession Agreement, and to refrain from engaging in conduct that would disturb the provision of the service.

245. ABA filed for bankruptcy reorganization proceedings on February 26, 2002. On March 7, 2002, the Province deemed that ABA had abandoned the service. On March 12, 2002, the Province terminated the Concession Agreement alleging ABA's fault: non-fulfillment of service expansion and quality goals, fines imposed on ABA, difficulties of ABA in obtaining chemical supplies in February 2002 and paying for electric power, Enron's bankruptcy and service abandonment. On March 15, 2002, ABA delivered the service to the Province.

### **(b) Positions of the Parties**

246. The Claimant has asserted that Article 48-II of the Law expressly delegated the definition of the right to terminate the Concession to the Concession Agreement, and that Article 14.1.4 of the Concession Agreement did not require the intervention of any authority to be terminated. On the other hand, Article 14.4.4 provides for court intervention for purposes of the reception of the service. Thus, concludes the Claimant, when the Province had considered it necessary to include reference to court intervention, it did so.<sup>182</sup>

247. The Claimant also addresses the need for the competent authorities to intervene in case of termination of a concession required by Article 49-II of the Law.

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<sup>182</sup> Reply, para. 520.

According to the Claimant, this Article has to be construed appropriately and can “only be interpreted as appointing the competent governmental authorities for the purposes of declaring termination of the Concession Agreement upon the occurrence of events allowing the grantor its right of termination [...] It cannot be construed as a reference to termination when it is not declared by ‘an authority’”.<sup>183</sup>

248. The Claimant also draws the attention of the Tribunal to the different treatment of termination on account of the grantor’s fault in the case of the Concession Agreement as compared to other concession agreements previously entered into by the Province and in which intervention of the courts is required to declare the agreement terminated in the event of resistance on the part of the Province. The Claimant draws the conclusion that these previous agreements were taken into account by provincial officials in drafting the Concession Agreement and departed from them, *inter alia*, in respect of the Concessionaire’s right to terminate the Concession Agreement.<sup>184</sup>

249. The Claimant maintains that the many serious breaches of the Concession Agreement caused an irreversible imbalance of the economics of the Concession and that, in these circumstances, the demand by the Government that ABA continue to provide the service and complying with the expansion goals constituted overt and unwarranted abuse of its rights.<sup>185</sup> On the basis of Professor Fernández’s legal opinion, the Claimant affirms that, if it were not possible for the Concessionaire to terminate the Concession Agreement unilaterally without further intervention of the Province the contractual provision would lack any practical application; because the final settlement of this matter would be entirely left to the discretion of the Government, ignoring what the law specifically intended to avoid.<sup>186</sup> The same expert considers that:

“whenever the Law or the agreement recognizes in contractors the right to terminate said agreement, the general rule that sets forth that the termination of the agreement always requires a formal pronouncement by the Government must be replaced by the maxim *exceptio non adimpleti contractus*, as the only

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<sup>183</sup> Ibid., para. 517.

<sup>184</sup> Ibid., para. 525.

<sup>185</sup> Ibid., para. 503.

<sup>186</sup> Ibid., para. 528.

possible way of avoiding an abuse by the Government under this rule, disregarding the contents of its provisions and forcing the contractor into a ruinous situation.”<sup>187</sup>

250. The Claimant adduces extensive doctrinal opinion and Argentine and European administrative case law to defend the applicability of the *exceptio non adimpleti contractus* to the termination of the Concession Agreement.<sup>188</sup> The Claimant also refers to *Aucoven* where the arbitral tribunal, when faced with a similar situation found that, if the parties had intended to subject the termination of the concession agreement to a ruling by a judicial body, they would have expressly referred to such requirement in the clause in question.<sup>189</sup> The Claimant further argues that, if Article 14.1.4 is ambiguous, then it should be construed against its drafter.<sup>190</sup>

251. According to the Claimant, the Province fabricated a case against Azurix to hide its own breaches while the Concessionaire continued to provide the service. The Concessionaire informed the Province on the day of the termination that it would continue to provide service for 90 days. In fact, it provided it for more than five months, which proves that the Concessionaire did not abandon the Concession.<sup>191</sup>

252. The Claimant draws the attention of the Tribunal to the fact that the Respondent continued to take measures that have aggravated the situation notwithstanding the Tribunal’s order to refrain from doing so. In particular, the Province indicated that it would not approve ABA’s proposal to creditors, collected payments of ABA’s customers, and cashed ABA’s and OBA’s performance bonds.<sup>192</sup>

253. The Respondent argues that the Province had the exclusive power to terminate the Concession, that the Concessionaire had to request termination from the Province and, if the Province denied it, then the Concessionaire could file an action in the local courts to seek a judgment declaring contractual termination. In fact, ABA lodged an appeal against the Province’s termination before the Argentine Courts.

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<sup>187</sup> Ibid., para. 528, quote from Professor Fernández’s legal opinion, Reply, Annex 1, para.160.

<sup>188</sup> Reply, paras. 541-555.

<sup>189</sup> Ibid., para. 557.

<sup>190</sup> Ibid., paras. 558-559.

<sup>191</sup> Ibid., para. 571 and ff.

<sup>192</sup> Ibid., para. 580 and ff.

According to Argentina's expert, Dr. Solomoni, Article 14.1.4 does not authorize the Concessionaire to declare the Concession Agreement terminated but it regulates the Province's prerogative to terminate the Concession Agreement even in the event of non-compliance by the Province. The Respondent alleges that the defense of the Claimant based on the *exceptio non adimpleti contractus* is not applicable here because it was never used by ABA when it defended its action. ABA always maintained that it had the right to terminate the Concession Agreement unilaterally.<sup>193</sup>

254. The Respondent also raises the issue of a conflict between the BIT and human rights treaties that protect consumers' rights. According to Argentina's expert, a conflict between a BIT and human rights treaties must be resolved in favor of human rights because the consumers' public interest must prevail over the private interest of service provider.<sup>194</sup> On this point, the Claimant argues that the user's rights were duly protected by the provisions made in the Concession Agreement and the Province fails to prove how said rights were affected by the termination.<sup>195</sup>

**(c) Considerations of the Tribunal**

255. Article 14.1.4 – Termination due to Fault of the Granting Authority - reads as follows in the translation furnished by the Claimant:<sup>196</sup>

“The Concessionaire may claim termination of the Agreement based on the Concession Grantor's fault where a rule, act, fact or omission by the Concession Grantor results in a substantial noncompliance with the obligations undertaken by the Concession Grantor under the Agreement reasonably impairing its performance.

In such event, within thirty (30) days from knowledge or occurrence of said event, the Concessionaire shall demand the Concession Grantor to cease such noncompliance, and grant a reasonable term of at least thirty (30) days. In the event that Grantor fails to observe its obligations, the Agreement shall terminate.”

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<sup>193</sup> Rejoinder, paras. 809-917.

<sup>194</sup> Dr. Solomoni's expert opinion, pp. 27-28.

<sup>195</sup> Reply, para. 565.

<sup>196</sup> Memorial, p. 128, footnote 528.

256. The Tribunal notes first that the last sentence quoted is not an accurate translation from the original Spanish version, which reads: “En el supuesto que el Concedente no cumpla con sus obligaciones, deberá declarar rescindido el Contrato.”

257. The Claimant has read this sentence as if the subject of the verb “deberá” were the Concessionaire. However, the Concessionaire is not mentioned at all in the sentence and it is more logical to consider the “Concedente” (the Grantor) as the subject. This reading is consistent with the first paragraph of the Article which refers to the ability of the Concessionaire to request the termination of the Agreement (“podrá solicitar”). The mandatory use of “deberá” (“shall”) would also seem to refer to the obligation of the Grantor since the Concessionaire may or may not wish to pursue its right. If the subject of the sentence were the Concessionaire, the term “may” would have been more appropriate.

258. This interpretation fits with Article 49-II of the Law that provides:

“The rescission of the contract or the salvaging of the services must be resolved by the Provincial Executive Authority with the intervention of ORAB.”

This text does not differentiate between rescission at the initiative or the nonperformance of one or the other of the parties. In all cases, the issue must be resolved by the Grantor. In the specific case of the Concession Agreement, the Grantor had no alternative but to declare the termination if its noncompliance continued, but this is where the parties disagreed. Both parties alleged noncompliance as a cause for their respective rescission of the Concession Agreement.

259. The above interpretation does not match the procedure for the rescission of the Concession Agreement on grounds of the Grantor’s fault in Article 14.4.4. When the Concession Agreement is terminated because of the Concessionaire’s fault, Article 14.4.3 provides that the Concessionaire shall deliver the service once it has been notified of the decree of the Grantor terminating the Concession. In contrast, Article 14.4.4 does not refer to any administrative act of the Grantor to rescind the Concession Agreement. It simply states that “Once the Contract shall have been terminated because of the Grantor’s fault...” without indicating by whom or by what action. The comparison of the two provisions seems to reflect the difference between the procedure

to be followed by a public authority which acts through decrees and resolutions and a private party which may simply notify the Grantor.

260. The difficulty in interpreting the provisions of Article 14 harmoniously is compounded by Article 49-II of the Law which, as already noted, prescribes that termination “must be resolved by the Provincial Executive Authority with the intervention of ORAB.” The Law does not distinguish between termination by the Grantor or the Concessionaire. It would seem appropriate that the Concession Agreement be interpreted consistently with the provisions of the Law. On the other hand, the Tribunal cannot ignore the practical result of this interpretation: if taken to the extreme, a concessionaire would be obliged to continue to provide the service indefinitely at the discretion of the government and its right to terminate the Concession Agreement would be deprived of any content. For this reason, the application of the maxim *exceptio non adimpleti contractus* provides a balance to the relationship between the government and the concessionaire. The Tribunal considers it immaterial whether ABA raised this defense in its recourse to the Argentine courts. The Tribunal is assessing the conduct of the Respondent and its instrumentalities in the exercise of its public authority against the standards of protection of foreign investors agreed in the BIT, and the application of the maxim *exceptio non adimpleti contractus* has been raised by the Claimant in these proceedings. This exception is not unknown to Argentine law and to legal systems generally as it is a reflection of the principle of good faith. The Tribunal will take it into account when evaluating the actions of the Province under the standards of protection.

261. The Respondent has also raised the issue of the compatibility of the BIT with human rights treaties. The matter has not been fully argued and the Tribunal fails to understand the incompatibility in the specifics of the instant case. The services to consumers continued to be provided without interruption by ABA during five months after the termination notice and through the new provincial utility after the transfer of service.



## **9. Conduct of the Province after Service Transfer**

### **(a) Positions of the Parties**

262. The Claimant points out that, on March 20, 2002, the ORAB issued Resolution 20/02 preventing ABA from collecting amounts owed in its accounts receivables for services provided prior to the date the service was transferred. Two days later an announcement in the press advised the public that all amounts payable to ABA for service before March 7, 2002 and not yet paid should be paid to the new service provider, and that payments made to ABA would not be honored. ABA requested the bankruptcy court to issue a protective measure. This measure was issued on June 4, 2002, “ordering the appropriate entities and agencies to refrain from collecting payments on invoices issued for services rendered by Azurix during periods preceding March 7, 2002, which shall only be paid to the debtor in these reorganization proceedings, at the domicile of such company. Furthermore, in the event that payments have already been collected on any such invoice, the appropriate entities shall deposit such amounts into an account opened for these proceedings and all other amounts shall be deposited at the Tribunales branch of Banco de la Ciudad de Buenos Aires.”<sup>197</sup>

263. The Claimant notes that only one sanction had been imposed on ABA before the letter of July 18, 2001. Thereafter, there was a radical change and numerous penalties were levied against ABA as a clear harassment by the Province. The ORAB continued to impose sanctions on ABA even after the service was transferred. The Province was driven by the bankruptcy proceedings and the deadline to request the court to allow their claims. The deadline was June 3, 2002 and on such date the Province and its instrumentalities filed claims for AR\$187 million and US\$2.85 million as compared to AR\$15 million by all other creditors. The Claimant points out that the claims were filed four days before ABA itself was notified by Resolution No. 46/02, dated June 7, 2002, and that ABA was denied access to the documentation on which the penalty was based and an extension of the deadline to file an appeal. ABA filed an

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<sup>197</sup> Memorial, p. 144 and Exhibit 203.

appeal to the trustee in bankruptcy who, according to the Claimant, considered most of the claims without merit.<sup>198</sup>

264. Based on the report of the University of La Plata (“UNLP Report”),<sup>199</sup> the ORAB adopted Resolution No. 52/02 approving the final credit and debit account of the Concession resulting in a credit of the Province against ABA of AR\$640 million. According to the Claimant, the supporting documentation and a request for an extension of the deadline to file an appeal were denied. ABA filed an appeal on September 30, 2002 based on the hypothetical nature of the claims and their lack of grounds. Specifically, the Claimant alleges that damages concerning assets were estimated even though the ORAB never made the inventory required by Sections 14.4.3 and 14.4.4 of the Concession Agreement; the cost of new water and sewage connections were claimed although the Province released the new provider of making such investments; obligations not enforceable until years 3 and 5 of the Concession were considered unfulfilled and related damages were claimed; and damages concerning the same assets were duplicated. Furthermore, the credit and debit account includes hypothetical damages such as the loss in tax collections caused by the loss of possible increases in real estate properties value due to the interruption of the POES, the cost of a new bidding for the Concession which was never organized, increases in tax collection that the Province could have obtained from hotel, restaurant and tourism activities if ABA had continued as Concessionaire for 30 years.<sup>200</sup>

265. In the Counter-Memorial, the Respondent contests that the penalties reflected anything more than the non-performance of ABA. The Respondent notes first that the Claimant had failed to indicate to the Tribunal that ABA had a penalty holiday of six months after the takeover of the Concession. This grace period was a change introduced to the model contract included in the Bidding Documents. There was no doubt that such grace period was not part of the draft contract as confirmed by a reply of the Privatization Commission to a question.<sup>201</sup> The Respondent cites two other penalties imposed on ABA by Resolution No. 34/00 and Resolution No. 50/00. The

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<sup>198</sup> Ibid., p. 135 and pp.145-146.

<sup>199</sup> Exhibit 175 to the Counter-Memorial.

<sup>200</sup> Memorial, pp. 146-148.

<sup>201</sup> Rejoinder, para. 551, footnote 397, and Circular 21(A), reply to question 92.

Respondent points out that before imposing a penalty ORAB had to determine non-performance and follow the pertinent administrative proceedings. It was not a hostile attitude but respect for the administrative procedures to impose sanctions.<sup>202</sup>

266. According to the Respondent and on the basis of the UNLP Report, the damages to be borne by the Province as a result of failure to meet the goals undertaken in the POES and termination of the Concession Agreement for causes attributable to ABA exceeded AR\$149 million and the economic impact of the environmental damages caused by ABA amounted to over AR\$467 million.<sup>203</sup> The Respondent observes that, in the statement of credits in favor of the Province, the amount collected for service prior to March 7, 2002 has been taken into account and that the relevant protective measure was revoked on appeal by the Commercial Court of Appeal. The Respondent also notes that ABA brought an action against Decree 508/02 terminating the Concession Agreement before the Supreme Court of the Province.<sup>204</sup>

267. In its Reply, the Claimant alleges that the sanctions imposed on ABA were part of a strategy to overwhelm Azurix's claim in these proceedings. They were a set of measures taken in a wider context of abusive measures by the Province and Argentina, including measures taken after the Decision on Provisional Measures of this Tribunal.<sup>205</sup>

268. In its analysis of the penalties imposed, the Claimant finds that: (i) 14 out of 16 fines were imposed after the termination of the Concession Agreement by ABA, (ii) during the two months that Decrees No. 2598/01 and 3039/01 were issued, ABA was fined seven times for a total of US\$555,000, (iii) seven more fines were imposed after the transfer of the service for a total of US\$1,960,000, and (iv) four fines for a total of US\$1,800,000 were levied between the filing of reorganization proceedings and the deadline for creditors to file a petition for allowance of claims.<sup>206</sup>

269. The Claimant points out, in particular, that the fine for the violation of biological parameters in Bahía Blanca related to an incident that happened in April 2000

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<sup>202</sup> Counter-Memorial, paras. 559-569.

<sup>203</sup> *Ibid.*, pp. 240-241.

<sup>204</sup> *Ibid.*, para. 823.

<sup>205</sup> *Ibid.*, paras. 602-603.

<sup>206</sup> *Ibid.*, para. 590.

and ORAB did not file the charge until August 2001, and that in the case of 14 out of 16 fines, the drafts were prepared from July 2001 onwards.<sup>207</sup>

270. The Claimant observes that the six-month grace period is customary in this type of agreements to allow the concessionaires to adapt to the poor service management conditions that existed before privatization.<sup>208</sup>

271. In the Rejoinder, the Respondent enumerates 12 procedures underway at the time when ABA terminated the Concession Agreement to show that the process had started long before July 18, 2001 and before the penalties were imposed. The failures of ABA range from the breakage of an aqueduct, to over billing, breakage of a master pipe, deficiencies in operation and reconditioning of effluent purifying plants, lack of water quality standards at Bahía Blanca and Vedia.<sup>209</sup> According to the Respondent, every single fine was imposed for a specific violation of the Concession Agreement by ABA. It was ABA that was exclusively responsible for supplying drinking water that met the quality and standards agreed in the Concession agreement and for performing under the POES.<sup>210</sup>

272. The Respondent further notes that the Claimant in its Reply did not refer to the specific grounds of termination set forth in Decree 508/02, nor the effect of ABA's filing for bankruptcy and ENRON's bankruptcy on the Concession Agreement, nor ABA's filing against Decree 508/02.<sup>211</sup>

273. As to the damage sustained by the Province, the Respondent defends the calculation of the economic impact of the termination of the Concession as part of the damages for which ABA is liable and quotes from the UNLP Report: "The reasons that led the Province to start the bidding process – in which Azurix voluntarily submitted its bid – were to achieve positive environmental, sanitary, economic, fiscal, and operating results. All these privatization purposes may be assessed in economic terms. Azurix assessed them in order to submit the bid that secured Azurix the award of the contract;

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<sup>207</sup> Ibid., paras. 591-592.

<sup>208</sup> Ibid., para. 600.

<sup>209</sup> Ibid., para. 571 and Rejoinder, paras. 456-533.

<sup>210</sup> Rejoinder, paras. 555 and 557.

<sup>211</sup> Ibid., paras. 842-850.

and the Province should assess them in order to determine the costs of the failure and seek fair compensation."<sup>212</sup>

274. The Respondent concludes on this point by observing that the allowance of the Province's claim against ABA has yet to be adjudicated by the bankruptcy court.<sup>213</sup>

**(b) Considerations of the Tribunal**

275. The Claimant has not questioned the underlying reasons for the penalties except in the case of Bahía Blanca and the fines and claims taken into account in the credit and debit account of the Concession, in particular the claims based on the UNLP Report. As noted by the Claimant, it is striking to note the contrast of administrative speed with which the fines and claims were processed after ABA gave notice of termination of the Concession and the deliberate pace with which other administrative matters were handled such as the construction variations or the valuations 2000. The Tribunal is surprised that the underlying documentation on which Resolutions 46/02 and 52/02 were based would be denied to ABA for purposes of filing an administrative appeal. The Tribunal is equally surprised that damages against ABA would be assessed in part on considerations that do not find any basis in the Concession Agreement or the Law.

**VII. Breach of the BIT**

**1. Expropriation without compensation**

**(a) Positions of the Parties**

276. Azurix claims that its investment, the Concession Agreement, has been expropriated as a result of "measures tantamount to expropriation". For Azurix, what is important is not the form of the measures or their intent but their consequences. Azurix argues that the expropriation of its contract rights – and contract rights are included in the definition of investment - is the consequence of a series of acts that alone may not be sufficient to constitute expropriation but taken together constitute creeping

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<sup>212</sup> Ibid., quoted in para. 854. Emphasis of the Respondent.

<sup>213</sup> Ibid., para 858.

expropriation. Based on a review of case law and authorities, the Claimant defines this type of expropriation as “unreasonable or incidental interference that significantly deprives an owner of the control, use, benefits, enjoyment, access to, or reasonably-to-be-expected economic benefits of property, rights or interests to an extent that is more than ephemeral.”<sup>214</sup> Azurix notes that public utility companies are particularly exposed to this type of measures because the privatizing State “may be tempted to exploit the company once it has constructed a water system. When the water system is built the company can no longer walk away and take the pipelines with it, but is at the mercy of the regulator.”<sup>215</sup> The Claimant further observes that “The political capture of rents is equivalent to asset expropriation, as the company – whether public or private – will be unable to reap the rewards associated with those sunk costs.”<sup>216</sup>

277. According to Azurix, the Province took away Azurix’s rights under the tariff regime of the Concession, compromised the ability of ABA to obtain financing, saddled ABA with unexpected expenses by not finishing the promised infrastructure included in Circular 31(A), and took away Azurix’s right to recover fully the Canon. After paying for the Concession, “Provincial officials used Azurix’s investment as their personal ‘whipping boy’ to stir the pot of ratepayer anger caused by years of neglect of the water infrastructure and misdirect it towards ABA.” The Province broke the Regulatory Compact and signaled that it was not committed to a sustainable Concession. To conclude, “Under any plausible construction of expropriation, the Province and the Republic deprived Azurix of the use and enjoyment of the reasonably-to-be-expected economic benefits of the Concession and expropriated its investments.”<sup>217</sup>

278. The Respondent contests the definition of creeping expropriation arrived at by the Claimant. The Respondent argues that a central aspect of the test related to the notion of unlawfulness or unreasonableness is missing in that definition: “only if Buenos Aires Province has ignored ABA’s contractual rights may an evaluation be made about whether or not an expropriation has occurred. If Buenos Aires Province has

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<sup>214</sup> Memorial, p.166.

<sup>215</sup> Ibid., p. 169 quoting from a World Bank study.

<sup>216</sup> Ibid., p. 168.

<sup>217</sup> Ibid., p. 180.

not ignored Azurix's contractual rights, there is no expropriation to complain about."<sup>218</sup> According to the Respondent, the Province acted at all times in accordance with the Law and the Concession Agreement. On the other hand, there has been a gradual violation of both by ABA which, from the beginning, attempted to renegotiate the Concession Agreement under more convenient terms to its own satisfaction and has failed to meet its obligations under the POES. According to Argentina, citing *Lauder* and *S.D. Myers*, in order to determine whether or not an expropriation has occurred the government's intention may not be disregarded:

"Detrimental effect on the economic value of property is not sufficient; Parties to [the Bilateral Treaty] are not liable for economic injury that is the consequence of *bona fide* regulation within the accepted police powers of the State."<sup>219</sup>

"Both words ['tantamount' and 'expropriation'] require a tribunal to look at the substance of what occurred and not only at form. A tribunal should not be deterred by technical or facial considerations from reaching a conclusion that an expropriation has occurred. It must look at the real interests involved and the purpose and effect of the government measure." (emphasis added by the Respondent).<sup>220</sup>

279. The Respondent argues that respecting a contract may never be held to be an expropriation. The Concession Agreement stipulated the tariff structure for the entire term of the Concession, "an error in the Concession fee calculation might not be invoked for amending the tariffs."<sup>221</sup> If investment risk in the case of utilities is usually considered low, as stated by Azurix, this is because the utility provider knows "in advance the tariff regime to be applied throughout the term of the concession before submitting the Offer."<sup>222</sup>

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<sup>218</sup> Counter-Memorial, para. 944.

<sup>219</sup> *Lauder v. Czech Republic*, UNCITRAL, Final Award, September 3, 2001, para. 198, quoted in Counter-Memorial, para. 950.

<sup>220</sup> *S.D. Myers v. Canada*, Partial Award of November 13, 2000, para. 285, quoted in the Counter-Memorial, para 950.

<sup>221</sup> *Ibid.*, para. 952.

<sup>222</sup> *Ibid.*, para. 953.

280. The Respondent affirms that the sunken cost argument made by Azurix does not apply in this case; it was the Province that installed the infrastructure and the fee paid was to exercise “the natural monopoly facilitated by the investment previously made by the State.”<sup>223</sup>

281. The Respondent comments in relation to the tariff conflicts that, except in one case, they all referred to the non-metered regime which was a temporary regime, and, as regards the exception, no damage occurred because the tariff increase sought was based on a cost increase that never existed. The Respondent refers again to *S.D. Myers* where the tribunal held, on the facts of the case that a temporary measure should not be characterized as an expropriation, “the evidence did not support a transfer of property or benefit directly to others, simply an opportunity was delayed”.<sup>224</sup> The Respondent points out that a reasonable period of time needs to pass to examine whether or not measures actually have the expropriating effect attributed to them, and that time is also important to determine when the expropriation took place:

“According to Azurix’s conduct ... the investment conflict had already arisen by January 5, 2001, that is to say only a few months after having executed the contract. This position is untenable and purely speculative. The operability of a Concession such as Azurix had in its hand is not defined in less than eighteen months. Moreover, validating the way Azurix acted would mean rewarding self-fulfilling prophecies. Azurix could not have negotiated in good faith because the investment conflict it was claiming could not have possibly arisen.”<sup>225</sup>

282. In the Reply, the Claimant argues that the measures alleged to constitute tantamount to expropriation are not limited to mere breaches of contract. The Claimant brings to the attention of the Tribunal that the tariff regime incorporated into the contract also represents “part of a regulatory system established by law whereby the regulatory agency ... -which is not a direct party to the contract – unilaterally interprets the Tariff Regime and holds the power to order the implementation of its interpretations. That is not a normal contract situation, and the refusal of the ORAB properly to interpret and

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<sup>223</sup> Ibid., para. 957.

<sup>224</sup> Ibid., para. 967.

<sup>225</sup> Ibid., para. 971.



implement the Tariff System is not a mere contract breach, although it does breach the contract as well.”<sup>226</sup>

283. The Claimant lists, as other measures tantamount to expropriation beyond the repudiation of the tariff regime, the repudiation by the Province of representations and assurances provided in the bidding process through circulars and information communiqués, the public call for customers not to pay their bills in August 1999 when the equalization subsidy was eliminated, the public calls by the provincial Governor and the Mayor of Bahía Blanca for users not to pay their water bills, the incorrect public statements by provincial office holders that the Concessionaire was wholly responsible for the incident, the incorrect public statements by public officials creating hysteria by suggesting that the water was toxic, the ORAB resolutions not allowing ABA to collect for its services, etc.<sup>227</sup>

284. The Claimant argues that, in any case, breaches of contract may constitute an expropriation and cites internal legislation of the United States, a party to the BIT, where it is stated that ‘any abrogation, repudiation, or impairment by a foreign government of its own contract with an investor ... and [which] materially adversely affects the continued operation of the project ...’<sup>228</sup> According to the Claimant, breach of contract or actions affecting contract rights may constitute an expropriation in certain situations: a breach of contract which is part of a series of acts that combined would have the effect of a creeping expropriation (*Waste Management*), a fundamental breach of contract, which goes to the heart of the performance promised and adversely affects the continued operation of the project subject of the contract (*BP v. Libyan Arab Republic*), regulatory conduct that denies contract rights or requires their alteration (*CME v. Czech Republic*), repudiation of specific contract rights or a contract as a whole (*Phillips Petroleum v. Iran*), and a breach of a stabilization clause in a contract (*Agip v. Congo*).<sup>229</sup>

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<sup>226</sup> Reply, para. 641.

<sup>227</sup> Ibid., paras. 643-644.

<sup>228</sup> Ibid., para. 647.

<sup>229</sup> Ibid., para. 648.

285. As regards whether the deprivation of rights or benefits is ephemeral, the Claimant observes that the relevant inquiry is the duration of the deprivation of rights or benefits, nor the duration of the expropriatory acts themselves. First, there is no set duration for a period of time to be classified as being more than ephemeral in international law. The Claimant in this respect refers to the General Conditions of Guarantee for Equity Investments of MIGA which require that the failure by an administrative agency to act remain uncured for one year. Second, the measures of the Province were permanent measures: ABA was permanently deprived from its right to eliminate the zoning subsidy, so were the repudiation of Circular 52(A) and the contract rights embodied in Articles 7.8 and 12.1.1 of the Concession Agreement to treat the Canon payment as an investment, the actions of the Province resulted in the permanent denial of multilateral financing, the Province permanently refused to return the unamortized portion of the Canon payment, the Province permanently repudiated the contractual rights to calculate tariffs in US dollars and to index the tariffs by US indexes. The effect of these measures was to drive ABA into bankruptcy and permanently put it out of business.<sup>230</sup>

286. According to the Claimant the notion advanced by the Respondent - that there cannot be an expropriation without an effect on an investor's contractual rights - ignores the authorities and the case law. According to the Claimant, "Conduct contrary to an investor's legitimate expectations that constitute a norm or were induced by the government also can amount to expropriation."<sup>231</sup> The Claimant refers to a long line of case law to prove this point, "*Middle East Cement, Goetz, Metalclad, Tecmed*, and other recent cases, "demonstrate that a State's actions need not affect formal contractual rights in order to constitute expropriation. Contrary to the GOA's assertions, the case law shows that actions that have the effect of depriving a foreign investor of the 'reasonably-to-be-expected economic benefit' of an investment can amount to an expropriation even if the actions do not affect or alter contract rights."<sup>232</sup>

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<sup>230</sup> Ibid., para. 655

<sup>231</sup> Ibid., para. 660.

<sup>232</sup> Ibid., para. 666.

287. According to the Claimant, expropriation also exists when a State repudiates former assurances or refuses to give assurances that it will comply with its obligations, “which deprives the investor, in whole or significant part, of the use or reasonably-to-be-expected economic benefit of its investment constitutes an expropriation. Similarly, Azurix was deprived of the reasonably-to-be-expected economic benefit of its investment in the Concession and is entitled to compensation for this expropriation.”<sup>233</sup>

288. The Claimant alleges also loss of control of its investment as grounds for expropriation. The effect of the measures taken not only took away the financial benefits from the Concession by making it unsustainable, but also stripped the investment of its legal security. The Claimant relies in particular on *Revere* where the tribunal held that “the government’s actions were expropriatory because they repudiated contract rights resulting in the inability of the investor to make rational, calculated decisions based on known contract rights, thus causing the investor to lose control of the investment.”<sup>234</sup>

289. The Respondent in its Rejoinder explains that its reference to contract rights in the Counter-Memorial was motivated by the fact that Azurix had based its claims on breaches of contract rights. The Respondent then relies on *Serbian Loans*, *Woofruff*, *ELSI* and, in particular, *Vivendi*, *SGS v. Pakistan* and *SGS v. Philippines* to contest that contractual claims should be heard before arbitral tribunals. It is clear, according to the Respondent, that “arbitration tribunals do not accept hearing domestic contractual claims as if they were genuine international claims.”<sup>235</sup> According to the Respondent, if “the Tribunal understood the substance of the claim in the way Azurix does, said Tribunal would lack jurisdiction and the award would be clearly null.”<sup>236</sup>

290. The Respondent then alleges that Azurix introduces a confusion by contending that umbrella clauses apply beyond specific investment agreements, in reality, these clauses can only be applied in case of an investment agreement breach but not for a breach of a concession agreement governed by the domestic and

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<sup>233</sup> Ibid., para. 228.

<sup>234</sup> Ibid., para. 681.

<sup>235</sup> Rejoinder, para. 971. Emphasis in the original.

<sup>236</sup> Ibid., para. 980.

administrative law agreed in the forum clause: “Azurix intently confuses Investment Agreement with investment, terms that are not equivalent or amalgamable.”<sup>237</sup>

291. Argentina also argues against a pro-investor interpretation of the BIT. By protecting investors and investment broadly, the treaties would come to be regarded as guarantees and assurances, eliminating the notion of risk and venture as stated by the tribunal in *Tecmed*. According to Argentina, in this case the tribunal had, “to consider the elements forming the standard banning expropriation without compensation, it was far from claiming broad and vague interpretative assumptions in favor of the investor based on BIT supposed purposes. On the contrary, it acknowledged the principle of deference to the State in order to define the public interest or usefulness reasons upon which its actions are founded.”<sup>238</sup>

292. Argentina alleges that, in the Reply, the Claimant tries to reformulate the standard so that it can be read “exactly in the same way as what is under the protection of the general clauses (*umbrella clauses*).” According to Argentina, the Claimant alleges that some of the actions were expropriatory *per se*. The Respondent explains that in a progressive expropriation no action in itself is expropriatory. The Respondent relies on the dissident opinion of Keith Highet in *Waste Management*:

“a ‘creeping expropriation’ is comprised of a number of elements, none of which can - separately – constitute the international wrong. These constituent elements include non-payment, non-reimbursement, cancellation, denial of judicial access, actual practice to exclude, non-conforming treatment, inconsistent legal blocks, and so forth. The ‘measure’ at issue is the expropriation itself; it is not merely a sub-component part of expropriation.”<sup>239</sup>

293. The Respondent also quotes from *Santa Elena*,

“As it is well known, there is a wide spectrum of measures that a state may take in asserting control over property, extending from limited regulation of its use to a complete and formal deprivation of the owner’s legal title. Likewise, the period of

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<sup>237</sup> Ibid., para. 981.

<sup>238</sup> Ibid., quote in para. 985.

<sup>239</sup> Ibid., quote in para. 1001.

time involved in the process may vary – from an immediate and comprehensive taking to one that gradually and by small steps reaches a condition in which it can be said that the owner has truly lost all attributes of ownership. It is clear, however, that a measure or a series of measures can still eventually amount to a taking though the individual steps in the process do not formally purport to amount to a taking or to a transfer of title. What has to be identified is the extent to which the measures taken have deprived the owner of the normal control of his property.”<sup>240</sup>

294. Furthermore, according to the Respondent, in a creeping expropriation what matters is not the duration of the effects but the intensity of the expropriatory process. The Respondent contests the affirmation by the Claimant that international law fixes an exact limit as regards when to determine a creeping expropriation, only a reasonable period of time is required. The Respondent also contests the interpretation of MIGA’s General Conditions and observes that they have been only partially quoted by the Claimant. These Conditions require that, for some measures, the company concerned should not have been able, for three years, to operate without losses. In any case, the time would run from the measure that culminates in the expropriation, since none of the preceding measures *per se* constituted expropriation.

295. The Respondent concludes that the individual effect of each measure may never be expropriatory; to determine if a series of measures has an expropriatory effect, the intensity of the process globally considered should be measured; the expropriatory effect should have lasted until it consolidated and could be considered a permanent effect; the set time to lapse is not defined by international law as an algorithm, but it requires the passing of reasonable time.<sup>241</sup>

296. The Respondent disagrees with Azurix’s insistence exclusively on the effect of the measures as the key element to determine whether an expropriation has occurred. There is another element. The investor needs to have a right to the specific treatment expected, “If there is no legal right to be treated in a specific manner, no

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<sup>240</sup> Ibid., quote in para. 1003.

<sup>241</sup> Ibid., para. 1017.

expropriation can be considered when someone is treated according to the law.” In this respect, the Respondent refers to the tribunal’s finding in *Feldman* that NAFTA and principles of customary international law do not require a State to permit a gray market of cigarette exports. Mexican law did not afford cigarette resellers a right to export cigarettes and the claimant’s investment remained under its complete control and with the right to export other Mexican products.<sup>242</sup>

297. Furthermore, the Respondent argues that the effect and intent of measures cannot be separated as Azurix has done. The intent is important to differentiate between legitimate regulation and confiscatory regulation. The Respondent refers approvingly to the statement in *Feldman* that,

“not all government regulatory activity that makes it difficult or impossible for an investor to carry out a particular business, change in the law or change in the application of existing laws that makes it uneconomical to continue a particular business, is an expropriation under Article 1110. Governments, in their exercise of regulatory power, frequently change their laws and regulations in response to changing economic circumstances or changing political, economic or social considerations. Those changes may well make certain activities less profitable or even uneconomic to continue.”<sup>243</sup>

298. The Respondent further refers to *Generation Ukraine*,

“Predictability is one of the most important objectives of any legal system. It would be useful if it were absolutely clear in advance whether particular events fall within the definition of an ‘indirect’ expropriation. It would enhance the sentiment of respect for legitimate expectations if it were perfectly obvious why, in the context of a particular decision, an arbitration tribunal found that a governmental action or inaction crossed the line that defines acts amounting to an indirect expropriation. But there is no checklist, no mechanical test to achieve that purpose. The decisive considerations vary from case to case, depending not only on the specific facts of a grievance but also on the way the evidence is

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<sup>242</sup> Ibid., para. 1022.

<sup>243</sup> Ibid., quote in para. 1024.

presented, and the legal bases pleaded. The outcome is a judgment, *i.e.*, the product of discernment, and not the printout of a computer program.”<sup>244</sup>

299. Faced with the task of judging, the tribunal in *Generation Ukraine*, set some negative criteria that the Respondent quotes as supporting its argument that mere effect is not enough:

“The fact that an investment has become worthless obviously does not mean that there was an act of expropriation; investment always entails risk. Nor is it sufficient for the disappointed investor to point to some governmental initiative, or inaction, which might have contributed to its ill fortune. Yet again, it is not enough for an investor to seize upon an act of maladministration, no matter how low the level of the relevant governmental authority; to abandon his investment without any effort at overturning the administrative fault; and thus to claim an international delict on the theory that there had been an uncompensated virtual expropriation. In such instances, an international tribunal may deem that the failure to seek redress from national authorities disqualifies the international claim, not because there is a requirement of exhaustion of local remedies but because the very reality of conduct tantamount to expropriation is doubtful in the absence of a reasonable – not necessarily exhaustive – effort by the investor to obtain correction.”

300. And further,

“There is, of course, no formal obligation upon the Claimant to exhaust local remedies before resorting to ICSID arbitration pursuant to the BIT. Nevertheless, in the absence of any *per se* violation of the BIT discernible from the relevant conduct of the Kyiv City State Administration, the only possibility in this case for the series of complaints relating to highly technical matters of Ukrainian planning law to be transformed into a BIT violation would have been for the Claimant to be denied justice before the Ukrainian courts in a *bona fide* attempt to resolve these technical matters.”<sup>245</sup>

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<sup>244</sup> Ibid., quote in para. 1027.

<sup>245</sup> Ibid., quote in para. 1029.

301. Argentina agrees with this consideration of the tribunal “to avoid becoming an administrative tribunal that conscientiously goes through the actions and omissions of the host State administrative bodies.”<sup>246</sup>

302. As regards the protection of the investor’s expectations, the Respondent affirms that the cases adduced by the Claimant do not support the Claimant’s contentions because Azurix’s claim is based completely on alleged contractual breaches by the Province.<sup>247</sup> Addressing the specific cases, Argentina argues that the *Aminoil* tribunal never analyzed whether Kuwait had expropriated legitimate expectations from the private petroleum company, but it considered that contractual rights have been expropriated. Legitimate expectations are not the basis for expropriation but the measure of compensation. Argentina considers that the same is true of *Middle East Cement*. This case simply shows that the contractual rights of the investor are able to be expropriated even when a contract has not been formally terminated and its contractual rights had been *de facto* revoked. Argentina points out that, in *Goetz*, the tribunal did not make a finding regarding legitimate expectations, but whether rights conferred by a unilateral act –such as granting of a license- can also be expropriated. Argentina considers that *Metalclad* and *Tecmed* are not applicable because in neither of these cases Mexico had entered into a contract with the investor and hence it was impossible for the tribunals to decide in favor of the expropriation of contractual rights.<sup>248</sup>

303. The Respondent emphasizes that there were no contractual breaches by the Province and that, if there had been, as held in *Waste Management*, contractual breaches did not generate international responsibility:

“In the Tribunal’s view, an enterprise is not expropriated just because its debts are not paid or other contractual obligations towards it are breached. There was no outright repudiation of the transaction in the present case, and if the City entered into the Concession Agreement on the basis of an over-optimistic assessment of the possibilities, so did Acaverde. It is not the function of Article

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<sup>246</sup> Ibid.

<sup>247</sup> Ibid., para. 1049.

<sup>248</sup> Ibid., paras. 1053-1062.



1110 to compensate for failed business ventures, absent arbitrary intervention by the State amounting to a virtual taking or sterilising of the enterprise.”<sup>249</sup>

304. And,

“The Tribunal concludes that it is one thing to expropriate a right under a contract and another to fail to comply with the contract. Non-compliance by a government with contractual obligations is not the same thing as, or equivalent or tantamount to, an expropriation. In the present case the Claimant did not lose its contractual rights, which it was free to pursue before the contractually chosen forum. The law of breach of contract is not secreted in the interstices of Article 1110 of NAFTA. Rather it is necessary to show an effective repudiation of the right, unredressed by any remedies available to the Claimant, which has the effect of preventing its exercise entirely or to a substantial extent.”<sup>250</sup>

305. The Respondent concludes by referring to the Regulatory Framework, the Bidding Conditions and the Concession Agreement. The Respondent affirms that the circulars and information communiqués had no power to modify substantially the established contractual system, which had been known and accepted by Azurix and ABA and hence “it is not possible that Azurix may construe, in good faith, that there had been alleged rights or expectations, which are manifestly in conflict with this normative system.”<sup>251</sup>

**(b) Considerations of the Tribunal**

306. The parties’ arguments raise issues ranging from whether the BIT should be interpreted in favor of the investor to the requirements of expropriation measures in terms of effect, intention and duration, and whether such measures may, or may not necessarily, be contractual breaches which cumulatively may be tantamount to expropriation or the taking of the benefits legitimately expected by the investor. The Tribunal will now address these arguments in that order.

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<sup>249</sup> Ibid., quote in para. 1063.

<sup>250</sup> Ibid., quote in footnote 885.

<sup>251</sup> Ibid., para. 1067.

**(i) Interpretation of the BIT**

307. The Tribunal does not consider that the BIT should be interpreted in favor or against the investor. The BIT is an international treaty and should be interpreted in accordance with the interpretation norms set forth by the Vienna Convention on the Law of the Treaties (“the Vienna Convention”), which is binding on the States parties to the BIT. Article 31(1) of the Vienna Convention requires that a treaty be “interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose.” The Tribunal observes that the BIT itself is an instrument agreed by the two State parties to encourage and protect investment. In the preamble of the BIT, the parties agreed that “fair and equitable treatment of investment is desirable in order to maintain a stable framework for investment and maximum effective use of economic resources”. Therefore, the BIT itself is a document that requires certain treatment of investment which the parties have considered necessary to “stimulate the flow of private capital”. The Tribunal in interpreting the BIT must be mindful of the objective the parties intended to pursue by concluding it.

**(ii) Effect, Intent and Duration of Expropriation Measures**

308. The parties agree that cumulative steps which individually may not qualify as an expropriating measure may have the effect equivalent to an outright expropriation. The parties also agree on the varied nature of possible steps, including breach of contract: the Respondent affirms that if the Province had “ignored ABA’s contractual rights an evaluation could be made about whether or not an expropriation has occurred.”<sup>252</sup> The Respondent has adduced Mr. Highet’s definition of creeping expropriation, which includes in the list of examples of possible constituent elements non-payment and non-reimbursement, elements which refer to contractual non-performance. On the other hand, the Respondent has also relied on holdings of the tribunal in *Waste Management* to the effect that breach of contract is not the same as expropriation of a contractual right.

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<sup>252</sup> Counter-Memorial, para. 180.

309. The parties disagree on the relevance of taking into account the intent pursued by the measures concerned and the time needed for the measures to consolidate into a creeping expropriation. Whether to consider only the effect of measures tantamount to expropriation or consider both the effect and purpose of the measures is a point on which not only the parties disagree but also arbitral tribunals. In *Santa Elena*, that the Respondent found a useful point of reference for the concept of creeping expropriation, the tribunal did not take into account the environmental purpose of the expropriatory measures: “Expropriatory environmental measures – no matter how laudable and beneficial to society as a whole – are, in this respect, similar to any other expropriatory measures that a state may take in order to implement its policies: where property is expropriated, even for environmental purposes, whether domestic or international, the state’s obligation to pay compensation remains.”<sup>253</sup> The same tribunal was persuaded by the finding in *Tippetts* that “The intent of the government is less important than the effects of the measures on the owner, and the form of the measures of control or interference is less important than the reality of their impact.”<sup>254</sup>

310. For the Tribunal, the issue is not so much whether the measure concerned is legitimate and serves a public purpose, but whether it is a measure that, being legitimate and serving a public purpose, should give rise to a compensation claim. In the exercise of their public policy function, governments take all sorts of measures that may affect the economic value of investments without such measures giving rise to a need to compensate. The tribunal in *S.D. Myers* found the purpose of a regulatory measure a helpful criterion to distinguish measures for which a State would not be liable: “Parties [to the Bilateral Treaty] are not liable for economic injury that is the consequence of *bona fide* regulation within the accepted police powers of the State.”<sup>255</sup> This Tribunal finds the criterion insufficient and shares the concern expressed by Judge R. Higgins, who questioned whether the difference between expropriation and regulation based on public purpose was intellectually viable:

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<sup>253</sup> *Compañía del Desarrollo de Santa Elena S.A. v. Republic of Costa Rica* (ICSID Case No. ARB/96/1), Award, para. 72.

<sup>254</sup> *Ibid.*, para. 77. Translation by the Tribunal.

<sup>255</sup> Counter-Memorial, quote in para. 950.

“Is not the State in both cases (that is, either by a taking for a public purpose, or by regulating) purporting to act in the common good? And in each case has the owner of the property not suffered loss? Under international law standards, a regulation that amounted (by virtue of its scope and effect) to a taking, would need to be ‘for a public purpose’ (in the sense of in general, rather than for a private interest). And just compensation would be due. At the same time, interferences with property for economic and financial regulatory purposes are tolerated to a significant extent.”<sup>256</sup>

311. The argument made by the *S.D. Myers* tribunal is somehow contradictory. According to it, the BIT would require that investments not be expropriated except for a public purpose and that there be compensation if such expropriation takes place and, at the same time, regulatory measures that may be tantamount to expropriation would not give rise to a claim for compensation if taken for a public purpose. The public purpose criterion as an additional criterion to the effect of the measures under consideration needs to be complemented. The parties have referred in their exchanges to findings of the tribunal in *Tecmed*. That tribunal sought guidance in the case law of the European Court of Human Rights, in particular, in the case of *James and Others*. The Court held that “a measure depriving a person of his property [must] pursue, on the facts as well as in principle, a legitimate aim ‘in the public interest’”, and bear “a reasonable relationship of proportionality between the means employed and the aim sought to be realized”. This proportionality will not be found if the person concerned bears “an individual and excessive burden”. The Court considered that such “a measure must be both appropriate for achieving its aim and not disproportionate thereto.” The Court found relevant that non-nationals “will generally have played no part in the election or designation of its [of the measure] authors nor have been consulted on its adoption”, and observed that “there may well be legitimate reason for requiring nationals to bear a greater burden in the public interest than non-nationals.”<sup>257</sup>

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<sup>256</sup> “The Taking of Property by the state: Recent Developments in International Law”, *Recueil des Cours*, vol. III (1982), p. 331.

<sup>257</sup> *In the case of James and Others*, sentence of February 21, 1986, paras. 50 and 63, and *Técnicas Medioambientales Tecmed, S.A. v. The United Mexican States* (ICSID Case No. ARB(AF)/00/2), paras. 121-122.

312. The Tribunal finds that these additional elements provide useful guidance for purposes of determining whether regulatory actions would be expropriatory and give rise to compensation.

313. The parties hold also different views on the time needed for a set of measures to have an expropriatory effect. There is no specific time set under international law for measures constituting creeping expropriation to produce that effect. It will depend on the specific circumstances of the case. Arbitral tribunals have considered that a measure is not ephemeral if the property was out of the control of the investor for a year (*Wena*) or an export license was suspended for four months (*Middle East Cement*), or that the measure was ephemeral if it lasted for three months (*S.D. Myers*). These cases involved a single measure. When considering multiple measures, it will depend on the duration of their cumulative effect. Unfortunately, there is no mathematical formula to reach a mechanical result. How much time is needed must be judged by the specific circumstances of each case. As expressed by the tribunal in *Generation Ukraine*: “The outcome is a judgment, *i.e.*, the product of discernment, and not the printout of a computer program.”<sup>258</sup>

**(iii) Breach of Contract and Expropriation**

314. Whether contract rights may be expropriated is widely accepted by the case law and the doctrine. The discussion by the parties reflects more a question of whether in the specifics of the instant case the alleged breaches of the Province can be considered to be such. As repeatedly stated by the Respondent, the Province with its actions did no more than to comply with the Concession Agreement and the Regulatory Framework. Therefore, according to the Respondent, ABA was not entitled to the alleged rights which supposedly the Province ignored.

315. The Tribunal agrees that contractual breaches by a State party or one of its instrumentalities would not normally constitute expropriation. Whether one or series of such breaches can be considered to be measures tantamount to expropriation will depend on whether the State or its instrumentality has breached the contract in the exercise of its sovereign authority, or as a party to a contract. As already noted, a State

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<sup>258</sup> Rejoinder, quote in para. 1027.

or its instrumentalities may perform a contract badly, but this will not result in a breach of treaty provisions, “unless it be proved that the state or its emanation has gone beyond its role as a mere party to the contract, and has exercised the specific functions of a sovereign.”<sup>259</sup> In considering each of the grounds which the Claimant has advanced to justify its expropriation claim and to the extent that they may be characterized as breaches of the Concession Agreement, the Tribunal will assess them from the perspective of possible breaches of the BIT and of whether they reflect the exercise of specific functions of a sovereign.

**(iv) Legitimate Expectations**

316. The issue of whether an expropriation may take place without formally affecting the contract rights has been discussed by the parties in the context of the frustration of the investor’s legitimate expectations when a State repudiates former assurances, or refuses to give assurances that it will comply with its obligations depriving the investor in whole or significant part, of the use or reasonably-to-be-expected economic benefit of its investment. *Tecmed* is a clear example in which a tribunal took into account the expectations of the investor. Argentina has dismissed the relevance of this case on the basis that Mexico had no contract with the investor. In fact, the tribunal in that case considered attributable to Mexico, as the sovereign, certain acts that frustrated the expectations generated in the investor even when Mexico was not party to the contract. That tribunal determined that the conduct of INE, the Mexican federal agency which had issued the license, was attributable to the government. Hence, the considerations of that tribunal are not without significance for these proceedings:

“The political and social circumstances [...] which conclusively conditioned the issuance of the Resolution, were shown with all their magnitude after a substantial part of the investment had been made could not have reasonably been foreseen by the Claimant with the scope, effects and consequences that those circumstances had. There is no doubt that, even if Cytrar [the vehicle used

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<sup>259</sup> *Consortium FRCC c. Royaume du Maroc* (Aff. No. ARB/00/6), Sentence arbitrale, para. 65 See also *Impregilo*, para. 260.

by the investor] did not have an indefinite permit but a permit renewable every year, the Claimant's expectation was that of a long-term investment relying on the recovery of its investment and the estimated return through the operation of the Landfill during its entire useful life."<sup>260</sup>

317. The tribunal then adds:

"Both the authorization to operate as landfill, dated May 1994, and the subsequent permits granted by INE, including the Permit, were based on the Environmental Impact Declaration of 1994, which projected a useful life of ten years for the Landfill [footnote deleted]. This shows that even before the Claimant made its investment, it was widely known that the investor expected its investments in the Landfill to last for a long term and that it took this into account to estimate the time and business required to recover such investment and obtain the expected return upon making its tender offer for the acquisition of the assets related to the Landfill. To evaluate if the actions attributable to the Respondent – as well as the Resolution – violate the Agreement, such expectations should be considered legitimate and should be evaluated in light of the Agreement and of international law."<sup>261</sup>

318. The expectations as shown in that case are not necessarily based on a contract but on assurances explicit or implicit, or on representations, made by the State which the investor took into account in making the investment. That tribunal, for instance, took into account the declaration of 1994 and the implicit need of a long-term operation of the landfill for the investor to be able to have a reasonable return on the expected investment even when the specific permit was only a one-year permit. In the case before this Tribunal, the Respondent has questioned that any of the alleged expectations may have been created by the Province when these expectations are in conflict with the normative system.<sup>262</sup> Whether they actually are in conflict with the normative system of the Concession and they have been frustrated to the extent of

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<sup>260</sup> *Técnicas Medioambientales Tecmed, S.A. v. The United Mexican States*(ICSID Case No. ARB(AF)/00/2), para 149.

<sup>261</sup> *Ibid.*, para. 150.

<sup>262</sup> Rejoinder, para 1067.

depriving the investor of the benefits of the investment is a matter that the Tribunal will now proceed to determine.

319. The measures and actions taken by the Province to be considered for purposes of determining whether they amounted to an expropriation are those related to the so called tariff conflicts, Canon recovery, the works under Circular 31(A) and the consequential effect on the ability of ABA to obtain financing. The actions of the provincial authorities in the case of the first tariff conflict and the Bahía Blanca works exceeded any contractual rights by inviting customers not to pay bills even before the administrative appeal of ABA against the decision of the ORAB was resolved, or notwithstanding the fact that the Province had not completed the works in the Paso las Piedras reservoir that it represented it would complete at the time of the bidding for the Concession. The same can be said of the public threats against officials of the ORAB for allowing ABA to resume billing of customers after the Bahía Blanca incident. These instances show the politicization of the Concession, as H & S noted, and the lack of commitment of the new provincial authorities to the privatization process undertaken by their predecessors.

320. The unhelpful attitude of the authorities is also evident in the procrastination in resolving the issue of the construction variations when the information given the bidders proved to be incorrect and in completing the works under Circular 31(A). Even if no specific date was established for their completion, the percentage of works completed given the bidders and the dates of completion in the respective contracts created a reasonable expectation that the works would be completed. Even if ABA had no right under the Concession Agreement to a revision of tariffs to recover the Canon, it had the right to recover it to the extent that this was feasible within the existing tariff framework; thus statements made by government officials that the Canon was not recoverable were not in accordance with the financial terms of the Concession. There is also no doubt that the image of the Concessionaire was damaged by the actions of the Province vis-à-vis its customers at the time when it was crucial for the privatized service to take hold.



321. However, the politicization of the Concession or the actions taken by the Province were not the only cause of OPIC's denial of financing. The letter of OPIC referred also to the capital requirements of the Concession as compared to the revenues generated by the existing tariff level were the tariff regime not amended. The conclusions reached by the Tribunal on the recovery of the Canon and the RPI are also significant for purposes of the determination of the degree of impact that the actions of the Province had on Azurix's investment. The Tribunal disagrees with the understanding of the Claimant of the terms of the Law and the Concession Agreement on these matters. Were this not the case, the Tribunal would agree that the breaches of the Concession Agreement would have had a devastating effect on the financial viability of the Concession, but the Claimant has been unable to convince the Tribunal of the correctness of its understanding of the terms of the Law and the Concession Agreement.

322. Therefore, the Tribunal finds that the impact on the investment attributable to the Province's actions was not to the extent required to find that, in the aggregate, these actions amounted to an expropriation; Azurix did not lose the attributes of ownership, at all times continued to control ABA and its ownership of 90% of the shares was unaffected. No doubt the management of ABA was affected by the Province's actions, but not sufficiently for the Tribunal to find that Azurix's investment was expropriated.

323. The Tribunal will turn now to whether the other standards of protection in the BIT were violated as claimed by Azurix. The Tribunal has grouped the arguments made under the heading of "Transparency" under "Fair and Equitable Treatment."

## **2. Fair and Equitable Treatment**

### **(a) *Positions of the Parties***

324. Azurix first refers to Article II(2)(a) of the BIT which provides that "[i]nvestment shall at all times be accorded fair and equitable treatment,...and shall in no case be accorded treatment less than required by international law." The BIT emphasizes this treatment by including it in the preamble: "agreeing that fair and equitable treatment of investment is desirable in order to maintain a stable framework

for investment and maximum effective use of economic resources...” Azurix notes that the BIT does not include a definition of the phrase “fair and equitable” and that its meaning revolves on whether it means the minimum standard required by international law or whether “the phrase represents an independent, self-contained principle, which must be given its ‘plain meaning’ pursuant to the general principle for interpreting treaties in Article 31 of the Vienna Convention.”<sup>263</sup>

325. The Claimant argues that, on the basis of the text of Article II(2)(a), doctrine and case law, the phrase in question does not refer to the minimum standard. In particular, the Claimant relies on the opinion of F.A. Mann:

“[t]he terms ‘fair and equitable treatment’ envisage conduct which goes far beyond the minimum standard and afford protection to a greater extent and according to a much more objective standard than any previously employed form of words. A tribunal would not be concerned with a minimum, maximum or average standard. It will have to decide whether in all the circumstances the conduct in issue is fair and equitable or unfair and inequitable. No standard defined by other words is likely to be material. The terms are to be understood and applied independently and autonomously.”<sup>264</sup>

326. The Claimant analyzes the text of the provision and considers that the comma separating the phrase of fair and equitable treatment from the treatment required by international law would seem to indicate a sequence of standards and, “strongly suggests that the latter is intended to be a self-contained standard independent of the former. Moreover, the introductory phrase, ‘in no case ... less than that required by international law’, appears to establish the international law standard as the minimum standard against which, *ipso facto*, the ‘fair and equitable treatment’ standard must be deemed a higher, more rigorous standard.”<sup>265</sup>

327. The Claimant notes that a position paper of UNCTAD on the meaning of ‘fair and equitable treatment’ reaches the conclusion that “[t]hese considerations point

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<sup>263</sup> Memorial, p. 181.

<sup>264</sup> F.A. Mann, “*British Treaties for the Promotion and Protection of Investments*,” 52 *Brit. & B. International Law* (1982) p. 244. Quoted in the Memorial, p. 181.

<sup>265</sup> Memorial, p. 182.

ultimately towards fair and equitable treatment not being synonymous with the international minimum standard.”<sup>266</sup>

328. The Claimant refers to *Pope & Talbot*, and to the fact that the tribunal in that case relied on Mann’s article and UNCTAD’s paper extensively in its reasoning. That tribunal held that the standard under NAFTA was different from the minimum international law requirement and considered that “compliance with the fairness elements must be ascertained free of any threshold that might be applicable to the evaluation of measures under the minimum standard of international law”. The tribunal rejected that the State’s conduct needed to be egregious, outrageous, shocking or otherwise extraordinary, which is the standard applied in *Neer*.<sup>267</sup>

329. The Claimant also refers to the plain meaning of fair and equitable. Fair means impartial, honest, free from prejudice, favoritism and self interest, equitable is just, conformable to the principles of justice and right.

330. The Claimant alleges that Argentina breached this standard because as it occurred in *Pope & Talbot*,

“Azurix’s Investment was subjected by the Province to refusals to provide necessary information (DPTC records), indefinite delays in verifying information and taking decisions (Resolution 7/00, property improvements and ABA’s proposal for equivalence of Valuations 1958), assertions of non-existent policy reasons and requests for unnecessary information (cost study for RPI adjustment), manipulation of contract language while ignoring express representations during the contracting process (Resolution 1/99 and Information Communiqué No. 12), changes of position (Canon), public vilification and administrative fines for actions for which the Province was responsible (Circular 31(A) Works), and threats of criminal action against ABA’s directors.”<sup>268</sup>

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<sup>266</sup> UNCTAD, “*Fair and Equitable Treatment*,” No. E. 99, II.D.15 (1999) Quoted in the Memorial, p. 182.

<sup>267</sup> Memorial, pp.182-183.

<sup>268</sup> *Ibid.*, p. 190.

331. All this occurred, according to the Claimant, because the Province needed money to balance its budget deficit and was unwilling to allow water increases because it would be a political problem for the new administration.<sup>269</sup>

332. In its Counter-Memorial, Argentina disagrees on the meaning of fair and equitable, which it considers inextricably attached to the international minimum standard, on the controversial appreciation of the facts, which do not constitute a violation of the standard, and on the autonomous characterization of the standard.

333. Argentina argues that there are very few awards and authors that postulate the assertion that the standard of fair and equitable treatment is different from the minimum international standard. Based on the findings of the tribunals in *Genin*, *Azinian*, and *S.D. Myers*, Argentina considers that the meaning of this standard is “related to the purpose of providing a basic and general principle”, “constitutes a minimum international standard”, and “for it to be violated it is necessary that the State receiving the investment incur in acts that demonstrate a premeditated intent to not comply with an obligation, insufficient action falling below international standards or even subjective bad faith.”<sup>270</sup> The Respondent emphasizes that in *Myers* the tribunal stated that Article 1105(1) of the NAFTA imposes “fair treatment at a level acceptable to the international community, measured with the highest degree of deference towards domestic authorities.” Thus, “[o]nly the reasonableness of the measure claimed to be grievous must be measured, and this, with deference.”<sup>271</sup>

334. Argentina expresses its agreement with the binding interpretation of Article 1105(1) of NAFTA by the Free Trade Commission (“FTC”). The FTC interpreted the article as follows:

“1. Article 1105(1) prescribes the customary international law minimum standard of treatment of aliens as the minimum standard of treatment to be afforded to investments of investors of another Party.

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<sup>269</sup> Ibid., p. 191.

<sup>270</sup> Counter-Memorial, para. 981.

<sup>271</sup> Ibid., para. 987. Emphasis added by the Respondent.

2. The concepts of ‘fair and equitable treatment’ and ‘full protection and security’ do not require treatment in addition to or beyond that which is required by the customary international law minimum standard of treatment of aliens.

3. A determination that there has been breach of another provision of the NAFTA, or of a separate international agreement, does not establish that there has been a breach of Article 1105(1).”

335. The Respondent also manifests its agreement with the provision of Article 10.4 of the Free Trade Agreement between the United States of America and Chile which in reference to “fair and equitable treatment” and “full protection and security” “does not require treatment in addition or beyond that which is required by that standard and does not create additional substantive rights.”<sup>272</sup>

336. The Respondent denies the contention of Azurix that this standard would refer to the expectations of the investor not being frustrated by legislation, rules and regulations and adduces as reasons for casting aside this conception that, “Fairness and equitableness may require (not merely allow) the amendment of a legal system. Such would be the case if, for example, the beneficiary of such legal system is causing harm to others. This is frequently true in environmental and health matters...thus violating the fundamental juristic principle forbidding causing harm.” The Respondent argues that, “Any acceptable concept of what constitutes ‘property’ incorporates as property rights the expectations based on the legal system that begets them. Therefore, in the event of changes to such system (or of the property rights or of the vested rights), the aggrieved party is faced not with unfair treatment but rather with an alleged expropriatory treatment. The legitimate expectations, as part of any reasonable concept of property, are protected by a different standard.”<sup>273</sup>

337. Argentina questions the facts on which the alleged breach of this standard is claimed by Azurix. Referring to the list of expectations reproduced early here, Argentina qualifies them as rash or extremely vague or semantic labels rather than

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<sup>272</sup> Ibid., para. 993.

<sup>273</sup> Ibid., para. 985.

description of the facts.<sup>274</sup> Argentina argues that, in terms of the standard proposed, Argentina cannot be held responsible for a breach of the BIT nor can it be held to have breached it even under the standard proposed by Azurix. Neither the Province nor Argentina departed from applicable legislation, rules and regulations.

338. Argentina disagrees with the autonomous categorization of unfair and inequitable acts. The facts, measures, events, acts and omissions described by the Claimant in violation of the fair and equitable standard are the same as those alleged to be expropriatory, “[s]uch is the extent of this identification that when it comes to claiming a compensation only the expropriation of the investment is taken into account.”<sup>275</sup>

339. Argentina maintains that the events or acts that qualify as expropriation cannot be the same as those that qualify as unfair and inequitable treatment. Depending on their legal qualification, facts produce different legal consequences. According to Argentina, “confusion between expropriatory acts and acts constituting unfair treatment renders one of the two claims invalid.”<sup>276</sup> Argentina then contests the supposed strategy of Azurix to pursue the two claims so that if the Tribunal would not consider the measures expropriatory then they could be considered as constituting unfair and inequitable treatment with a claim to the same compensation. Argentina questions that this could be the case,

“unfair treatment can never be characterized as the loss of a property right because that is precisely the core of an expropriation ... The unfair treatment should generate some other form of damage, a detrimental consequence other than the alleged loss of property rights. It should be a consequence as independent from the expropriation damage consequence as the acts that trigger the application of this second standard are (or ought to be) independent and autonomous of the events that caused the application (or non-application) of the first standard.”<sup>277</sup>

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<sup>274</sup> Ibid. para. 998.

<sup>275</sup> Ibid., para 1000.

<sup>276</sup> Ibid., para. 1004.

<sup>277</sup> Ibid., para. 1006.

340. Argentina supports further its argument by referring to *Azinian*. In that case, the claimant had alleged violations of Articles 1110 and 1105 of NAFTA. The tribunal reasoned that,

“The only conceivably relevant substantive principle of Article 1105 is that a NAFTA investor should not be dealt with in a manner that contravenes international law. There has not been a claim of such a violation of international law other than the one more specifically covered by Article 1110. In a feeble attempt to maintain Article 1105, the Claimants’ Reply Memorial affirms that the breach of the Concession Contract violated international law because it was ‘motivated by non-commercial considerations, and compensatory damages were not paid.’ This is but a paraphrase of a complaint more specifically covered by Article 1110. For the avoidance of doubt, the Arbitral Tribunal therefore holds that under the circumstances of this case if there was no violation of Article 1110, there was none of Article 1105.”

Argentina considers that the same reasoning applies to the instant case.

341. In its Reply, the Claimant alleges that the interpretation of Article II(2)(a) of the BIT by the Respondent is erroneous. According to the Claimant, the basic touchstone of fair and equitable treatment is to be found in the legitimate and reasonable expectations of the parties. The Claimant considers that, as recommended by Jan Paulsson, the Tribunal should examine “the impact of the measure on the reasonable investment backed-expectations of the investor, and whether the state is attempting to avoid investment-backed expectations that the state created or reinforced through its own acts.”<sup>278</sup> The Claimant finds support for this view in *Tecmed* where the tribunal held that fair and equitable treatment requires treatment by the Contracting Parties “that does not affect the basic expectations that were taken into account by the foreign investor to make the investment.”<sup>279</sup>

342. The Claimant argues that this standard encompasses more specific standards recognized by international tribunals the breach of which entails the breach of

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<sup>278</sup> Reply, quote in para. 685.

<sup>279</sup> Ibid.

the fair and equitable treatment standard, such as that a government will obey its own laws and customary international law, will act honestly, transparently, consistently with representations made and in good faith. As part of good faith, according to the Claimant, the State's rights must be exercised reasonably and within the limits of international law, domestic law and the contract, otherwise it incurs in abuse of those rights.<sup>280</sup>

343. The Claimant questions the interpretation of ICSID awards by the Respondent. According to the Claimant, in *Genin* the tribunal did not attempt to develop a comprehensive definition of the meaning of fair and equitable treatment, as opposed, for instance, to the full analysis provided in *Tecmed*. The standard in NAFTA is different from the standard in the BIT. Article 1105(1) of NAFTA states that investments must be provided "treatment in accordance with international law, including fair and equitable treatment and full protection and security" (emphasis added by the Claimant). This text differs from the corresponding provision of the BIT in the way "international law" and "fair and equitable treatment" are connected. For the Claimant, it is evident that, under the BIT, "fair and equitable treatment" is "a separate requirement and additional requirement from the international law standard, and that international law sets a floor, indicating that 'fair and equitable treatment' requires something different from and more, but never less, than international law."<sup>281</sup>

344. According to the Claimant, even in *S.D. Myers* the tribunal did not say what the Respondent pretends. The tribunal held that the standard is breached when "an investor has been treated in such an unjust or arbitrary manner that the treatment rises to the level that is unacceptable from the international perspective." That tribunal concluded that Canada had acted in a discriminatory manner and had breached Article 1102, and such breach also entailed a breach of the fair and equitable standard provided in Article 1105.<sup>282</sup>

345. The Claimant observes that the minimum standard argument of the Respondent is based on the standard set in *Neer* in the 1920s and that the standard

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<sup>280</sup> Ibid., paras. 687-693.

<sup>281</sup> Ibid., para. 699.

<sup>282</sup> Ibid., para. 701.



has evolved as pointed out in *Mondev*: The minimum standard today cannot be limited to the content of customary international law as recognized in arbitral decisions in the 1920s; what is unfair or inequitable to today's eye need not equate with the outrageous or egregious. In that tribunal's view: "there can be no doubt that, by interpreting Article 1105(1) to prescribe the customary international law minimum standard of treatment of aliens as the minimum standard of treatment to be afforded to investments of investors of another Party under NAFTA, the term "customary international law" refers to customary international law as it stood no earlier than the time at which NAFTA came into force." The customary international law standard is defined by the ordinary meaning of the terms "fair and equitable".<sup>283</sup> *Tecmed*, on the other hand, maintains that this standard requires the contracting parties "to provide to international investments treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment."<sup>284</sup>

346. Then the Claimant turns to the Respondent's contention that Azurix's confuses the meaning of expropriatory acts and acts constituting unfair and inequitable treatment. The Claimant argues that the BIT provides rights that are independent from each other and the breach of any one of them would entitle the investor to resort to the dispute settlement procedure provided by the BIT and would give rise to a right to compensation for the economic harm sustained. What are independent are the rights under the BIT not necessarily the measures that have breached those rights.<sup>285</sup>

347. The Claimant addresses the question of which losses suffered by Azurix could be attributed to unfair and inequitable treatment and which to expropriation. According to the Claimant, unfair and inequitable treatment does not generate a different form of damage. The real question that Argentina is raising is whether Azurix is claiming double recovery. The Claimant affirms that this is not the case. Azurix is entitled to recover its full damages, but only once. The Claimant quotes from *S.D. Myers* on the cumulative nature of the rights and remedies under BITs:

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<sup>283</sup> *Ibid.*, para. 703.

<sup>284</sup> *Tecmed*, para. 154, quoted in the Reply, para. 705.

<sup>285</sup> Reply, paras. 715-718.

“When both Article 1102 and 1105 have been breached, as the Tribunal has found in this case, the usual principle to be applied is that rights and remedies under trade agreements are cumulative unless there is actual conflict between different provisions. The fact that a host Party has breached both Article 1102 and Article 1105 cannot be taken to mean that the investor is entitled to less compensation than if only Article 1103 were breached. A host Party does not reduce the extent of its liability by breaching more than one provision of the NAFTA.”<sup>286</sup>

348. The Claimant argues that it has provided the Tribunal a discrete damage evaluation that identifies which damages were caused by each of the measures. This should be sufficient to answer Argentina’s question. As regards the Respondent’s question about the causal relationship between an unfair act and the damage that the expropriatory is alleged to have caused, the Claimant considers that this concern has become meaningless once it has been shown that the same measure may breach more than one right under the BIT and the analysis of damages presented by Azurix allows the Tribunal to identify the impact caused by each measure of Argentina.<sup>287</sup>

349. The Claimant observes that the Respondent qualifies Azurix’s claims as rash and states that they are not independent and cannot be analyzed, but it does not explain the reasons for these statements. The Claimant alleges that Argentina is wrong on both counts and lists in non-exhaustive form the ways in which the Province frustrated Azurix’s expectations by not allowing to charge tariffs in accordance with the Concession Agreement, by repudiation of Circular 52(A), by refusing to accept ABA’s termination of the Concession, by refusal to return the non-amortized portion of the investments, by not allowing ABA to collect the receivables, by requiring that ABA continue to operate the service for more than 90 days, by imposing arbitrary penalties, by politicizing the tariff regime, by publicly calling on customers not to pay their bills, by provoking the illegal intervention of the Provincial Domestic Trade Bureau to enjoin ABA from billing for its services.<sup>288</sup>

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<sup>286</sup> Ibid., paras. 715-722.

<sup>287</sup> Ibid., paras. 723-725.

<sup>288</sup> Ibid., paras. 725-727.

350. In the Rejoinder, the Respondent points out that it never referred to *Neer* in the Counter-Memorial, and contests the interpretation given by the Claimant to *Tecmed*. According to the Respondent, *Tecmed* and *Genin* arrive to the same conclusion. The Mexican authorities had engaged in conduct that was notoriously unfair. This was not the case of ABA's treatment, which was never a cooperative investor and had breached the Concession Agreement. *Tecmed* supports the Argentine position because it distinguishes between "the object of protection (that could be legitimate expectations, good faith and transparency) from the level of protection granted by the Treaty". The Respondent emphasizes that its own concept of fair and equitable permits to differentiate between standards rather than collapse them. The Respondent notes that the Reply does not change the fact that NAFTA tribunals apply a minimum standard defined more recently in *Waste Management*.

"...despite certain differences in emphasis, a general standard for Article 1105 arises. Taken together, cases *S.D. Myers*, *Mondev*, *ADF* and *Loewen* suggest that the minimum standard of fair and equitable treatment is infringed by conduct attributable to the State and harmful to the claimant if the conduct is arbitrary, grossly unfair, unjust or idiosyncratic, is discriminatory and exposes claimant to sectional or racial prejudice or involves a lack of due process leading to an outcome which offends judicial propriety- as may be the case with a manifest failure of natural justice in judicial proceedings or a complete lack of transparency and candour in an administrative process. In applying this standard it is relevant that the treatment is in breach of representations made by the host State which were reasonably relied on by the claimant."<sup>289</sup>

351. The Respondent concludes that this is the standard applied in NAFTA, which delimits the level of violation from the object of the protection, and the scope that the Claimant gives to the standard would make irrelevant all the standards of protection because it would encompass them all.<sup>290</sup>

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<sup>289</sup> Rejoinder, quote in para. 1077.

<sup>290</sup> *Ibid.*, paras. 1078 and 1080.

352. As regards Article II(7) of the BIT, the Claimant has argued that the Respondent breached its duty of transparency under this article. The Claimant points out that Article II(7) of the BIT requires that “each Party shall make public all laws, regulations, administrative practices and procedures, and adjudicatory decisions that pertain to or affect investments.” This requirement prevents States, according to the Claimant, from imposing undisclosed laws, regulations or practices that adversely affect investments. The Claimant refers to how the tribunal in *Metalclad* understood a similar provision in NAFTA. That tribunal understood the concept of transparency “to include the idea that all relevant legal requirements for the purpose of initiating, completing and successfully operating investments made, or intended to be made, under the [NAFTA] should be capable of being readily known to all affected investors of another Party. There should be no room for doubt or uncertainty on such matters.”<sup>291</sup> The Claimant argues that the transparency provision under the BIT is reinforced by the requirement of a transparent regulatory environment under the Law and the Concession Agreement. Specifically, the ORAB never made public its “regulations, administrative practices and procedures”. The Concession Agreement requires the ORAB to rule on any proposals for tariff adjustment within the period set in the “procedural regulation”. If such regulation had been issued, compliance with it would have prevented the dilatory tactics that compromised the tariff regime.<sup>292</sup>

353. The Claimant observes that the ORAB was established as an autonomous entity under the Law and had exclusive authority to supervise the Concession. Regardless of this fact, the decisions of the ORAB were controlled and dictated by the MOSP. To this allegedly improper influence, the Claimant attributes the request of the RPI study and other instances may be established circumstantially:

“because the ORAB candidly told ABA that, although they believed it was correct in its position on Resolution 1/99, they could not undo it because of political pressures. This is confirmed by the statements to ABA by Minister Romero and Undersecretary García about the political problems created by increased water bills. And in fact (based on Minister’s Romero’s comments) newspapers reported

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<sup>291</sup> Memorial, p. 216.

<sup>292</sup> Ibid., pp. 216-217.

that the ORAB would issue a resolution forcing withdrawal of the bills before the ORAB ever met to issue Resolution 1/99. Similarly, the ORAB President told ABA the ORAB could not grant the RPI adjustment because of political pressure from the MOSP, and ORAB directors said the Bahía Blanca ‘crisis’ was not ABA’s fault, but when the Governor and the MOSP Minister publicly attacked ABA, the ORAB also took actions against the company. These actions are consistent with the Governor’s pronouncement to Azurix and ABA.”<sup>293</sup>

354. The Minister also admitted before the provincial House of Representatives that there was still a great lack of transparency on the regulation of the concessionaires:

“The other element we consider worth mentioning is Resolution 16 under which controlling entities are to make public all their decisions. This is a point we should like to emphasize since we consider there used to be a great lack of transparency – and there still is – on the control of companies under concessions in Argentina”.<sup>294</sup>

355. In its Counter-Memorial, the Respondent considered that the *Metalclad* case was not relevant because of the different circumstances of that case which concerned a regulatory conflict between different jurisdictions of a Federal State.<sup>295</sup>

356. Azurix insists in its Reply that the case is analogous to the instant case and provides useful guidance on the application of the transparency standard: “the facts of the present case are more compelling than *Metalclad* since the BIT explicitly requires that ‘[e]ach party shall make public all...administrative practices and procedures [...]’ and the Province indisputably failed to do so.”<sup>296</sup> The Claimant also observes that this standard has been applied by other tribunals besides in *Metalclad*. In *Maffezini* the tribunal held that the lack of transparency in a loan transaction was incompatible with Spain’s commitment to ensure fair and equitable treatment of the investor, and in *Tecmed* the tribunal found that the State had an obligation in applying the fair and

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<sup>293</sup> Ibid., p. 217.

<sup>294</sup> Quoted in the Memorial, p. 216.

<sup>295</sup> Counter-Memorial, para. 1049.

<sup>296</sup> Reply, para. 756.

equitable treatment standard to act ‘totally transparently in its relations with the foreign investor...’<sup>297</sup>

357. The Respondent, in the Rejoinder, simply affirms its previous defense, and points out its surprise that the Province is accused of lack of transparency when it was Azurix and ABA “who after being in charge of the Service provision, pretended to make an attempt against the terms of the Contract that they had known and accepted.”<sup>298</sup>

**(b) Considerations of the Tribunal**

358. The arguments exchanged by the parties raise the following issues:

1. Whether the standard of fair and equitable treatment is a standard which entails obligations for the parties to the BIT in the treatment of foreign investment which are additional to those required by the minimum standard of treatment of aliens under customary international law;
2. What conduct attributable to the State can be characterized as unfair and inequitable? In other words, what is the substantive content of the standard?; and
3. Whether Article II(7) of the BIT has been breached.

359. In discussing the first issue, the Tribunal will start by considering the specific provision of the BIT on fair and equitable treatment and recall that the BIT is an international treaty that should be interpreted in accordance with the norms of interpretation established by the Vienna Convention. As already noted, the Vienna Convention is binding on the parties to the BIT. Article 31(1) of the Convention requires that a treaty be “interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose”.

360. In their ordinary meaning, the terms “fair” and “equitable” used in Article 3(1) of the BIT mean “just”, “even-handed”, “unbiased”, “legitimate.”<sup>299</sup> As regards the purpose and object of the BIT, in its Preamble, the parties state their desire to promote

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<sup>297</sup> Ibid., para. 757.

<sup>298</sup> Rejoinder, para. 1087.

<sup>299</sup> *Oxford English Dictionary*. These terms are similarly defined in *Diccionario de la lengua española*, 22<sup>nd</sup> edition at [www.rae.es](http://www.rae.es).

greater cooperation with respect to investment, recognize that “agreement upon the treatment to be accorded such investment will stimulate the flow of private capital and the economic development of the Parties”, and agree that “fair and equitable treatment of investment is desirable in order to maintain a stable framework for investment and maximum effective use of economic resources.” It follows from the ordinary meaning of the terms fair and equitable and the purpose and object of the BIT that fair and equitable should be understood to be treatment in an even-handed and just manner, conducive to fostering the promotion of foreign investment. The text of the BIT reflects a positive attitude towards investment with words such as “promote” and “stimulate”. Furthermore, the parties to the BIT recognize the role that fair and equitable treatment plays in maintaining “a stable framework for investment and maximum effective use of economic resources.”

361. Turning now to Article II.2(a), this paragraph provides: “Investment shall at all times be accorded fair and equitable treatment, shall enjoy full protection and security and shall in no case be accorded treatment less than required by international law.” The paragraph consists of three full statements, each listing in sequence a standard of treatment to be accorded to investments: fair and equitable, full protection and security, not less than required by international law. Fair and equitable treatment is listed separately. The last sentence ensures that, whichever content is attributed to the other two standards, the treatment accorded to investment will be no less than required by international law. The clause, as drafted, permits to interpret fair and equitable treatment and full protection and security as higher standards than required by international law. The purpose of the third sentence is to set a floor, not a ceiling, in order to avoid a possible interpretation of these standards below what is required by international law. While this conclusion results from the textual analysis of this provision, the Tribunal does not consider that it is of material significance for its application of the standard of fair and equitable treatment to the facts of the case. As it will be explained below, the minimum requirement to satisfy this standard has evolved and the Tribunal considers that its content is substantially similar whether the terms are interpreted in

their ordinary meaning, as required by the Vienna Convention, or in accordance with customary international law.<sup>300</sup>

362. Argentina has declared its agreement with the interpretation of Article 1105 of NAFTA by the “FTC. This article bears the heading of the “Minimum Standard of Treatment”. Paragraph 1 reads as follows: “Each Party shall accord to investments of investors of another Party treatment in accordance with international law, including fair and equitable treatment and full protection and security.” In this provision, the standards of fair and equitable and full protection and security are defined as part of the treatment in accordance with international law. As interpreted by the FTC, the standard of treatment, and as indicated in the title of the article, is the minimum required under customary international law.

363. Argentina has also drawn the attention of the Tribunal to recent Free Trade Agreements (FTAs) entered by the United States, such as the Free Trade Agreement with Chile, where the minimum treatment required is that required under international law. The interpretation of the FTC or the examples of FTAs adduced by the Respondent may be evidence of a significant practice by one of the parties to the BIT, but the Tribunal has difficulty in reading it in the text of the BIT which governs these proceedings. The fact that the FTC interpreted Article 1105 in reaction to a tribunal’s different understanding of this article and that, in recent agreements, the correlative clause has been drafted to reflect the FTC’s interpretation show that the meaning of that article and similar clauses in other agreements could reasonably be understood to have a different meaning.

364. The question whether fair and equitable treatment is or is not additional to the minimum treatment requirement under international law is a question about the substantive content of fair and equitable treatment and, whichever side of the argument one takes, the answer to the question may in substance be the same.

365. In 1927, the US-Mexican Mixed Claims Commission considered in the *Neer* case that a State has breached the fair and equitable treatment obligation when

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<sup>300</sup> See *Técnicas Medioambientales Tecmed, S.A. v. The United Mexican States* (ICSID Case No. ARB(AF)/00/2), para. 155.



the conduct of the State could be described as outrageous, egregious or in bad faith or so below international standards that a reasonable and impartial person would easily recognize it as such. This description of conduct in breach of the fair and equitable treatment standard has been considered as the expression of customary international law at that time. In deciding the determinant elements of fair and equitable treatment, the question for the Tribunal is whether, at the time the BIT was concluded, customary international law had evolved to a higher standard of treatment.

366. The parties have interpreted differently how arbitral tribunals have understood this standard. We will turn to the cases discussed. Argentina has placed particular emphasis on *Genin*. In that case, the tribunal had to decide on whether the investor had been treated fairly and equitably in the context of the revocation of a banking license. The tribunal found no breach of the standard because there were ample grounds for the action taken by the Bank of Estonia. The tribunal in considering the meaning of fair and equitable did not engage in a textual analysis of the fair and equitable treatment clause in the US-Estonia BIT but simply referred to how this requirement has been generally understood under international law, namely, an international minimum standard separate from domestic law but “that is, indeed, a minimum standard.”<sup>301</sup> According to the same tribunal, for State conduct to breach such standard, it would need to reflect “a willful neglect of duty, an insufficiency of action falling far below international standards, or even subjective bad faith.”<sup>302</sup>

367. Notwithstanding the finding that, in the circumstances of the case, Estonia did not breach the duty of fair and equitable treatment, the tribunal seems to have been uneasy about letting the conduct of Estonia stand without criticism and considered it necessary to express the hope that “Bank of Estonia will exercise its regulatory and supervisory functions with greater caution regarding procedure in the future.”<sup>303</sup> In considering the award of costs, the same tribunal noted that “the awkward manner by which the Bank of Estonia revoked EIB’s license, and in particular the lack of prior notice of its intention to revoke EIB’s license and of any means for EIB or its

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<sup>301</sup> Para. 367.

<sup>302</sup> *Ibid.*

<sup>303</sup> *Ibid.*, para. 372.

shareholders to challenge that decision prior to its being formalized, cannot escape censure.”<sup>304</sup>

368. Arbitral tribunals under NAFTA have found, after the interpretation of the FTC, that the customary international law to be applied is the customary international law as it stood in 1994 not in 1927. In *Mondev*, the tribunal considered that “the content of the minimum standard today cannot be limited to the content of customary international law as recognized in arbitral decisions in the 1920s.”<sup>305</sup> The tribunal noted that the parties in that case agreed that the international standard of treatment has evolved as all customary international law had evolved, and that the two other State parties to NAFTA also agreed with this point.<sup>306</sup> Therefore, the customary international law to be applied “is not limited to the international law of the 19<sup>th</sup> century or even of the first half of the 20<sup>th</sup> century, although decisions from that period remain relevant. In holding that Article 1105(1) refers to customary international law, the FTC interpretations incorporate current international law, content, the content of which is shaped by the conclusion of more than two thousand bilateral investment treaties and many treaties of friendship and commerce. Those treaties largely and concordantly provide for ‘fair and equitable’ treatment of and, and for ‘full protection and security’ for, the foreign investor and his investments.”<sup>307</sup> Applying this evolutionary concept to customary international law, the tribunal found that “To the modern eye, what is unfair or inequitable need not equate with the outrageous or the egregious. In particular, a State may treat foreign investment unfairly and inequitably without necessarily acting in bad faith.”<sup>308</sup>

369. The tribunal in *Loewen* came to a similar conclusion: “Neither State practice, the decisions of international tribunals nor the opinion of commentators

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<sup>304</sup> *Ibid.*, para. 381.

<sup>305</sup> *Mondev International Ltd. v. United States of America* (ICSID Case No. ARB(AF)/99/2), Award of October 11, 2002, para. 123.

<sup>306</sup> *Ibid.*, para. 124.

<sup>307</sup> *Ibid.*, para. 125.

<sup>308</sup> *Ibid.*, para.116. The tribunal in *ADF* affirmed the same point: “what customary international law projects is not a static photograph of the minimum standard of treatment of aliens as it stood in 1927 when the Award in the *Neer* case was rendered. For both customary international law and the minimum standard of treatment of aliens it incorporates, are constantly in a process of development.” *ADF Group, Inc. v. USA*, (ICSID Case No. ARB(AF)/00/1) Award of January 9, 2003, para.179.

support the view that bad faith or malicious intention is an essential element of unfair and inequitable treatment or denial of justice amounting to a breach of international justice.”<sup>309</sup>

370. After an analysis of arbitral decisions and awards under NAFTA, the tribunal in *Waste Management* reached the conclusion that:

“the minimum standard of treatment of fair and equitable treatment is infringed by conduct attributable to the state and harmful to the claimant if the conduct is arbitrary, grossly unfair, unjust or idiosyncratic, is discriminatory and exposes the claimant to sectional or racial prejudice, or involves a lack of due process leading to an outcome which offends judicial propriety – as might be the case with a manifest failure of natural justice in judicial proceedings or a complete lack of transparency and candor in an administrative process. In applying this standard it is relevant that the treatment is in breach of representations made by the host State which were reasonably relied on by the claimant.”<sup>310</sup>

371. The parties have also referred to *Tecmed*, which describes just and equitable treatment as requiring:

“the Contracting Parties to provide to international investments treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment. The foreign investor expects the host State to act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor, so that it may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investment and comply with such regulations.”<sup>311</sup>

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<sup>309</sup> *The Loewen Group, Inc. and Raymond L. Loewen v. United States of America* (ICSID Case No. ARB(AF)98/3), Award of June 26, 2003, para. 132.

<sup>310</sup> *Waste Management, Inc. v. The United Mexican States* (ICSID Case No. ARB(AF)/3) Award of 30 April 2004, para. 98.

<sup>311</sup> *Técnicas Medioambientales Tecmed, S.A. v. The United Mexican States* (ICSID Case No. ARB(AF)/00/2), para. 154. Unofficial translation from the Spanish original published by ICSID on its web site.

372. Except for *Genin*, there is a common thread in the recent awards under NAFTA and *Tecmed* which does not require bad faith or malicious intention of the recipient State as a necessary element in the failure to treat investment fairly and equitably. As recently stated in *CMS*, it is an objective standard “unrelated to whether the Respondent has had any deliberate intention or bad faith in adopting the measures in question. Of course, such intention and bad faith can aggravate the situation but are not an essential element of the standard.”<sup>312</sup> It is also understood that the conduct of the State has to be below international standards but those are not at the level of 1927. A third element is the frustration of expectations that the investor may have legitimately taken into account when it made the investment. The standards of conduct agreed by the parties to a BIT presuppose a favorable disposition towards foreign investment, in fact, a pro-active behavior of the State to encourage and protect it. To encourage and protect investment is the purpose of the BIT. It would be incoherent with such purpose and the expectations created by such a document to consider that a party to the BIT has breached the obligation of fair and equitable treatment only when it has acted in bad faith or its conduct can be qualified as outrageous or egregious.

373. Based on these considerations, the Tribunal will now turn to whether the Respondent breached its obligation to treat the Claimant’s investment fairly and equitably. To this effect, the Tribunal considers the instances described below to be particularly relevant:

374. The Tribunal is struck by the conduct of the Province after the Claimant gave notice of termination of the Concession Agreement. ABA had requested to terminate it in agreement with the Province. The Province refused what was a reasonable request in light of the previous behavior of the Province and its agencies. The refusal by the Province to accept that notice of termination and its insistence on terminating it by itself on account of abandonment of the Concession is a clear case of a breach of the fair and equitable treatment standard. It is evident from the facts before this Tribunal that the Concession was not abandoned.

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<sup>312</sup> *CMS Gas Transportation Company v. Argentine Republic* (ICSID Case No. ARB/01/8) Award of May 12, 2005, para. 280.

375. Although the Tribunal has rejected to a certain extent the interpretations of the Concession Agreement and the Law alleged by the Claimant regarding the RPI and the Canon, it is also clear that the tariff regime was politicized because of concerns with forthcoming elections or because the Concession was awarded by the previous government. The issues of the zoning coefficients and the construction variations are cases in point. It is significant that, once the service was transferred, the new service provider was allowed to raise tariffs reflecting the construction variations.

376. Finally, the repeated calls of the Provincial governor and other officials for non-payment of bills by customers verges on bad faith in the case of the Bahía Blanca incident when the Province itself had not completed the works that would have helped to avoid the problem in the first place.

377. Considered together, these actions reflect a pervasive conduct of the Province in breach of the standard of fair and equitable treatment.

378. It remains to be considered whether Argentina also breached Article II(7) of the Treaty. Azurix bases its claim on the fact that ORAB never published its regulations and lacked independence. Article II(7) requires publication of the laws, regulations, adjudicatory decisions and administrative practices and procedures pertaining or affecting investments. The Tribunal has already found that the politicization of the Concession is an element in the Tribunal's determination that the fair and equitable standard has been breached. On the other hand, the Tribunal has also found that ORAB's request for a study in the context of the RPI was a legitimate request. The Tribunal considers that, in view of the facts, what is at issue here is the conduct in the application of the regulatory framework rather than its publicity. There is no doubt that publication of ORAB's regulations would have been a desirable improvement, but the lack of it as argued by the Claimant is not sufficient to conclude that Article II(7) has been breached.

### **3. Failure to Observe Obligations**

#### **(a) Positions of the Parties**

379. In its Memorial, the Claimant argues that the Province and the Republic have failed to observe their obligations as required by Article II(2)(c) of the BIT: “Each Party shall observe any obligation it may have entered into with regard to investments.” The Claimant refers to the fact that Article XIII of the BIT extends its application to the political subdivisions of the Respondent and concludes from it that the BIT imposes an obligation directly on the Province to observe its obligations to foreign investors.<sup>313</sup>

380. In the Counter-Memorial, Argentina contends that contractual claims do not become automatically treaty claims, and that no tribunal has accepted such an argument. Furthermore, Azurix and ABA specifically renounced to raise contractual issues before an ICSID tribunal, and Article II(2)(c) of the BIT refers to obligations undertaken towards specific investment agreements and not to concession contracts governed by domestic administrative law. Argentina also observes that the Claimant has failed to prove the existence of a cause and effect link between the event and the loss and to provide a precise assessment of the losses. Argentina concludes its argument by affirming that it had not undertaken any contractual obligation whatsoever with Azurix and the same is true of the Province.<sup>314</sup>

381. In its Reply, the Claimant notes that Article II(2)(c) refers to “any obligation”, it includes obligations arising under international law and under municipal law; it is not limited to breaches of international agreements, which in any case is a term that would include concession agreements. The Claimant alleges that “To limit this BIT provision to any one category of obligations would require that limiting language be read into the treaty, something the drafters could have done but intentionally chose not to do. The Tribunal’s task, of course, is to construe the treaty as written, not rewrite it as the GOA would prefer.” Any uncertainties should be interpreted in favor of the investor given the objectives of the BIT as expressed in its preamble.<sup>315</sup>

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<sup>313</sup> Memorial, p. 192.

<sup>314</sup> Counter-Memorial, paras. 1009-1015.

<sup>315</sup> Reply, para. 732.

382. Azurix adds that the phrase “entered into” is not limited to any particular mode or method and encompasses obligations undertaken through contract, legislation, decrees, resolutions or regulations. Moreover, the BIT does not limit the application of this clause to a specific investment as claimed by the Respondent, Article II(2)(c) refers to obligations in respect of investments in plural and generically. As regards the issue of the forum for contractual disputes provided for in the Concession Agreement, the Claimant argues that Article VII(2) of the BIT is very clear in giving a choice to the private party concerned between submitting the dispute to the forum previously agreed or international arbitration. Azurix re-affirms that it had already proved that damages had occurred during the Concession and were continuing annually as a result of the Province’s breaches.<sup>316</sup>

383. In its Rejoinder, Argentina recalls the findings of the PCIJ in *Serbian Loans*, the ICJ in *ELSI*, the arbitral tribunal in *Woodruff*, the Ad hoc Annulment Committee in *Vivendi*, and the arbitral tribunals in the *SGS* cases, and concludes that general international law bluntly separates contractual claims from those under international law, that even in the case of BITs the prohibition to transubstantiate a contractual claim into a BIT claim remains, and that when a tribunal has established conditions for the application of an umbrella clause it has required the claimant to abide by the contract forum clause.<sup>317</sup>

**(b) Considerations of the Tribunal**

384. As already stated by the Tribunal in affirming its jurisdiction within the limits permitted by the Convention and the BIT, the Tribunal finds that none of the contractual claims as such refer to a contract between the parties to these proceedings; neither the Province nor ABA are parties to them. While Azurix may submit a claim under the BIT for breaches by Argentina, there is no undertaking to be honored by Argentina to Azurix other than the obligations under the BIT. Even if for argument’s sake, it would be possible under Article II(2)(c) to hold Argentina responsible for the

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<sup>316</sup> Ibid., paras. 729-737.

<sup>317</sup> Rejoinder, para. 987.

alleged breaches of the Concession Agreement by the Province, it was ABA and not Azurix which was the party to this Agreement.

#### **4. Arbitrary Measures**

##### **(a) Positions of the Parties**

385. The Claimant argues that arbitrary or discriminatory measures are listed as alternatives in the BIT and, therefore, it is sufficient that a measure be arbitrary to constitute a breach of the BIT. In its ordinary meaning arbitrary means “a characterization of a decision or action taken by an administrative agency... [as] willful and unreasonable action and without consideration or in disregard of facts or law or without determining principle.”<sup>318</sup> The Claimant also refers to the definition of arbitrary by the ICJ in *ELSI*, “Arbitrariness is not so much something opposed to a rule of law, as something opposed to the rule of law... It is willful disregard of due process of law, an act which shocks, or at least surprises, a sense of judicial propriety.” The Claimant observes that this definition is too narrow and does not accord with the ordinary meaning of arbitrariness. The Claimant refers to *Pope & Talbot* and its comments on the evolution of international law, as characterized by the ICJ decision, that moves away from the *Neer* formulation. According to that tribunal, the formulation in *ELSI*:

“leaves out any requirement that every reasonable and impartial person be dissatisfied and perhaps permits a bit less injury to the psyche of the observer, who need no longer be outraged, but only surprised by what the government has done. And, of course, replacing the neutral ‘governmental action’, with the concept of ‘due process’ perforce makes the formulation more dynamic and responsive to evolving and more vigorous standards for evaluating what governments do to people and companies.”<sup>319</sup>

386. The Claimant maintains that to determine whether an action is or not arbitrary in its ordinary meaning should meet four tests: it should be taken by the proper authority, for the proper purpose, because of relevant circumstances and should not be patently unreasonable. In accordance with these tests, the measures taken by the

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<sup>318</sup> Memorial, p. 217.

<sup>319</sup> Ibid, p. 208.



Province were arbitrary. Resolution 1/99 was issued for an improper purpose, the tariff regime was improperly applied, the issues related to Circular 58(A) were not dealt within reasonable periods of time, the RPI was denied for irrelevant reasons, the Province induced a high bid price with Circular 52(A) and then claimed that the bidder paid too much and it could not be fully included in the base rate. The Province acted according to the electoral needs of its officials rather than in accordance with the rule of law.<sup>320</sup>

387. The Respondent considers that the definition in *ELSI* is the most appropriate. Argentina contests the relevance of *Pope & Talbot*, which was referring to the concept of fair and equitable treatment not to a definition of discriminatory measures.. The Respondent points out that, in *Genin*, the tribunal held that “in order to amount to a violation of the BIT, any procedural irregularity that may have been present would have to amount to bad faith, a willful disregard of due process of law or an extreme insufficiency of action.”<sup>321</sup>

388. In its Reply, the Claimant insists that the meaning in the BIT should be the ordinary meaning of its terms. Article II.2(b) uses the most general of terms, “in any way” either party shall “impair” the management, operation, use, enjoyment, acquisition, expansion, or disposal of investment.” The verb “impair” means “to diminish, lessen, damage, deteriorate, or make worse.” From this the Claimant concludes that the terms used “indicate that the prohibition is to be applied broadly to any conduct that directly or indirectly achieves the prohibited result.”<sup>322</sup> If the drafters would have wished to limit the import of arbitrary measures to meaning a violation of the rule of law, they could have said it in no uncertain terms, directly and without bothering to draft the clause “with such precision and detail.”<sup>323</sup>

389. Argentina reaffirmed, in the Rejoinder, its understanding of arbitrary as defined by the ICJ and not by its ordinary meaning as pretended by the Claimant.

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<sup>320</sup> Ibid, p. 211.

<sup>321</sup> Counter-Memorial, para. 1024.

<sup>322</sup> Reply, para. 742.

<sup>323</sup> Ibid., 746.

**(b) Considerations of the Tribunal**

390. Article II.2(b) provides: “Neither Party shall in any way impair by arbitrary or discriminatory measures the management, operation, maintenance, use, enjoyment, acquisition, expansion, or disposal of investments. For the purposes of dispute resolution under Articles VII and VIII, a measure may be arbitrary or discriminatory notwithstanding the opportunity to review such measure in the courts or administrative tribunals of a Party.”

391. The Tribunal agrees with the interpretation of the Claimant that a measure needs only to be arbitrary to constitute a breach of the BIT. This interpretation has not been contested by the Respondent and it follows from the alternative way in which the term “measures” is qualified by the adjectives “arbitrary or discriminatory”. The parties disagree on whether the meaning of arbitrary should be the ordinary meaning of “arbitrary” or the meaning to arbitrary given by the ICJ in *ELSI*. The parties also disagree on the relevance of *Pope & Talbot* to this case and Argentina has pointed out the description of arbitrary given in *Genin*. The Tribunal is required to consider the ordinary meaning of the terms used in the BIT under Article 31 of the Vienna Convention. The findings of other tribunals, and in particular of the ICJ, should be helpful to the Tribunal in its interpretative task.

392. In its ordinary meaning, “arbitrary” means “derived from mere opinion”, “capricious”, “unrestrained”, “despotic.”<sup>324</sup> Black’s Law Dictionary defines the term, *inter alia*, as “done capriciously or at pleasure”, “not done or acting according to reason or judgment”, “depending on the will alone.” *Pope & Talbot* did not define arbitrary as it stood today. It only commented on the fact that the ICJ itself had moved from the standard advocated by Canada based on *Neer* to a less demanding standard. *Genin* does not seem to take notice of the change that has taken place when it adds the requirement of bad faith. The Tribunal finds that the definition in *ELSI* is close to the ordinary meaning of arbitrary since it emphasizes the element of willful disregard of the law.

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<sup>324</sup> *Oxford English Dictionary*. This term is similarly defined in the *Diccionario de la lengua española*, 22nd edition at [www.rae.es](http://www.rae.es).

393. The question for the Tribunal is whether the measures taken by the Province can be considered to be arbitrary and have impaired “the management, operation, maintenance, use, enjoyment, acquisition, expansion, or disposal” of the investment of Azurix in Argentina. The Tribunal finds that the actions of the provincial authorities calling for non-payment of bills even before the regulatory authority had made a decision, threatening the members of the ORAB because it had allowed ABA to resume billing, requiring ABA not to apply the new tariff resulting from the review of the construction variations and affirming that zone coefficients apply in contradiction with the information provided to the bidders at the time of bidding for the Concession, restraining ABA from collecting payment from its customers for services rendered before March 15, 2002, and denying to ABA access to the documentation on the basis of which ABA was sanctioned are arbitrary actions without base on the Law or the Concession Agreement and impaired the operation of Azurix’s investment.

## **5. Full Protection and Security**

### **(a) Positions of the Parties**

394. In its Memorial, the Claimant argues that the standard of full protection and security imposes an obligation of vigilance and due diligence upon the government, as stated in *APPL*, “according to modern doctrine, the violation of international law entailing the state’s responsibility has to be considered constituted by ‘the mere lack or want of diligence’, without any need to establish malice or negligence”. The Claimant defines further the standard by referring to *AMT*. The tribunal in that case found that:

“It would not appear useful for the Tribunal to enter into the debate whether in the case on hand Zaire is bound by an obligation of result or simply an obligation of conduct. The Tribunal deems it sufficient to ascertain, as it has done, that Zaire has breached its obligation by taking no measure whatever that would serve to ensure the protection and security of the investment in question ... Zaire is responsible for its inability to prevent disastrous consequences of these events affecting the investments of AMT which Zaire had the obligation to protect.”<sup>325</sup>

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<sup>325</sup> Memorial, p. 213.

395. The Claimant proceeds to argue that the standard goes beyond physical protection and includes the protection described in *CME Czech Republic B.V.*: “The host State is obligated to ensure that neither by amendment of its laws nor by actions of its administrative bodies is the agreed and approved security and protection of the foreign investor’s investment withdrawn or devalued.”<sup>326</sup>

396. The Claimant alleges that Argentina breached the standard so defined by failing to apply the regulatory framework and the Concession Agreement and thus destroying the security provided by them: the Province never revoked Resolutions 1/99 and 7/00 or decided on the RPI adjustment or on the issue of the valuations, ABA was never compensated for, *inter alia*, the Bahía Blanca damages, the Province insisted that ABA give up the right assured by the Law, Circular 52(A) and the Concession Agreement to recover the Canon in full, and the Respondent failed to take any action to protect the Claimant’s investment.

397. In its Counter-Memorial, the Respondent observes that Azurix had simply requested the use of its good offices to ensure the Province’s compliance with the Concession Agreement. Thus Azurix was requesting assistance in a contractual dispute between ABA and the Province.<sup>327</sup> The Respondent refers to the view held by the *ad hoc* Committee in *Aguas del Aconquija* and the assertion of the tribunal in that case that “federal authorities could have reasonably considered the difference as being one of a contractual nature, and the scope of any federal obligation to react could have been reasonably influenced by this perception.”<sup>328</sup>

398. The Respondent argues that the nature of the dispute brought to its attention was a contractual dispute not a dispute related to an investment, and that no new ground may be adduced after filing, otherwise, either the claim was immature or there was a new dispute.<sup>329</sup> The Respondent notes that the Claimant has not determined what specific duty to act it has breached under the BIT, and that the

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<sup>326</sup> *Idem.*

<sup>327</sup> Counter-Memorial, para. 1035.

<sup>328</sup> *Ibid.*, para. 1037.

<sup>329</sup> *Ibid.*, para. 1039.

standard allegedly breached requires active behavior and not simply omissions in the duty of care.<sup>330</sup>

399. The Respondent also contests the relevance of cases such as *AAPL* and *AMT* which involved physical destruction of facilities of the investor by the armed forces. As for the relevance of *CME*, the Respondent points out that it is questionable to adduce *CME* without referring to *Lauder* where, on the basis of the same facts, the tribunal reached the opposite conclusion.<sup>331</sup>

400. As a final argument, the Respondent requests the Tribunal, in examining Argentina's liability, to consider that, "during the period under review the country was undergoing the worst economic, social and institutional crisis in its history."<sup>332</sup>

401. In its Reply, the Claimant observes that the Respondent confuses "its obligation to comply affirmatively with the BIT standards in its own conduct with its ultimate responsibility under international law for violations of the BIT by its political subdivisions."<sup>333</sup> Acts or omissions of the Province that violate the BIT are "necessarily and automatically" the responsibility of Argentina under international law. Furthermore, it is not correct that Azurix simply requested the good offices of Argentina in a contractual dispute. In its response, Argentina ignores clear statements in the communications of the Claimant addressed to Argentina whereby the latter is informed not only of contractual breaches but also of deviations from the regulatory framework and arbitrary acts of the officers and entities of the Province which constitute violations of the BIT "for which the Argentine Republic is directly responsible." (letter of January 5, 2001). In another letter dated May 24, 2001, Azurix stated:

"The purpose of this letter is to reiterate the need for the Argentine Republic to rectify the failure to comply with its obligations under the BIT, international law and the Concession Agreement. The Argentine Republic has an obligation to prevent violations of the BIT and international law within its territory whether committed by the federal government or its political subdivisions. The federal

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<sup>330</sup> Ibid., paras. 1043 and 1047.

<sup>331</sup> Ibid., para. 1050.

<sup>332</sup> Ibid., 1051.

<sup>333</sup> Reply, para. 749.

government has an obligation to prevent expropriations [without compensation] by it or its political subdivisions. Azurix requests that the Argentine Republic take all necessary actions to prevent such violations ...”<sup>334</sup>

402. The Claimant considers that it has amply made its case on the responsibility of Argentina for the acts and omissions of the Province under international law, and that , “It is unnecessary, and perhaps confusing, to analyze the GOA’s liability as ‘absolute’ or ‘strict’ for the acts of its political subdivisions”, as mentioned by the Respondent.<sup>335</sup>

403. As regards the allegation of the Respondent that no new grounds may be stated, Rule 40 of the Arbitration Rules permits a party to present incidental, ancillary or additional claims arising directly out of the subject matter of the dispute not later than the reply memorial.<sup>336</sup>

404. The Claimant re-affirms that the standard of full protection and security is not limited to basic police functions as alleged by Argentina. The Claimant finds nothing in the language of the BIT that would limit the application of this standard to issues of physical security and protection. According to the Claimant, this standard requires the government to exercise “vigilance and use due diligence within its political and legal system to protect investments.”<sup>337</sup>

405. In its Rejoinder, the Respondent refers to *Tecmed* that held that “the guarantee of full protection and security is not absolute and does not impose strict liability upon the State that grants it.” Based on this interpretation of the standard, the Respondent concludes that the argument of the Claimant cannot be accepted.<sup>338</sup>

### **(b) Considerations of the Tribunal**

406. While the cases of *APPL* and *AMT* refer to physical security, there are other cases in which tribunals have found that full protection and security has been breached because the investment was subject to unfair and inequitable treatment –

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<sup>334</sup> Ibid., para. 753.

<sup>335</sup> Ibid., para. 754.

<sup>336</sup> Ibid., para. 755.

<sup>337</sup> Ibid., para. 758.

<sup>338</sup> Rejoinder, para. 1088.

*Occidental v. Ecuador* – or, conversely, they have held that the obligation of fair and equitable treatment was breached because there was a failure to provide full protection and security – *Wena Hotels v. Egypt*. The inter-relationship of the two standards indicates that full protection and security may be breached even if no physical violence or damage occurs as it was the case in *Occidental v. Ecuador*.

407. In some bilateral investment treaties, fair and equitable treatment and full protection and security appear as a single standard, in others as separate protections. The BIT falls in the last category; the two phrases describing the protection of investments appear sequentially as different obligations in Article II.2(a): “Investment shall at all times be accorded fair and equitable treatment, shall enjoy full protection and security and...” The tribunal in *Occidental* based its decision on a clause worded exactly like in the BIT, and nonetheless considered that, after it had found that the fair and equitable standard had been breached, “the question of whether in addition there has been a breach of full protection and security under this Article becomes moot as a treatment that is not fair and equitable automatically entails an absence of full protection and security.”<sup>339</sup>

408. The Tribunal is persuaded of the interrelationship of fair and equitable treatment and the obligation to afford the investor full protection and security. The cases referred to above show that full protection and security was understood to go beyond protection and security ensured by the police. It is not only a matter of physical security; the stability afforded by a secure investment environment is as important from an investor’s point of view. The Tribunal is aware that in recent free trade agreements signed by the United States, for instance, with Uruguay, full protection and security is understood to be limited to the level of police protection required under customary international law. However, when the terms “protection and security” are qualified by “full” and no other adjective or explanation, they extend, in their ordinary meaning, the content of this standard beyond physical security. To conclude, the Tribunal, having held that the Respondent failed to provide fair and equitable treatment to the

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<sup>339</sup> *Occidental Exploration and Production Company v. Ecuador* (LCIA Administered Case No. UN 3467) Award, dated July 1, 2004, para. 187.

investment, finds that the Respondent also breached the standard of full protection and security under the BIT.

## **VIII. Compensation**

### **1. Positions of the Parties**

409. Azurix has requested full compensation for expropriation as required by the BIT under Article IV paragraph 1. Azurix has also argued that the expropriation was unlawful because it did not satisfy the form and substance requirements of due process nor was full or fair compensation paid. Therefore, Azurix claims that it is entitled to enhanced compensation that, in the words of the Permanent Court of International Justice in the *Chorzów Factory* case, “wipe-out all the consequences of the illegal act and re-establish the situation which would, in all probability, have existed if the act had not been committed.”<sup>340</sup>

410. Azurix has proposed four possible dates for purposes of determining the compensation due for expropriation: (A) July 1999 just before the issuance of Resolution 1/99 on August 4; (B) December 2000, when the MSP Undersecretary had promised that the tariff issues would be resolved in favor of Azurix and they were not; (C) August 2001 when the Province denied any breaches of the Concession Agreement, the Tariff Regime or the Regulatory Framework and refused to permit ABA to fully recover the Canon payment; and (D) November 2001 when Decree No 2598/01 was issued refusing to accept ABA’s notice of termination of October 5, 2001. Professor Riesman in his opinion cautioned that, in a case of creeping expropriation, the use of a later date may reward the Province for its own arbitrary conduct in regulating the Concession.<sup>341</sup> Azurix takes the position that “No matter what date is fixed by this Tribunal, the Province should not be permitted to benefit from its own unlawful acts.”<sup>342</sup>

411. Azurix discusses the compensation methodologies for expropriation, and submits claims under each one of them without expressing a preference for one or another method. Under the actual investment method, Azurix claims to have invested

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<sup>340</sup> Memorial, pp. 218-221.

<sup>341</sup> Exhibit to the Memorial, pp. 71-72.

<sup>342</sup> Memorial, p. 223.



\$449 million when it acquired the Concession, \$102.4 million in additional capital contributions to ABA, and \$15 million on consequential costs including corporate expenditures and legal costs related to negotiations with the Province. Under the book value method and based on NERA's report calculation for each of the four dates referred to above, Azurix considers that the book value of the Concession in August 1999 was \$516.9 million, in January 2001 \$484.6 million, in August 2001 \$483.9, and in November 2001 \$482.2 million.<sup>343</sup> Alternatively, Azurix submits the possibility for the Tribunal to consider compensation based on unjust enrichment - on the benefits received by the Province. On this basis, the Province was enriched by the Canon, the further investment of \$102.4 million, and the time value - interest - of the funds. In the case of the Canon, Azurix submits that in accordance with the NERA report, the consideration of the time value would raise it to \$450.5.<sup>344</sup>

412. Additionally, Azurix has claimed the amount due by customers to ABA when the Concession was taken over by the Province and which the Province publicly requested the customers not to pay to ABA. According to Azurix, these accounts receivable amounted approximately to AR\$120 million.

413. In its Counter-Memorial, the Respondent does not comment on the compensation claimed by Azurix. Azurix in its Reply, considers that, by not responding, Argentina has conceded Azurix's damages and reaffirms them. In its Rejoinder, Argentina notes that Azurix claimed compensation only for expropriation and questioned the dates chosen by the Claimant as possible dates for purposes of calculating compensation. Furthermore, Argentina argues that the standard of compensation under the BIT is the fair market value and that value cannot be the amount paid for the Concession when extraneous considerations influence it. Argentina recalls that the bid of Azurix was out of line with the other bids for the concession areas and calculates that, "considering the bids that would have maximized the revenues of the Province from those regions [A, C1, C2, C3, and C4] excluding Azurix's bid, the maximum amount that would have been paid by the other bidders for the ABA Concession is

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<sup>343</sup> Ibid., pp. 225-227.

<sup>344</sup> Ibid., pp. 227-228.

38.52 million dollars.”<sup>345</sup> In any case, argues Argentina, Azurix would not be entitled to more than 90% of the fair market value of ABA and the effect of the deep economic crisis that affected the country on asset values cannot be disregarded.<sup>346</sup>

414. In the Post-Hearing Memorial, the Claimant has defined “full compensation” as including, as a minimum, “(i) the unamortized value of all investments made, including the US\$438.55 million Canon payment and Azurix’s additional capital contributions to ABA through 2002 of US\$114,864,000, which were lost as a result of the GOA [Government of Argentina]’s actions, (ii) discrete damages in excess of US\$55 million, and (iii) costs.”<sup>347</sup>

## **2. Considerations of the Tribunal**

415. On compensation, three issues have to be addressed by the Tribunal: (i) the difference in compensation claimed by Azurix in its various submissions, (ii) the starting point for the calculation of damages, and (iii) the principle upon which those damages should be based.

416. First, the Tribunal notes that Azurix’s request for compensation in its Memorial is limited to amounts related to the Canon payment, the additional capital contributions made, the accounts receivable and consequential costs. This request is confirmed in the Reply. In the Post-Hearing Memorial the accounts receivable are not included in the definition of “full compensation” and, on the other hand, an amount in excess of \$55 million is claimed on account of discrete damages detailed in the NERA report. The Tribunal considers that the Post-Hearing Memorial is not the place to change the submissions for compensation since the simultaneous timing of the memorials of the parties does not permit the other party to comment on the changes made. Thus, the Tribunal shall retain for consideration the compensation requested in the Memorial and confirmed in the Reply. The Tribunal is aware that the discrete damages listed in the NERA report are part of the allegations made in the Memorial but they were not included in the calculation of compensation pleaded then by the Claimant.

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<sup>345</sup> Rejoinder, para. 1107.

<sup>346</sup> *Ibid.*, para. 1112.

<sup>347</sup> Post-Hearing Memorial, para. 68.

417. As to the second issue, various dates in 2001 have been proposed by Azurix. In a case of direct expropriation, the moment when expropriation has occurred can usually be established without difficulty. In the case where indirect or “creeping” expropriation has taken place or, as the *Santa Elena* tribunal put it, “the date on which the governmental ‘interference’ has deprived the owner of his rights or has made those rights practically useless”<sup>348</sup>, it will be much more difficult for the tribunal to establish the exact time of the expropriation. The difficulty is no less severe, unless the decision is based on a single act creating liability, when the Tribunal concludes that an investor has not received fair and equitable treatment or that it has been subjected to arbitrary treatment or that the host State has not provided the investor the full protection and security guaranteed by the BIT. The Iran-U.S. Claims Tribunal, in one of its awards, decided that “where the alleged expropriation is carried out by way of a series of interferences in the enjoyment of property”, the date of the expropriation is “the day when the interference has ripened into a more or less irreversible deprivation of the property rather than on the beginning date of the events”.<sup>349</sup> It has been sometimes argued that applying this formula would lead to an inequitable situation where the investment’s value would be assessed at the time when the cumulative actions of the State would have led to a dramatic devaluation of the investment. However, such a view does not take into account that, in assessing fair market value, a tribunal would establish that value in a hypothetical context where the State would not have resorted to such maneuvers but would have fully respected the provisions of the treaty and the contract concerned.

418. There can be legitimate disagreement as to the date in 2001 at which the cumulative actions of the Province led to breaches of the Treaty; but, in the Tribunal’s view, there can be no doubt that, by March 12, 2002 when the Province put an end to the Concession, alleging abandonment by ABA, its breaches of the BIT had reached a watershed. For purpose of calculating the compensation due to Azurix, this is the date which will be retained by the Tribunal.

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<sup>348</sup> *Compañía del Desarrollo de Santa Elena, S.A. v. Costa Rica* (ICSID Case No. ARB/96/1), Award of February 17, 2000, 39 ILM 1317, 1330 (2000).

<sup>349</sup> *Malek v. Iran*, award 534-193-3, para. 114 (1992) (citing *Int’l Technical Prods. Corp. v. Iran*, Award No. 190-302-3, at 49, 9 Iran-U.S. Cl. Trib. Rep. 206, 240-241 (1985)).

419. The Tribunal will now proceed to deal with the third issue relating to compensation, i.e., the basis upon which the damages should be assessed. The Tribunal points out that the Treaty only provides for the measure of compensation in the case of an expropriation that meets the Treaty's requirements that it be done for a public purpose and be non-discriminatory. In such case, Article IV (1) of the BIT provides:

“Compensation shall be equivalent to the fair market value of the expropriated investment immediately before the expropriatory action was taken or became known, whichever is earlier; be paid without delay; include interest at a commercially reasonable rate from the date of expropriation; be fully realizable; and be freely transferable at the prevailing market rate of exchange on the date of expropriation”.

420. The tribunal, in the recent *CMS v. Argentina* case, when faced with a similar situation, was “persuaded that the cumulative nature of the breaches discussed here is best dealt with by resorting to the standard of fair market value. While this standard figures prominently in respect of expropriation, it is not excluded that it might also be appropriate for breaches different from expropriation if their effect results in important long-term losses”.<sup>350</sup>

421. Under NAFTA, tribunals which have held that a standard of protection was breached and no expropriation had occurred were in the same position as the Tribunal, since NAFTA does not provide for a measure of compensation in such situations. In three NAFTA cases, tribunals awarded damages for breaches other than expropriation, *S.D. Myers, Pope & Talbot* and *Feldman*. The tribunal in *Feldman* after having considered the other two cases concluded: “It is obvious that in both of these earlier cases, which as here involved non-expropriation violations of Chapter 11, the tribunals exercised considerable discretion in fashioning what they believed to be reasonable approaches to damages consistent with the requirements of NAFTA.”<sup>351</sup>

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<sup>350</sup> *CMS Gas Transmission Company v. Argentine Republic* (ICSID Case No. ARB/01/8), para. 410.

<sup>351</sup> *Marvin Roy Feldman Karpa v. The United Mexican States* (ICSID Case No. ARB(AF)/99/1), Award of December 16, 2002, para. 197.

422. In fact, in *S.D. Myers* the tribunal considered that the lack of a measure of compensation in NAFTA for breaches other than a finding of expropriation reflected the intention of the parties to leave it open to the tribunals to determine it in light of the circumstances of the case taking into account the principles of both international law and the provisions of NAFTA.<sup>352</sup>

423. In *MTD*, another ICSID case, the tribunal found that the respondent had breached the fair and equitable treatment obligation and accepted the Claimants' proposal to apply the standard of compensation formulated in *Chorzów*. The tribunal noted that the Respondent had not objected to the application of this standard and that "no differentiation has been made about the standard of compensation in relation to the grounds on which it is justified. Therefore, the Tribunal will apply the standard of compensation proposed by the Claimants to the extent of the damages awarded."<sup>353</sup>

424. In the present case, the Tribunal is of the view that a compensation based on the fair market value of the Concession would be appropriate, particularly since the Province has taken it over. Fair market value has been defined as: "the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts."<sup>354</sup>

425. Azurix has submitted, in its Memorial, two methodologies to measure fair market value in the present case: the actual investment and the book value. It has asserted in addition that the argument in support of using actual investment is compelling as the investment is recent and highly ascertainable. The Tribunal agrees that the actual investment method is a valid one in this instance. However, the Tribunal considers that a significant adjustment is required to arrive at the real value of the Canon paid by the Claimant.

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<sup>352</sup> *S.D. Myers v. Canada*, Partial Award of November 13, 2000, paras. 303-319.

<sup>353</sup> *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Chile* (ICSID Case No. ARB/01/7), Award of May 21, 2004, para. 238.

<sup>354</sup> *International Glossary of Business Valuation Terms*, American Society of Appraisers, ASA website, June 6, 2001, p. 4.

426. First of all, in the Tribunal's view, no well-informed investor, in March 2002, would have paid for the Concession the price (and more particularly, the Canon) paid by Azurix in mid-1999, irrespective of the actions taken by the Province and of the economic situation of Argentina at that time. In that regard, the Tribunal refers to some of the concerns expressed by OPIC at the time it denied financing the investment plan of ABA. As already noted, OPIC pointed out the size of the investments needed to achieve the Concession's objectives as compared to the estimated revenues expected from the tariffs in effect, and considered that failure to agree on a modification of the Concession in order to establish a sustainable situation was an obstacle to OPIC's financing. Yet, at the time Azurix won the Concession, the Province accepted the price paid by Azurix as the fair market price for the Concession and the Province benefited from the alleged aggressive price paid. Furthermore, there is no doubt that the loss in value is partly attributable to the actions of the Province and the politicization of the Concession.

427. More importantly, the Tribunal refers to the conclusions it reached concerning the RPI review process and the impossibility of including the Canon in the recoverable asset base for the purpose of tariff increases. Azurix has argued that the right price for an auctioned item is the price paid by the winning bidder. Argentina, for its part, argues that the fair market value of the Concession should be based on the much lower competing bids. The function of the Tribunal is not to second-guess the values established by the various bidders at the time of the privatization of AGOSBA, but to try and determine what an independent and well-informed third party would have been willing to pay for the Concession in March 2002, in a context where the Province would have honored its obligations. In that regard, being aware that the RPI tariff adjustment was not automatic and that the Canon could only be recoverable over the remaining duration (some 27 years and 9 ½ months) of the Concession and on the basis of the existing tariffs as adjusted periodically through the review process spelled out in the Concession Agreement, such investor would have realized that his only hope of recouping the Canon was essentially through expansion of the system and through efficiency improvements between the periodic 5-year tariff reviews. On the other hand, as to the RPI review process, it would have been reasonable for such an investor to

conclude that the ORAB would have approved tariff increases from time to time to take into account the Argentine inflation rate, if not the American one.

428. At the same time, the Tribunal cannot ignore the fact that the Province, through its actions and inaction, contributed to the loss in value of the Concession. When the Province accepted Azurix's bid, it considered it as the fair market value for the Concession and the Province benefited from the alleged aggressive price paid.

429. Considering those factors and valuing the Canon at present-day value, the Tribunal is of the opinion that no more than a fraction of the Canon could realistically have been recuperated under the existing Concession Agreement. The Tribunal therefore concludes that the value of the Canon on March 12, 2002 should be established at US\$60,000,000 (sixty million US dollars).

430. Secondly, Azurix should be compensated, as part of the fair market value of the Concession, for the additional investments to finance ABA. In its Memorial, Azurix has claimed US\$102.4 million in additional capital contributions to the initial sum invested of US\$449 million of which US\$438,555,551 represent the payment for the Canon. The amount of US\$102.4 million when added to the difference between the initial sum invested and the Canon results in investments additional to the Canon of US\$112,844,446 (one hundred and twelve million eight hundred forty-four thousand four hundred forty-six US dollars). However, the Tribunal considers that this amount should be reduced by US\$7,603,693 (seven million six hundred and three thousand six hundred ninety-three US dollars) which represent the aggregate of the claims presented by Azurix on account of damages which the Tribunal has found to be related to contractual claims -those related to the works listed in Circular 31(A) except for Bahía Blanca<sup>355</sup>- and that should be borne by Azurix as part of its business risk. Therefore, the amount awarded on account of additional investments is US\$105,240,753 (one hundred and five million two hundred forty thousand seven hundred fifty-three US dollars).

431. Thirdly, Azurix has claimed AR\$120 million on account of unpaid bills to ABA for services rendered prior to the take over of the Concession by the Province and which the Province directed customers not to pay to ABA. According to Argentina, only

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<sup>355</sup> NERA Report, p.170. Exhibit 19-C to the Memorial.

an amount of about half million pesos has been paid and it is held separately. The Tribunal notes that the amount claimed by Azurix represents all bills due by customers on March 7, 2002. The Tribunal considers that this amount is owed by the Province to ABA and, therefore, should not be part of the compensation awarded to Azurix..

432. Fourthly, Azurix has claimed US\$15,000,000 (fifteen million US dollars) on account of consequential damages in order to wipe out the consequences of a breach of an international obligation. This amount relates to: (i) corporate expenditures for negotiations with the Province, termination of the Concession and transfer of the service (US\$7.1 million), and (ii) costs for the preparation, registration, and participation in these proceedings (US\$7.9million). The Tribunal will consider the second component as part of the award of costs of these proceedings. As for the first component, the Tribunal finds that it has not received sufficient evidence in support of such costs and that, in any case, these are costs related to the business risk that Azurix took when it decided to make the investment. Therefore, while the Tribunal agrees that in principle compensation should be such that wipes out the consequences of an illegal act, in the circumstances of this particular case, the Tribunal does not find the amount claimed to be justified.

433. Fifthly, bearing in mind the responsibility of the Province in the failure of the Concession and the fact that the implementation of the POES was spread over a five-year period, while the Concession was cancelled after less than half of that time, the Tribunal concludes that Azurix should bear no liability with regard to the non-execution of that plan.

434. The Claimant has proposed, as an alternative to the fair market value of the investment, that compensation be based on “the theory of unjust enrichment”. In this respect, the Claimant has referred to the decision of the court (in fact, an arbitral tribunal) in *Lena Goldfields* which chose to base the award on unjust enrichment rather than damages. As stated by the court and quoted in the Memorial:

“The Court further decides that the conduct of the Government was a breach of the contract going to the root of it. In consequence, Lena is entitled to be relieved from the burden of further obligations thereunder and to be compensated in



money for the value of the benefits of which it had been wrongfully deprived. On ordinary legal principles this constitutes a right of action for damages, but the Court prefers to base its award on the principle of “unjust enrichment,” although in its opinion the money result is the same.”<sup>356</sup>

435. The Tribunal observes that the court did not give any reason for its choice of unjust enrichment as opposed to damages. This decision has been criticized for its lack of clarity and the reference to the same result in monetary terms,

“raises the suspicion that these considerations, far from being decisive for the outcome of the award, were merely used to add an appearance of broad general justice. This case, although frequently quoted in support of a ‘principle against unjustified enrichment’ in international law, has probably contributed nothing but a great deal of confusion.”<sup>357</sup>

436. The Tribunal further observes that damages and unjust enrichment are conceptually distinct in terms of the principles of liability and the measure of restitution. In the case of damages, liability rests on an unlawful act, which is not necessarily the case in unjust enrichment. As to compensation on account of an unlawful act, it is based on the loss suffered, while, in the case of unjust enrichment, it is based on restitution: for instance, what can be claimed, at least under some civil law regimes, is restitution of the lower of the amount contributed by the impoverished or the gain made by the enriched.<sup>358</sup>

437. The Iran-US Tribunal, which has dealt with claims based on the principle of unjust enrichment on several occasions, defined the principle of unjust enrichment and its applicability as follows:

“There must have been an enrichment of one party to the detriment of the other, and both must arise as a consequence of the same act or event. There must be

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<sup>356</sup> Memorial, p. 227.

<sup>357</sup> Christoph Schreuer, “Unjust Enrichment in International Law”, *The American Journal of Comparative Law*, vol. XXII, No. 2, p. 289.

<sup>358</sup> Bryce Dickson, “Unjust Enrichment Claims: a Comparative Overview”, *Cambridge Law Journal*, 54(1), March 1995, pp. 100-126; G. Bonet, “L’enrichissement sans cause, droit privé et droit public”, *LITEC, Extrait du Juris-Classeur Civil*, 1989; Jason W. Neyers, Mitchell McInnes & Stephen G.A. Pitel, *Understanding Unjust Enrichment*, Oxford: Hart, 2004.

no justification for the enrichment, and no contractual or other remedy available to the injured party whereby he might seek compensation from the party enriched.”<sup>359</sup>

438. The Tribunal has found that Argentina breached the Treaty, an unlawful act under international law. The Claimant has chosen the remedy provided for in the Treaty and the Tribunal has also found that the measure of compensation applicable in this case is not the restitution of the Claimant’s investment in respect of which the breach has been found but its fair market value before the breach occurred. For these reasons the Tribunal has not pursued the alternative of compensation on account of unjust enrichment proposed by the Claimant.

#### **IX. Interest**

439. The Claimant has requested the award of interest on all damages suffered at the average rate applicable to US six-month certificates of deposit compounded semi-annually. The Respondent has affirmed that it would not be legitimate to award compound interest and that, were the Tribunal to find for Azurix, a simple rate of interest should be used.

440. The Tribunal considers that compound interest reflects the reality of financial transactions, and best approximates the value lost by an investor. Therefore, compound interest should be paid on the amount of damages awarded as from the date at which the Province terminated the Concession – March 12, 2002 - until the date of dispatch of this award to the parties at the average rate applicable to US six-month certificates of deposit. In case the amount awarded is not paid in full 60 days after such date, the Respondent shall pay interest at the rate applicable to US six-month certificates of deposit until the day of payment in full and such rate shall also be compounded.

#### **X. Costs**

441. The Claimant has partially prevailed on the merits. The Tribunal declined to issue the provisional order requested by the Claimant and Argentina failed in its

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<sup>359</sup> *Sea-Land Service, Inc. v. Iran* (6 Iran-U.S.C.T.R.) p. 169.

objections to the jurisdiction of the Tribunal and its challenge to the president of the Tribunal. The Claimant did not submit its own copy of envelopes 1 and 2 as requested by the Tribunal, and Argentina requested that the Claimant bear the costs related to this procedural incident. For these reasons, the Tribunal decides: (1) that each party shall pay its own costs and counsel fees, and (2) that the arbitrators' fees and expenses and the cost of the ICSID Secretariat shall be borne by Argentina, except for the amount of US\$34,496 (thirty-four thousand four hundred ninety six U.S. dollars), which shall be borne by the Claimant and correspond to the said provisional measures and the procedural incident.

## **XI. Decision**

442. For the reasons above stated, the Tribunal unanimously decides:

1. That the Respondent did not breach Article IV(1) of the BIT.
2. That the Respondent breached Article II(2)(a) of the BIT by failing to accord fair and equitable treatment to Azurix's investment.
3. That the Respondent failed to accord full protection and security to Azurix's investment under Article II(2)(a) of the BIT.
4. That the Respondent breached Article II(2)(b) of the BIT by taking arbitrary measures that impaired Azurix's use and enjoyment of its investment.
5. To award compensation to Azurix on account of the fair market value of the Concession in the amount of US\$165,240,753 (one hundred sixty-five million two hundred forty thousand seven hundred fifty-three US dollars), including in part the additional investments made by Azurix to finance ABA.
6. To award interest compounded semi-annually on the amount referred to in paragraph 5 of this decision: (i) as from March 12, 2002 to June 30, 2006 at the rate of 2.44%, which is the average rate applicable to US six-month certificates of deposit during that period, and (ii) as from 60 days after the dispatch of this award to the parties until such amount has been fully paid at the average rate applicable to US six-month certificates of deposit.

7. That each party shall be responsible for their own costs and counsel fees, and the Respondent shall bear the fees and expenses of the arbitrators and the costs of the ICSID Secretariat except for US\$34,496 (thirty-four thousand four hundred ninety six U.S. dollars) which shall be borne by Claimant.

8. That all other claims are dismissed.

Made in Washington, DC, in English and Spanish, both versions equally authentic.

\_\_\_\_\_  
[SIGNED]

Dr. Daniel Hugo Martins

Arbitrator

Date: 19 June 2006

\_\_\_\_\_  
[SIGNED]

Mr. Marc Lalonde, P.C., O.C., Q.C.

Arbitrator

Date: 14 June 2006

\_\_\_\_\_  
[SIGNED]

Dr. Andrés Rigo Sureda

President

Date: 23 June 2006

Date of dispatch to the parties: February 6, 2007

INTERNATIONAL CENTRE FOR SETTLEMENT  
OF INVESTMENT DISPUTES  
WASHINGTON, D.C.

IN THE PROCEEDING BETWEEN

SIEMENS A.G.  
(CLAIMANT)

AND

THE ARGENTINE REPUBLIC  
(RESPONDENT)

ICSID CASE No. ARB/02/8

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AWARD

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*Members of the Tribunal*

Dr. Andrés Rigo Sureda, President  
Judge Charles N. Brower, Arbitrator  
Professor Domingo Bello Janeiro, Arbitrator

*Secretary of the Tribunal*

Ms. Claudia Frutos-Peterson

*Representing the Claimant*

Dr. Guido Santiago Tawil  
M. & M. Bomchil  
Buenos Aires  
Argentina

and

Dr. Peter Gnam  
Siemens A.G.

*Representing the Respondent*

H.E. Osvaldo César Guglielmino  
Procurador del Tesoro de la Nación Argentina  
Procuración del Tesoro de la Nación Argentina  
Buenos Aires  
Argentina

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## **I. Procedural History**

1. On May 23, 2002, the International Centre for Settlement of Investment Disputes (“ICSID” or the “Centre”) received from Siemens A.G. (“Siemens” or “Claimant”) a request for arbitration against the Argentine Republic (“Respondent”, “Argentina” or “Government”). On June 7, 2002, the Centre acknowledged receipt of the request in accordance with Rule 5 of the ICSID Rules of Procedure for the Institution of Conciliation and Arbitration Proceedings (“Institution Rules”) and informed the Claimant that it would not take further action until it had received the prescribed lodging fee as provided by Institution Rule 5(1)(b). On June 13, 2002, the Centre acknowledged receipt of the prescribed lodging fee by the Claimant and transmitted a copy of the request to Argentina and to the Argentine Embassy in Washington, D.C. in accordance with Institution Rule 5(2).

2. According to Article 36(3) of the Convention on the Settlement of Investment Disputes between States and Nationals of other States (“the Convention”), the Secretary-General of the Centre registered the request for arbitration on July 17, 2002. In accordance with Institution Rule 7, the Secretary-General notified the parties on the same date of the registration of the request and invited them to proceed to constitute an Arbitral Tribunal as soon as possible.

3. On August 7, 2002, the parties agreed that the Arbitral Tribunal would consist of three arbitrators, one arbitrator to be appointed by each party and the third, who shall serve as the President of the Tribunal, to be appointed by the agreement of the parties. The Claimant appointed Judge Charles N. Brower, a U.S. national, and the Respondent appointed Professor Domingo Bello Janeiro, a Spanish national. However, the parties failed to agree on the appointment of the third, presiding arbitrator. On October 21, 2002, the Claimant requested that the third, presiding arbitrator be appointed in accordance with Article 38 of the Convention and Rule 4 of the ICSID Rules of Procedure for Arbitration Proceedings (“Arbitration Rules”).

4. After consulting the parties, Dr. Andrés Rigo Sureda, a national of Spain, was appointed by the Centre as the third, presiding arbitrator. In accordance with Rule 6(1) of the Arbitration Rules, on December 19, 2002, the Secretary-General notified the parties that all three arbitrators accepted their appointment and that the Arbitral Tribunal was deemed to be constituted and the proceedings to have begun on that date. On the same date, pursuant to ICSID Administrative and Financial Regulation 25, the parties were informed that Mr. Gonzalo Flores, Senior Counsel, ICSID, would serve as Secretary of the Arbitral Tribunal. The Tribunal held its first session with the parties in Washington, D.C. on February 13, 2003.

5. Mr. Guido Santiago Tawil of M. & M. Bomchil and Mr. Peter Gnam of Siemens A.G. represent the Claimant. Messrs. Tawil and Gnam represented the Claimant at the first session. Mr. Osvaldo César Guglielmino, Procurador del Tesoro de la Nación Argentina, represents the Respondent. Messrs. Ignacio Suárez Anzorena and Carlos Lo Turco, acting on instructions from the then Procurador del Tesoro de la Nación Argentina, and Mr. Osvaldo Siseles, from the Ministerio de Economía, represented the Respondent at the first session.

6. During the first session, the parties agreed that the Tribunal had been properly constituted in accordance with the ICSID Convention and the Arbitration Rules and that they did not have any objections to any members of the Tribunal. It was also noted that the proceedings would be conducted under the Arbitration Rules in force since September 26, 1984.

7. During the first session, the parties also agreed on several other procedural matters, which were later set forth in the written minutes signed by the President and the Secretary of the Tribunal. Regarding the written submissions, the Tribunal, after consulting with the parties, fixed the following time limits for the presentation of the parties' pleadings: The Claimant would file a Memorial within 90 (ninety) days from the date of the first session; the Respondent would file a Counter-Memorial within 90 (ninety) days from its receipt of the Claimant's Memorial; the Claimant would file a Reply within 60 (sixty) days from its receipt of the Respondent's Counter-Memorial, and the Respondent would file a Rejoinder within 60 (sixty) days from its receipt of the Claimant's Reply.

8. The Tribunal further noted that, according to the Arbitration Rules, the Respondent has the right to raise any objections to jurisdiction no later than the expiration of the time limit fixed for the filing of its Counter-Memorial, and that, in the event that the Respondent would raise objections to jurisdiction, the following schedule would apply: the Claimant would file its Counter-Memorial on jurisdiction within the same number of days used by Argentina to file its objections to jurisdiction, but in any event, the Claimant would have a minimum of 60 (sixty) days to file its Counter-Memorial on jurisdiction; the Respondent would file its Reply on jurisdiction within 30 (thirty) days from its receipt of the Claimant's Counter-Memorial on jurisdiction; and the Claimant would file its Rejoinder on jurisdiction within 30 (thirty) days from its receipt of the Respondent's Reply on jurisdiction. It was also agreed that, if the Respondent would raise any objections to jurisdiction and proceedings would be resumed following the filing of such objections (because the Tribunal dismisses the objections or because it decides to join them with the merits of the dispute), the calendar agreed for the merits would recommence, and the Respondent would have the remaining number of days at the date of the filing of its objections to jurisdiction for the filing of its Counter-Memorial on the merits.

9. On March 14, 2003, the Claimant filed its Memorial on the merits and accompanying documentation.

10. On March 24, 2003, Ms. Claudia Frutos-Peterson, ICSID, Counsel, replaced Mr. Flores as the Secretary of the Tribunal.

11. On April 8, 2003, the parties agreed that the hearing on jurisdiction would take place on January 20-22, 2004, in Washington, D.C.

12. By letter of June 10, 2003, the Argentine Republic requested an extension of time due to the institutional succession in the Argentine Government to file its Counter-Memorial on the merits and/or to raise any objections to the jurisdiction of the Centre until August 4, 2003. By letter of June 18, 2003, the Claimant objected to the extension requested by the Respondent.

13. On June 23, 2003, due to the particular circumstances, the Tribunal granted the extension sought by Argentina and informed the parties that if Argentine filed its Counter-Memorial without objecting to jurisdiction, the Claimant, if requested, would be granted a similar extension of time to file its

Reply on the merits. The Tribunal further noted that if the Argentine Republic filed any objections to jurisdiction, the Claimant would have the same number of days used by the Argentine Republic to file such objections for the filing of its Counter-Memorial on jurisdiction.

14. On July 1, 2003, Mr. Horacio Daniel Rosatti informed the Tribunal that he had been appointed Procurador del Tesoro de la Nación Argentina.

15. In accordance with Arbitration Rule 41(1), on August 4, 2003, the Respondent filed a Memorial raising objections to the jurisdiction of the Centre and the competence of the Tribunal. In its Memorial on jurisdiction, Argentina requested the Tribunal for a 45 (forty-five) day extension of the time limit to file its Counter-Memorial on the merits in the event that the Tribunal would declare that it has competence over this matter.

16. Pursuant to Arbitration Rule 41(3), on August 7, 2003, the Tribunal suspended the proceedings on the merits.

17. After inviting the Claimant to present any observations on the time limit extension requested by the Respondent, the Tribunal informed the parties on August 21, 2003, that it was premature to decide on the extension of the time limit to file the Counter-Memorial on the merits requested by Argentina.

18. On October 16, 2003, the Claimant filed its Counter-Memorial on jurisdiction. On November 17, 2003, the Respondent filed its Reply on jurisdiction.

19. On December 10, 2004, the Respondent requested to postpone the hearing on jurisdiction scheduled for January 20-22, 2004 until February 15, 2004. On December 11, 2004, the Tribunal invited the Claimant to present any observations to the Respondent's request. On the same date, the Claimant presented its observations asking the Tribunal to reject the Respondent's request and to maintain the previous agreed schedule for the hearing on jurisdiction.

20. After considering the Respondent's request to postpone the hearing on jurisdiction, the Claimant's observations thereon, the fact that the development of the proceeding would not be affected due to the brevity of the postponement requested, the availability of the parties, and the agreement of the same to have a two-day hearing, the Tribunal, by letter of December 19, 2003,

informed the parties of its decision to schedule the hearing on jurisdiction on February 3 and 4, 2004.

21. On December 24, 2003, the Claimant filed its Rejoinder on jurisdiction.

22. As previously decided by the Tribunal, the hearing on jurisdiction took place in Washington, D.C. on February 3 and 4, 2004. At the hearing, the Claimant was represented by Mr. Guido Santiago Tawil, Mr. Peter Gnam, Mr. Stephan Signer and Ms. María Inés Corrá. Messrs. Tawil and Gnam addressed the Tribunal on behalf of the Claimant. The Respondent was represented by Ms. Andrea Gualde, Ms. Ana Badillos, and Mr. Jorge Barraguirre from the Procuración del Tesoro de la Nación Argentina, as well as by Messrs. Osvaldo Siseles from the Ministerio de Economía, and Mr. Roberto Hermida from the Embassy of Argentina in Washington, D.C. Ms. Gualde and Mr. Barraguirre addressed the Tribunal on behalf of the Respondent. During the hearing, the Tribunal also questioned to the parties in accordance with Arbitration Rule 32(3).

23. On July 2, 2004, the Respondent requested to extend its 45-day extension request to file its Counter-Memorial on the merits to 75 days, in the event that the Tribunal would declare that it had jurisdiction.

24. On August 3, 2004, the Tribunal issued its Decision on Jurisdiction, which is part of this Award, declaring that the dispute was within the jurisdiction of the Centre and the competence of the Tribunal.

25. On that same date, the Tribunal issued Procedural Order No. 1, establishing the timetable for the continuation of the proceeding, after taking into consideration the reasons expressed by the Respondent in its requests for an extension of the time limit to file its Counter-Memorial on the merits and the observations of the Claimant. The timetable was decided as follows: the Respondent was to file its Counter-Memorial on the merits within 60 (sixty) days, counting from the date of that Procedural Order; the Claimant was to file its Reply within 60 (sixty) days from its receipt of the Respondent's Counter-Memorial, and the Respondent was to file its Rejoinder within 60 (sixty) days from its receipt of the Claimant's Reply. Two alternate dates were set for the hearing on the merits, and the parties were asked to inform the Secretariat on the number of days needed for the hearing.

26. On August 10, 2004, both parties requested the hearing on the merits to be held on April 4-15, 2005. Additionally, the Claimant reserved its right to request an extension, if needed, to file its Reply, in the understanding that such an extension should not change the hearing dates already set.

27. On August 16, 2004, Argentina notified the appointment of Mr. Osvaldo César Guglielmino as Procurador del Tesoro de la Nación Argentina.

28. On August 19, 2004, the Tribunal confirmed that the hearing on the merits was to be held on April 4-15, 2005, and that, if needed, the Tribunal would additionally be available on April 18-19, 2005. (Later on the parties confirmed to the Tribunal that there would be no need to extend the hearing to April 18-19, 2005).

29. On September 24, 2004, Argentina requested an additional extension of 15 (fifteen) days of the time limit to file its Counter-Memorial on the merits due to the recent appointment of Mr. Osvaldo César Guglielmino as Procurador del Tesoro de la Nación Argentina. By letter of September 29, 2004, the Claimant objected to the extension requested by the Respondent. After considering the Respondent's request and the Claimant's observations, the Tribunal, by letter also of September 29, 2004, granted the 15 day extension requested by the Respondent to file its Counter-Memorial on the merits, on the understanding that a similar extension, if requested, would be granted to the Claimant, and informed the parties that no further extensions would be authorized. The Tribunal also invited the parties to directly exchange their filings in Buenos Aires to avoid further delays.

30. In accordance with the Tribunal's decision, the Respondent filed its Counter-Memorial on the merits on October 19, 2004. In its Counter-Memorial, the Respondent requested the production of certain documents by the Claimant: (i) forward contract in US dollars ("dollars or "\$"), (ii) financial statements of Siemens IT Services, S.A. ("SITS") from its commencement of business in Argentina, and (iii) financial statements of Siemens for the same period with respect to the registration of all operations transacted between SITS-Siemens and the rest of the affiliates of the Claimant parent corporation. By letter of December 1, 2004, the Claimant informed the Tribunal that it would submit, together with its Reply, a copy of SITS' financial statements for the fiscal years

ended September 30 of 1997 to 2003 and the Annual Reports of Siemens for the fiscal years ended September 20 of 1997 to 2003.

31. On December 1, 2004, the Respondent filed an application to disqualify the President of the Tribunal under Article 57 of the Convention. On December 7, 2004, in accordance with Arbitration Rule 9(6), the two co-arbitrators informed the parties that the proceedings were suspended and that the schedule for the parties' submissions and the date for the hearing on the merits were to be maintained.

32. On December 14, 2004, the Claimant requested a 15-day extension to file its Reply on the merits, which was due on December 20, 2004. By letter of December 21, 2004, the two co-arbitrators granted the extension requested by the Claimant, in accordance with the Tribunal's letter of September 29, 2004. Accordingly, the Claimant was to file its Reply on the merits no later than January 4, 2005. The Claimant filed its Reply on the merits on December 27, 2004. However, due to the suspension of the proceedings, the Claimant's Reply was circulated neither to the Tribunal nor to Argentina. After considering several communications exchanged by the parties regarding whether to provide a copy of the Claimant's Reply to the Respondent, the co-arbitrators decided, with the agreement of the parties, that a copy of the Claimant's Reply be delivered directly to the Respondent in Buenos Aires and that the Respondent was to file its Rejoinder within 60 (sixty) days from the receipt of the Claimant's Reply, i.e., no later than March 14, 2005.

33. By letter of February 3, 2005, the co-arbitrators, having considered the parties' request to delay for some days the hearing on the merits, granted such request.

34. On March 2, 2005, the Respondent requested a 15-day extension to file its Rejoinder due to translation difficulties. On March 3, 2005, the Claimant expressed its opposition to granting the extension.

35. On March 10, 2005, the Secretariat sent the parties Judge Brower's and Professor Bello Janeiro's separate opinions concerning Argentina's proposal for disqualification. In accordance with Arbitration Rule 9, the proceeding was to remain suspended pending a decision on the disqualification proposal, and, therefore, the date for the hearing on the merits was postponed

indefinitely. In addition, the 15-day extension requested by the Respondent to file its Rejoinder was granted, which was then to be filed no later than March 29, 2005.

36. On March 16, 2005, the Deputy Secretary-General of ICSID informed the parties that in accordance with Article 58 of the ICSID Convention, the Chairman of the Administrative Council was to decide on the Respondent's proposal for disqualification as the other members of the Tribunal were divided on the proposal. In addition, the Deputy Secretary-General also informed the parties that, because the President of the Tribunal had been a staff member of the World Bank and as proceeded in an earlier similar ICSID case, the request would be sent to the Secretary-General of the Permanent Court of Arbitration ("PCA") at The Hague to provide his recommendation on the disqualification proposal.

37. As directed, on March 29, 2005, the Respondent filed its Rejoinder on the merits.

38. On April 8, 2005, the parties were informed that the PCA would not hold a hearing with the parties, as requested by Argentina, but that it had agreed to receive any additional written information from the parties, besides that already filed by them and provided by ICSID to the PCA. Accordingly, the parties were informed on April 11, 2005, that considering Argentina's intention to send such additional information, the decision by the Secretary-General of the PCA on the disqualification proposal was postponed until April 15, 2005. On such a date, the Secretary-General of the PCA sent his recommendation to ICSID. Based on that recommendation, the Secretary-General of ICSID informed the parties on April 15, 2005 that the disqualification proposal was not sustained. In accordance with Arbitration Rule 9, the proceeding was resumed with the composition of the Arbitral Tribunal unchanged.

39. On April 15, 2005, two letters from the Respondent, dated December 7, 2004 and February 25, 2005, that had been received while the proceedings were suspended, were circulated. In its letters, the Respondent insisted on its request for the production of evidence by the Claimant of: (i) a copy of the "forward" contract, and (ii) a copy of SITS' financial statements and



Siemens' annual reports for the periods therein indicated. The Respondent also requested a 30-day period for the examination of such documents.

40. On April 18 2005, the Claimant requested that the hearing on the merits be scheduled to take place at the earliest possible time.

41. By letter of April 25, 2005, the Claimant, by invitation of the Tribunal, filed its observations on the Respondent's letters of December 7, 2004 and February 25, 2005.

42. On April 26, 2005, the Tribunal informed the parties that the hearing on the merits would be held on October 10-21, 2005, in Washington, D.C.

43. Between June 7, 2005 and July 28, 2005, the parties exchanged multiple communications regarding the Respondent's document request. The Tribunal granted the Claimant and the Respondent, respectively, time to present observations with respect to the Respondent's document request, as well as with respect to the different documents presented by the Claimant in this regard, (Tribunal's letters of June 7 and 27, 2005, and July 15 and 26, 2005). On September 2, 2005, after taking note of the Respondent's letter of August 17, 2005, objecting to the documents provided by the Claimant in connection with the Respondent's document request, as well as the Claimant's response of August 22, 2005, the Tribunal informed the parties that the information filed by the Claimant was not the information that the Tribunal had requested on July 15, 2005. Consequently, the Tribunal ordered the Claimant to furnish the requested information no later than September 8, 2005.

44. On September 2, 2005, the parties filed a document with their comments on the Tribunal's directives concerning the organization of the hearing on the merits. In addition, the parties requested the Tribunal to fix a time limit in order for the parties to file additional documents to be used during the hearing. According to the agreement of the parties, such documents were to be limited to: (i) new issues brought up by the Respondent, its experts or witnesses in its Rejoinder; (ii) documents in support of the examination of witnesses and experts, and (iii) documents related to events that occurred after the parties' pleadings.

45. As instructed by the Tribunal, on September 9, 2005, the Claimant filed accounting information in connection with Siemens Nixdorf

Informationssysteme A.G. (“SNI”)’s investment in SITS. The Tribunal, by letter of September 12, 2005, invited the Respondent to make any observations on the documents filed by the Claimant no later than September 29, 2005.

46. Between September 9, 2005 and September 15, 2005, in accordance with the Tribunal’s instructions of September 2, 2005, the parties informed the Tribunal of the names of the witnesses and experts that they were planning to examine and cross examine during the hearing as well as their agreement on the order of appearance for the witnesses and experts. (Respondent’s letters of September 9 and September 14, 2006, and Claimant’s letter of September 15, 2006).

47. On September 15, 2005, the Tribunal set September 23, 2005 as a deadline for the parties to object to the additional documents that were to be filed respectively by the Claimant and the Respondent.

48. As instructed by the Tribunal, the parties filed their respective additional documents on September 16, 2005, and on September 21, 2005, the Claimant submitted further information with respect to the capital contributions made by SNI in SITS.

49. On September 27, 2005, following the Tribunal’s invitation of that same date, the Respondent made certain observations with regard to the information filed by the Claimant on September 9 and 21, 2005 in connection with SNI’s investment in SITS.

50. On September 28, 2005, the Claimant rebutted the observations made by the Respondent by letter of September 23, 2005, with regard to the additional documents that had been filed by the Claimant on September 16, 2005.

51. In connection with the Respondent’s observations filed on September 27, 2005, the Claimant, by letter of October 3, 2005, offered, among other things, to submit, if the Tribunal so requested, a copy of SITS’s books related to its expenditures, as well as any other additional documentary information that the Tribunal may consider appropriate.

52. On October 4, 2005, having taken into account the parties’ communications with regard to their additional documents, the Tribunal informed the parties of its decision to: (i) reject certain additional documents filed by the

Respondent, which referred to an issue that had been known to the Respondent since 1998, and had not been previously raised; (ii) request explanations from both parties with regard to certain additional documents; (iii) admit other additional documents filed by the Claimant for the reasons stated by the Claimant's letter of September 28, 2005; and (iv) subject the admission of certain exhibits filed by the Claimant to the timely submission of further explanations from the Claimant in such respect. The Tribunal set October 6, 2005 as the deadline for the parties to provide the information therein requested, and the parties did so.

53. By letter of October 4, 2005, the Claimant agreed to the modification of the schedule for the appearance of the witnesses and experts during the hearing requested by the Respondent by a letter of that same date.

54. On October 5, 2005, following the Tribunal's invitation of October 3, 2005, the Respondent filed observations with regard to the Claimant's objections raised on September 30, 2005 to the inclusion of Mr. Claudio Antonio Michalina as a member of Argentina's delegation to the hearing on the merits. According to the Claimant, Mr. Michalina was not part of the legal team, but rather an assistant to one of the Respondent's witnesses, Mr. Daniel Eduardo Martín.

55. All the pending matters raised before the Tribunal were decided on October 7, 2005, before the hearing on the merits took place. The Tribunal ratified the rejection of the Respondent's submission of certain additional documents, because they had been known to the Respondent since 1998. The Tribunal also decided that Mr. Michalina could attend the hearing because each party decides who attends the hearings in its representation. Regarding the Claimant's accounting information requested by the Respondent, the Tribunal decided to accept the information provided by the Claimant, to take note of the Claimant's willingness to submit SITS' accounting books, should the Tribunal need them, and to declare that the Claimant had complied with the filing of the supporting documents in connection with SNI's investment in SITS.

56. On October 7, 2005, the Respondent, referring to the Claimant's letter of September 28, 2005, ratified its objections of September 23, 2005 to the new evidence filed by the Claimant.

57. The hearing on the merits took place on October 10-17, 2005, in Washington, D.C., present at the hearing were:

*Members of the Tribunal*

Andrés Rigo Sureda, President

Charles N. Brower, Arbitrator

Domingo Bello Janeiro, Arbitrator

*ICSID Secretariat*

Claudia Frutos-Peterson, Secretary of the Tribunal

Mercedes Cordido-Freytes de Kurowski, Consultant

*On behalf of the Claimant*

Peter Gnam (Siemens A.G.)

Stephan Signer (Siemens A.G.)

Rubén Daniel Slame (Siemens A.G.)

Guido Santiago Tawil (M. & M. Bomchil)

Rafael Mariano Manóvil (M. & M. Bomchil)

María Inés Corrá (M. & M. Bomchil)

Ignacio Minorini Lima (M. & M. Bomchil)

Federico Campolieti (M. & M. Bomchil)

Agustín García Sanz (M. & M. Bomchil)

*On behalf of the Respondent*

Oswaldo César Guglielmino (Procurador del Tesoro de la Nación Argentina)

Jorge Alberto Barraguirre (Procuración del Tesoro de la Nación Argentina)

Fabián Rosales Markaida (Procuración del Tesoro de la Nación Argentina)

José Luis Cassinerio (Procuración del Tesoro de la Nación Argentina)

María Luz Moglia (Procuración del Tesoro de la Nación Argentina)

Adriana Lilian Busto (Procuración del Tesoro de la Nación Argentina)

Luis Eduardo Rey Vásquez (Procuración del Tesoro de la Nación Argentina)

Martín Guillermo Moncayo von Hase (Procuración del Tesoro de la Nación Argentina)

Claudio Antonio Michalina (Procuración del Tesoro de la Nación Argentina)

Philippe Sands, Q.C.

Helen Mountfield

58. As per request of the Tribunal, the Claimant filed during the hearing SITS's accounting books ("Mayor", "Caja" and "IVA") for the relevant periods.

59. As instructed by the Tribunal, on November 23, 2005, the parties filed their post-hearing briefs.

60. On November 23, 2005, the Respondent filed certain observations concerning the additional accounting information provided by the Claimant during the hearing and, on November 30, 2005, filed a report with accompanying documentation on the accounting documents provided by the Claimant, as well as on "the assessment conducted and Siemens A.G.'s claim for damages". The Respondent's letter of November 23, 2005 was contested by the Claimant on December 21, 2005. The Tribunal invited the Respondent to present any observations on this letter by January 14, 2006.

61. On January 17, 2006, the Claimant noted that the Respondent had not filed observations on the Claimant's letter of December 21, 2005 before the deadline set by the Tribunal, and requested the Tribunal to declare the proceeding closed pursuant to Arbitration Rule 38(1).

62. On January 26, 2006, the Respondent informed the Tribunal that it had not received the Tribunal's letter of December 27, 2005, and rejected the Claimant's request for the closure of the proceeding.

63. On January 30, 2006, the Claimant sent a letter reiterating that the deadline established by the Tribunal for the Respondent to file any

observations on its letter of December 27, 2005 had lapsed, and insisted on its request to the Tribunal to declare the proceedings closed.

64. On February 1, 2006, the Respondent sent its observations on the Claimant's letter of December 21, 2005, as well as supporting documentation to justify why they had not received the Tribunal's letter of December 27, 2005.

65. On February 16, 2006, the Tribunal, after considering the Respondent's communications of January 26 and February 1, 2006, and that of the Claimant of January 30, 2006, decided: (i) to accept the explanations given by the Respondent with regard to its delay in filing observations to the Claimant's letter of December 21, 2005; (ii) to admit the Respondent's letter of February 1, 2006; and (iii) to invite the Claimant to make, no later than February 23, 2006, any observations it might have. The Claimant filed its observations on February 17, 2006.

66. On March 1, 2006, the Respondent sent a letter in reply to the Claimant's letter of February 17, 2006, to which the Claimant answered on March 9, 2006. On March 13, 2006, the Tribunal informed the parties of its decision to disregard such communications because they had not been requested by the Tribunal, and the parties had already had several occasions to raise the observations they had deemed pertinent in such regard (Respondent's letters of November 23 and 30, 2005, January 26 and February 1, 2006, and Claimant's letters of December 21, 2005, January 17, 30, and February 17, 2006).

67. On March 31, 2006, the Respondent requested the Tribunal to reconsider its decision of March 13, 2006. On April 13, 2006, the Tribunal confirmed its decision of March 13, 2006 for the reasons there established.

## **II. The Jurisdiction of the Tribunal**

68. Argentina has invited the Tribunal to review its finding on jurisdiction in light of recent decisions in the cases of *Plama Consortium Ltd. v. Republic of Bulgaria*<sup>1</sup> and *Salini Costruttori, S.p.A. & Italstrade, S.p.A. v. Hashemite Kingdom of Jordan*<sup>2</sup> on the application of the most-favored-nation

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<sup>1</sup> *Plama Consortium Ltd. v. Republic of Bulgaria*, ICSID Case No. ARB/03/24, Decision on Jurisdiction (February 8, 2005).

<sup>2</sup> *Salini Costruttori, S.p.A. & Italstrade, S.p.A. v. Hashemite Kingdom of Jordan*, ICSID Case No. ARB/02/13, Decision on Jurisdiction (November 29, 2004).

clause (“MFN clause”). The Claimant has for its part referred to the decision of the tribunal in *Gas Natural SDG S.A. v. the Argentine Republic*<sup>3</sup> which reaches similar conclusions as *Emilio Agustín Maffezini v. Kingdom of Spain*<sup>4</sup> and the Tribunal on the scope of the MFN clause. The Tribunal will not review what it has already decided; it is inappropriate at this stage of the proceedings and the Tribunal has no doubt about its findings. The Tribunal will limit itself to observe that the cases adduced by the Respondent deal with the application of the MFN clause to situations not akin to the instant case. Indeed, in *Plama* and *Salini v. Jordan*, tribunals faced extensions of the MFN clause to situations widely different from the facts considered by the Tribunal or for that matter considered in *Maffezini* or *Gas Natural*. The Claimant in *Salini* sought to include, through the application of a MFN clause, an umbrella clause where the basic treaty had none. In *Plama*, there was no ICSID clause in the basic treaty. There had never been any question that the parties to these proceedings agreed to ICSID jurisdiction and the issue was avoidance, through the MFN clause, of a procedural requirement that Argentina has consistently dispensed within the investment treaties it has concluded since 1994.

### **III. Applicable Law**

#### **1. Positions of the Parties**

69. Siemens argues that the Treaty on the Mutual Protection and Promotion of Investments between the Federal Republic of Germany and the Argentine Republic, dated July 9, 1991 (“Treaty”), contains an explicit choice of law in Article 10(5) which mandates the Tribunal to decide the merits of the dispute “on the basis of this Treaty, and, as the case may be, on the basis of other treaties in force between the Contracting Parties, the internal law of the Contracting Party in whose territory the investment was made, including its rules of private international law, and on the general principles of international law”. Siemens then refers to Article 42(1) of the Convention which directs the Tribunal to look first to the rules agreed by the parties. In this case, the rules agreed by

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<sup>3</sup> *Gas Natural SDG S.A. v. the Argentine Republic*, ICSID Case No. ARB/03/10, Decision on Jurisdiction (June 17, 2005).

<sup>4</sup> *Emilio Agustín Maffezini v. Kingdom of Spain*, ICSID Case No. ARB/97/7, Decision on Jurisdiction (January 25, 2000).

the parties are the provisions of the Treaty that constitute a special bilateral regime with respect to the matters regulated by it.

70. Siemens argues further that, in the case of *lacunae*, general international law applies and it has a corrective role in the sense that it controls and prevails over domestic law. In this respect, Siemens refers to Professor Weil's statement on the relationship between domestic law and international law under Article 42(1) of the Convention, to wit: "[...] no matter how domestic law and international law are combined, under the second sentence of Article 42(1), international law always gains the upper hand and ultimately prevails."<sup>5</sup> Siemens also refers to the Draft Articles on Responsibility of States adopted by the International Law Commission ("ILC") ("Draft Articles"), which state: "The characterization of an act of a State as internationally wrongful is governed by international law. Such characterization is not affected by the characterization of the same act as lawful by internal law."<sup>6</sup>

71. Siemens contends that this conclusion is reinforced by Article 7(1) of the Treaty which provides:

"If the laws and regulations of either Contracting Party or obligations under international law existing at present or established hereafter between the Contracting Parties in addition to this Treaty contain a regulation, whether general or specific, entitling investments by nationals or companies of the other Contracting Party to a treatment more favorable than is provided for by the Treaty, such regulation shall to the extent that it is more favorable prevail over this Treaty."

Therefore, the Claimant argues that Argentine law may prevail over the provisions of the Treaty only to the extent that it provides treatment to the investment more favorable than the Treaty. Conversely, those provisions of domestic law that may be less favorable are not applicable.

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<sup>5</sup> P. Weil, *The State, the Foreign Investor, and International Law: The No Longer Stormy Relationship of a Ménage à Trois*, 15 ICSID Review – FILJ (2000), p. 409.

<sup>6</sup> Article 3 of the *Draft Articles on Responsibility of States for Internationally Wrongful Acts*, adopted by the International Law Commission. Claimant's LA No. 49.



72. In any case, according to Siemens, the host State's domestic law is relevant only with respect to factual issues as held by the doctrine and the International Court of Justice ("ICJ") in *Case Concerning Certain German Interests in Polish Upper Silesia (Germany v. Poland)*:

"From the standpoint of International Law and of the Court which is its organ, municipal laws are merely facts which express the will and constitute the activities of States, in the same manner as do legal decisions or administrative measures. The Court is certainly not called upon to interpret the Polish Law as such; but there is nothing to prevent the Court's giving judgment on the question whether or not, in applying that law, Poland is acting in conformity with its obligations towards Germany under the Geneva Convention."<sup>7</sup>

73. Furthermore, Siemens points out that, as held by the Annulment Committee in *Compañía de Aguas del Aconquija S.A. and Vivendi Universal v. the Argentine Republic*<sup>8</sup> and the tribunal in *Técnicas Medioambientales TECMED, S.A. v. the United Mexican States*<sup>9</sup>, governmental measures that are lawful under domestic law are not necessarily in conformity with international law. Siemens concludes that domestic law is only relevant as evidence of Argentina's measures and conduct and needs to be analyzed through the lens of international law.

74. Argentina contends that there is no express agreement between the parties as to the law applicable to the dispute and that the Treaty does not indicate the law to be applied and, therefore, the Tribunal should apply the municipal law of Argentina. In this respect, Argentina affirms that the constitutional law of Argentina is the first source of law to be applied, and explains that the Argentine Constitution recognizes the right to property and the right of the State to regulate it provided it is done by law and subject to principles

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<sup>7</sup> *Case Concerning Certain German Interests in Polish Upper Silesia (Germany v. Poland)*, Judgment No.7, May 25, 1926, 1 World Court Reports (1934), 510, Claimant's Legal Authorities No. 31.

<sup>8</sup> *Compañía de Aguas del Aconquija S.A. and Vivendi Universal v. the Argentine Republic*, ICSID Case No. ARB/97/3, Decision on Annulment (July 3, 2002).

<sup>9</sup> *Técnicas Medioambientales TECMED, S.A. v. the United Mexican States*, ICSID Case No. ARB(AF)/00/2, Award (May 29, 2003).

of reasonableness and equality. As further explained by Argentina, these principles mean that restrictions on individual rights must be warranted by the facts and meet a social necessity or convenience and the limitation must be in line with the ends sought. Argentina further points out that, under Article 75(22) of the Constitution, treaties rank above the law and, under Article 27, treaties must conform to the principles of public law set by the Constitution.

75. Argentina draws to the Tribunal's attention that the constitutional reform of 1994 recognized a number of international instruments on human rights to have constitutional rank. Argentina claims that the human rights so incorporated in the Constitution would be disregarded by recognizing the property rights asserted by the Claimant given the social and economic conditions of Argentina.

## **2. Considerations of the Tribunal**

76. The Tribunal has been established under the provisions of the Treaty and the ICSID Convention. Under Article 42(1) of the Convention, the Tribunal is obliged to apply the rules of law agreed by the parties. The Treaty provides that a tribunal established under the Treaty shall decide on "the basis of this Treaty, and, as the case may be, on the basis of other treaties in force between the Contracting Parties, the internal law of the Contracting Party in whose territory the investment was made, including its rules of private international law, and on the general principles of international law." By accepting the offer of Argentina to arbitrate disputes related to investments, Siemens agreed that this should be the law to be applied by the Tribunal. This constitutes an agreement for purposes of the law to be applied under Article 42(1) of the Convention.

77. In regards to the arguments whether international law is referred to in the Treaty or the Convention as a corrective to municipal law or as a filler of *lacunae* in that law, the Tribunal refers to the finding of the Annulment Committee in *Wena Hotels Limited v. Arab Republic of Egypt* in the sense that: "The law of the host State can indeed be applied in conjunction with international law if this is

justified. So too international law can be applied by itself if the appropriate rule is found in this other ambit.”<sup>10</sup>

78. The Tribunal has found that it has jurisdiction over breaches of the Treaty and will review the conduct of Argentina as a State party to the Treaty in respect of the commitments undertaken in the Treaty. In so doing, and as stated by the *Ad Hoc* Committee in *Vivendi II*, the Tribunal’s inquiry is governed by the Convention, by the Treaty and by applicable international law. Argentina’s domestic law constitutes evidence of the measures taken by Argentina and of Argentina’s conduct in relation to its commitments under the Treaty.

79. In any case, the Treaty is not a document foreign to Argentine law. As explained by Argentina, the Constitution and treaties entered into by Argentina with other States are the supreme law of the nation, and treaties have primacy over domestic laws.<sup>11</sup> In this respect, the Tribunal notes the reference made by Argentina to international human rights law ranking at the level of the Constitution after the 1994 constitutional reform and implying that property rights claimed in this arbitration, if upheld, would constitute a breach of international human rights law. This argument has not been developed by Argentina. The Tribunal considers that, without the benefit of further elaboration and substantiation by the parties, it is not an argument that, *prima facie*, bears any relationship to the merits of this case.

80. The allegations of the parties will require that the Tribunal interpret the Treaty. In this respect and as a general matter, the Tribunal recalls that the Treaty should be interpreted in accordance with the norms of interpretation established by the Vienna Convention on the Law of Treaties of 1969 (“Vienna Convention”). The Vienna Convention is binding on the parties to the Treaty. Article 31(1) of the Vienna Convention requires that a treaty be “interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.”

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<sup>10</sup> *Wena Hotels Limited v. Arab Republic of Egypt*, ICSID Case No. ARB/98/4, *Ad Hoc* Committee Decision on Application for Annulment (February 5, 2002), 41 *ILM* (2002), p. 941.

<sup>11</sup> Section 31 and Article 75(22) of the Argentine Constitution.

#### IV. The Facts

81. On August 26, 1996, Argentina called for bids on the provision of an integral service for the implementation of an immigration control (“the DNM<sup>12</sup> sub-system”), personal identification (“the RNP<sup>13</sup> sub-system”) and electoral information (“the DNE<sup>14</sup> sub-system”) system (“the System” or “the Project”), including the provision of all equipment necessary for data processing and the intercommunication of such equipment, start-up, technical support and maintenance services, and preparation, printing and home delivery of national identity cards (“DNIs”).

82. For the purpose of participating in the bidding, Siemens, acting through SNI, a company legally integrated into Siemens, created SITS, a domestic Argentine company as required by the Bidding Terms and Conditions. SITS was organized as a special purpose company and used by Siemens for the exclusive purpose of investing in the Project.

83. SITS submitted a bid which included, as required by Argentina, a statement declaring that: (i) SNI had been integrated into Siemens since 1992, Siemens being the owner of 100% of SNI’s stock; (ii) SNI was controlled by Siemens, which appointed SNI’s directors and instructed them in relation to SNI’s activities and projects; and (iii) as a result of SNI’s integration into Siemens, the latter was jointly and severally liable for SNI’s obligations towards third parties.

84. Argentina selected SITS’ bid taking into consideration Siemens’ credentials and financial soundness. The contract for the provision of the System (“the Contract”) was awarded to SITS by Decree No. 199/98. The Contract between SITS and Argentina was executed on October 6, 1998 and approved by Decree 1342/98. The Contract took effect on November 21, 1998.

85. The compensation for the services to be provided under the Contract consisted of the price of each DNI issued, including home delivery and DNI updates, the fees for the immigration proceedings processed through the System and the price for printing the voting rolls. All prices in the Contract were

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<sup>12</sup> *Dirección Nacional de Migraciones.*

<sup>13</sup> *Registro Nacional de las Personas.*

<sup>14</sup> *Dirección Nacional Electoral.*

denominated in Argentine pesos (“pesos” or “AR\$”). At the time, pesos were convertible into dollars at par pursuant to the Convertibility Law.

86. The Contract had a six-year term as from its effective date – November 21, 1998 - and was automatically renewable twice for a three-year term, i.e., for a total of twelve years, unless a notice of intent to the contrary had been given by either party. However, the parties had agreed to give such notice only if the purpose of the Contract had been fully met.

87. The execution of the Project had two stages: a System engineering stage, which consisted of designing the System specifications and acquiring the computer hardware, software and telecommunications networks necessary for its implementation, and a System operation stage, to be managed by the Government. SITS would receive compensation only during this second stage.

88. Production of DNIs was scheduled to begin in August 1999 and extend to the whole country. To this effect, it was necessary for the Argentine government to reach agreements with the Provinces and the City of Buenos Aires (“the External Circuit”).

89. In August 1999, Argentina requested SITS to postpone production of the new DNIs. According to the minutes signed by SITS and the Government, the postponement was due to an extraordinary increase in demand for DNIs because of the short period left before the elections scheduled on October 24, 1999, and to the fear that the introduction of the new mechanisms under such circumstances would burden the public with inconveniences that should be avoided.<sup>15</sup> Thus DNIs production was postponed to October 1, 1999 for foreign residents’ DNIs and November 1, 1999 for Argentine citizens’ DNIs. Production of the respective DNIs started on those dates.

90. In the October election, Mr. Fernando de la Rúa became President-elect. The new authorities took office on December 10, 1999.

91. The DNM sub-system started to operate on February 1, 2000 and its operation was halted on February 2, 2000. On that date, SITS requested an

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<sup>15</sup> Minutes dated August 18, 1999, approved by Decree No. 1054/99. Exhibit 40 to the Memorial.

explanation for the interruption. On February 7, SITS was informed that the operation of the sub-system required a governmental authorization. The sub-system continued to be interrupted indefinitely.

92. On February 24, 2000, Argentina suspended the production, printing and distribution of all new DNIs because, in the case of foreigners' DNIs, the RNP sub-system printed the left thumbprint at the place reserved for the right thumbprint. Argentina prohibited SITS from introducing any modification to the System to correct this problem.

93. These two suspensions occurred in the context of statements made by Government officers to SITS and Siemens in January 2000 to the effect that the Government would seek to renegotiate the DNIs price, and increase the number of free-of-charge DNIs.

94. In March 2000, the Government set up a special commission under the Ministry of the Interior to review the Contract and propose a course of action ("the Commission"). During the negotiations that ensued, Siemens made several proposals and agreement was reached with the Commission on a proposal on November 10, 2000. The Commission sent the negotiated proposal to the Government and the Government gave Siemens a "Contract Restatement Proposal" identical in its terms to the proposal submitted by the Commission for the Government's approval.

95. Siemens' representatives met with the President of Argentina on December 19, 2000. Allegedly he promised to issue the decree approving the negotiated terms of the Contract Restatement Proposal by December 31, 2000. When the decree was not issued, Siemens addressed several notes in February 2001 to the Minister of the Interior expressing concern over the delay.<sup>16</sup> The Minister replied on March 12, 2001 and attributed the delay to the required intervention of controlling agencies.<sup>17</sup>

96. In November 2000, the Argentine Congress approved the Economic-Financial Emergency Law ("the 2000 Emergency Law") which

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<sup>16</sup> Exhibit 57 to the Memorial.

<sup>17</sup> Exhibit 58 to the Memorial.

empowered the President to renegotiate public sector contracts. This law became effective two days before the Contract Restatement Proposal was submitted by the Commission to the Minister of the Interior. The Government proposed to include the Contract under the provisions of the 2000 Emergency Law and Siemens did not object, in the belief, according to Siemens, that this step would speed up the approval of the Contract Restatement Proposal.

97. The Minister of the Interior was replaced and, in March 2001, the new Minister, Mr. Mestre, claimed to be unaware of the Contract Restatement Proposal. On May 3, 2001, SITS received a new Draft Proposal from the Government which differed from the Contract Restatement Proposal. On May 8, 2001, SITS replied commenting on the new terms, and requesting the exhibits to the proposal which had not been enclosed. The Minister informed Siemens that the new proposal was not negotiable and, on May 18, 2001, the Contract was terminated by Decree 669/01 under the terms of the 2000 Emergency Law. SITS filed an administrative appeal which was rejected by Decree 1205/01.

## **V. Allegations of the Parties**

98. The Tribunal will now describe at length the allegations of the parties as they relate to the facts of the dispute.

### **1. Memorial**

99. In its Memorial, Siemens has framed its claim in the context of the Treaty, the Convertibility Law of 1991, Decree No. 2128/91, and the State Reform Law of 1989. Siemens contends that it entered into the Project based on the assurance of the authorities' commitment and the legal security framework provided by these instruments.

100. Siemens explains that significant investments were made during 1999 and further investments were made in 2000, due to Argentina's requirements as a prerequisite for resuming income-generating operations, for an aggregate amount of \$284 million up to May 18, 2001. Additional expenses exceeding \$9.1 million were incurred after termination of the Contract and until September 2002.

101. Siemens claims that the following results were achieved:

- (i) as regards the DNM sub-system, establishment of the immigration information center, and the immigration flows and border control systems at three locations; the Government first hindered this component from becoming operational and later hindered its functioning, but Argentina has nonetheless benefited from better processing, follow-up and control of immigration proceedings, and the generation of single, non-duplicate files for each alien, containing all identification data, which reduced tampering possibilities;
- (ii) as regards the RNP sub-system, the engineering stage was completed by August 1999 and it became operational by August 19, 1999, the electronic loading of the Remaining Human Potential File (“Back Record Conversion” or “BRC”) was performed (by December 1999, 45.8 million individual records had been digitalized), an ID personalization center was completed, hardware and software were acquired, buildings were fitted, the communications network was implemented, training courses were held, more detailed and demanding System applications were developed, and a pilot test not required under the Contract was performed. However, because of the measures taken by Argentina, only 3,189 DNIs were issued over a period of 147 days as opposed to 12,000 DNIs foreseen as the initial daily average;
- (iii) as regards the DNE sub-system, the electoral information component was completed by August 1999, and SITS carried out the processing, printing and distribution of provisional lists and final voting rolls for the national elections of October 24, 1999; and
- (iv) physical and IT security equipment and technical support were provided by SITS to the three implementation agencies.

102. Siemens explains that the investments were financed through capital contributions by Siemens through SNI in the amount of \$27 million, through loans made by one of the wholly owned subsidiaries or in minor amounts



by local financial institutions (later refinanced by Siemens directly or through SNI and totaling approximately \$242 million), and through non-financial funding by the Siemens Group in the amount of \$15 million approximately up to May 18, 2001. Siemens further explains that the investments were exclusively applied to the Project since SITS was a special purpose company used by Siemens only for the execution of the Project.

103. Siemens alleges that, during the first year of the Contract, Argentina failed to make budgetary provision for the obligations it had undertaken under the Contract, to provide facilities for Project development, to assign appropriate personnel to fill the different positions and take the corresponding training courses. Siemens also alleges that Argentina delayed approval of the Functional Operational Model (“FOM”) during seven months notwithstanding its relevance, failed to execute with the provincial authorities the agreements to carry out production of the new DNIs throughout the country, failed to adopt the measures necessary to replace the existing DNIs by those issued through the System, and failed to discontinue the manual system of issuing DNIs. Siemens observes that these breaches of the contractual obligations were noted by the independent auditor hired by the Government.

104. Siemens recalls that in the context of these failures, in August 1999, Argentina requested SITS, on account of the October elections, to postpone commencement of the new DNIs production until October 1, 1999 for foreign residents and November 1, 1999 for Argentine citizens. Later Argentina requested that the discontinuation of the old DNIs be postponed to November 30, 1999, except for certain jurisdictions for which a new deadline of January 31, 2000 was established.

105. According to Siemens, after the October elections, the new authorities failed to make budgetary provision for the second year of the Project and to enter into agreements with the provincial authorities. Argentina also delayed providing the technical definitions essential to complete the immigration component and, as a result, it did not start to operate until February 1, 2000.

106. Siemens refers to the suspension of the DNM sub-system on February 2, 2000, allegedly because of lack of authorization to operate the sub-system given that public funds were at issue. According to Siemens, the requirement of such authorization was not provided for in the Contract and was not required for the border control component of the DNM sub-system. Siemens alleges that SITS never got an adequate response and was never paid for the documents actually processed.

107. Regarding the suspension of production of DNIs on February 24, 2001, Siemens affirms that this is a technical inconsistency that could have been quickly solved by modifying one sentence in the printing software. Siemens recalls that Article 17 of the Contract established a procedure in the event that errors were detected but, instead of respecting it, the Argentine authorities prohibited SITS from introducing any correction while the Contract was in effect.

108. According to Siemens, since January 2000 the newly elected authorities had made public announcements reported in the press indicating their intention to renegotiate the Contract to obtain a reduction in the DNI price, a larger number of free DNIs and a postponement of the discontinuation of the manual system. Siemens submits that the actions taken in February 2000 by Argentina suspending the two income-generating activities of the Project had the objective of pressuring SITS to re-negotiate the Contract at the point at which most of the investment for the Project had been made.

109. Siemens explains that, during the renegotiation of the Contract with the Commission from March to November 2000, each proposal made by SITS was rejected and resumption of the operation of the System was subject to ever more demanding economic concessions. In November 2000, as explained by Siemens, the parties agreed on the basic terms on which the Contract would be reinstated and the immediate System operation would be resumed, namely, a \$5 reduction in the price of the DNIs (in part to be compensated by a \$3 increase in airport passengers' fees to be passed on to SITS), an increase in the annual free-of-charge DNIs from 75,000 to 250,000, and a reduction in the immigration and voting roll printing fees. Siemens draws to the attention of the Tribunal that the Ministry of Finance authorities opined favorably on the new terms as also did

the RNP, DNM and DNE. The restated terms were set forth in the Contract Restatement Proposal provided by the Government to Siemens on November 30, 2000 with the understanding that this proposal would now be formalized by the Government.

110. Siemens explains that the 2000 Emergency Law was published on November 21, 2000 and that, in order to facilitate the approval of the terms agreed, the Commission proposed to include the Contract under the provisions of the 2000 Emergency Law in a note to the Minister of the Interior dated November 23, 2000.<sup>18</sup> The Minister declared the Contract subject to the 2000 Emergency Law by Resolution No. 1779 of December 6, 2000.<sup>19</sup>

111. Siemens alleges that, when in March 2001 a new Minister of the Interior was appointed, he claimed to be unaware of the agreement reached between the two parties and the undertaking made by the President. The new Minister ordered, on April 6, 2001, the inclusion in the administrative file of the minutes, dated October 30, 2000, of a meeting of Directors of Provincial Registry Offices rejecting the Contract continuation. According to Siemens, he also instructed Sindicatura General de La Nación (“SIGEN”), RPN, DNM and DNE to re-analyze matters related to the Contract and these agencies reached different conclusions from when they reviewed the Contract Restatement Proposal.

112. Siemens refers to the new Draft Proposal presented to Siemens on May 3, 2001 with terms significantly different from those negotiated, mainly, reduction of the number of DNIs to be issued to almost one half as it did the effective term of the Contract, and elimination of the obligation to discontinue issuance of the old DNIs. Siemens points out that the exhibits referred to in the Proposal were not furnished to SITS. According to Siemens, the only purpose of this proposal was to trigger a rejection and create an excuse to terminate the Contract. In its Reply on May 8, Siemens recalled that the parties had already reached an agreement and certain aspects had already been implemented, and that the changes indicated above were unacceptable because they changed completely the economic-financial equation, and requested the missing exhibits

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<sup>18</sup> Exhibit 55 to the Memorial.

<sup>19</sup> Exhibit 60 to the Memorial.

to complete the evaluation. The Minister responded immediately indicating that failure to accept such proposal as a whole would result in early termination of the Contract. In fact, even when the proposal was presented to Siemens as a draft, the instruction of the Minister was that the Proposal was to be notified for acceptance or rejection.<sup>20</sup>

113. Siemens argues that such a proposal was only an illegitimate tool to avoid liability for frustrating the Contract. In this respect, *inter alia*, Siemens points out a number of irregularities in the proceedings for the Contract termination, such as the failure to obtain the Ministry of Economy's consent to subject the Contract to the 2000 Emergency Law and factual inaccuracies, e.g. the covering letter from the Minister of the Interior to the President submitting Decree 669/01 stated that the Contract costs were beyond the capabilities of the Government notwithstanding that there were no supporting budgetary reports and in November 2000 the Ministry of Economy had opined otherwise,<sup>21</sup> and the Government had approved the budget for the proposed restated terms of the Contract which in turn had been approved by Congress on December 12, 2000 and the President on December 29, 2000.<sup>22</sup> Siemens also points out that said letter reports errors in the System without supporting evidence (errors which were disregarded by the President), it uses the Provinces' opposition to the Project notwithstanding that the Contract was undertaken by Argentina itself within its exclusive powers,<sup>23</sup> and it exaggerates deliberately the costs based on RPN's analysis.

114. Siemens points out that the Contract was terminated on the sole grounds of the 2000 Emergency Law, which termination was ratified by Decree No. 1205/01 rejecting SITS's appeal against Decree 669/01. Siemens recalls that Argentina denied SITS access to the administrative file for purposes of filing the appeal and presenting evidence in support of its claims. Siemens alleges that the administrative file was not made available until Siemens reported the secret handling of the file and Siemens had filed the claim under the Treaty. After

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<sup>20</sup> Exhibit 66 to the Memorial.

<sup>21</sup> Exhibit 53 to the Memorial.

<sup>22</sup> Exhibit 70 to the Memorial.

<sup>23</sup> Article 2 of Law No. 17,671. Exhibit 35 to the Memorial.

Contract termination, Siemens claims that Argentina caused delays in the transfer and reception of equipment and in the assessment of the compensation, and never returned the performance bond, which had lost its purpose once Argentina terminated the Contract unilaterally. According to Siemens, SITS continued to provide technical support, train personnel as agreed in cases of Contract termination, assigned to the Government ownership of the computer hardware, the installed communications equipment and fittings and the non-exclusive licenses for use of application software, and requested the Ministry of the Interior to arrange for the transfer of the satellite links.

115. Siemens points out the passivity of the Government during the months that followed the termination of the Contract and that in November 2001, the Ministry of the Interior called the SITS' sub-contractors to conduct a test and assess the possibility of resuming production of the DNIs without Siemens. According to Siemens, the tests conducted in *Casa de Moneda* were satisfactory and *Casa de Moneda* proposed to produce DNIs through the System provided by SITS.

## **2. Counter-Memorial**

116. In its Counter-Memorial, Argentina alleges that Siemens raised false expectations by the statements made in the bid for the Contract. Siemens had stressed its experience and that of its sub-contractors in high-performance secure systems to meet automated data and image-capturing requirements for issuing passports, foreign resident documents, drivers licenses, visas, frequent traveler cards, health plan cards and DNIs, but in reality neither Siemens nor SNI had been involved in projects of a similar size because no country in the world had undertaken a project of the complexity, size and significance of the Project. According to Argentina, Siemens and SNI lacked the technical expertise to provide a comprehensive service involving the operation and support of a secure and reliable personal identification, migration control and electoral information system.

117. As regards Siemens' claim that Argentina delayed the approval of the FOM and it is at fault for the non-implementation of the External Circuit,

Argentina argues that Siemens presents a traditional notion of contracts with the parties' obligations bearing a relationship of interdependence and does not take into account the particularities and complexities surrounding the procurement of information technology products and services. Argentina explains that the Contract is a turnkey information technology contract including tailored software development and it is inevitable that there will be some uncertainty as to the actual completion date of the work.

118. Argentina alleges that in this type of contract the reporting and advisory duties of the information technology service provider and product supplier play a key role in maintaining the balance between the parties. Argentina recognizes that it received assistance from technical personnel who participated in the guideline-setting stages for the technical definition of the System, but this is not sufficient, argues Argentina, to eliminate the imbalance in technical expertise level between the parties.

119. As regards the approval of the FOM, Argentina describes how, a few days before the deadline for the presentation of the FOM, it requested SITS to deliver the working papers so that RNP's technical staff could advance with the examination of the FOM. SITS never provided the documentation requested. Argentina refers to a number of communications sent to SITS that show the delay in the acceptance of the FOM by Argentina was due to inconsistencies in the FOM proposed by SITS. To further support its argument, Argentina refers to two reports prepared by RNP on the weaknesses of the FOM submitted by SITS and the security of the FOM. In brief terms, several items in the FOM submitted by SITS did not comply with applicable law, were defined on a general or incomplete basis, or failed to provide specifications for the security, audit, and quality and management control of the System. Argentina infers from the foregoing that SITS' technical qualifications were not sufficient to perform the Contract and that it used the Project to gain experience.

120. As regards the External Circuit, Argentina explains that SITS and Argentina through RNP agreed that the proposed model could not be implemented as described in the Contract and SITS was requested to design an External Circuit taking into account the following general guidelines: (i) flexible

terms for a gradual regional implementation; (ii) installation of computers in the Manual Data Capture Centers under the charge of SITS to facilitate form scanning; (iii) set-up of scanning and quality control centers in every provincial capital, for purposes of resolving any possible rejection of the applications in the applicant's location; and (iv) the maintenance by the contractor of the investment levels that had originally been agreed.

121. Argentina further explains that it is not surprising that the Provinces were not interested in signing framework agreements for the External Circuit since they were not advantageous from an economic point of view; under them, the Provinces would receive lower compensation while the expenses they had to incur for the System to work efficiently were higher. Argentina also refers to the nature of its federal system of government where the Government cannot oblige the Provinces to enter into agreements to cooperate in the performance of functions that belong to the Federal Government.

122. Argentina argues that SITS was aware of the circumstances of the country, it had admitted that the design of the External Circuit was not consistent with the social reality of Argentina and it was necessary to do a comprehensive review of the design, the External Circuit could not be implemented until the FOM was approved on condition that SITS fulfilled certain requirements, and, in the agreement signed between Argentina and SITS on November 26, 1999, the Coordinator of the Project at RNP and the SITS' Project Director were empowered to introduce amendments to the System set-up schedules and in the size of the Electronic Data Capture Centers.

123. Argentina also argues that, given the long presence of Siemens in the country and as a product and service provider to the public sector, SITS should have been aware of the political issues that would necessarily have an impact on the performance of some stages of the Contract and compliance with its obligations.

124. Argentina alleges that data capture for the External Circuit could not be set up in the Provinces because of the suspension of manufacturing, printing and distribution of DNIs on February 24, 2000. Argentina alleges also

non-compliance by SITS with its obligation to deposit the source codes in escrow and transfer them to the Government upon completion of the Contract. Argentina affirms that without the source codes it could not properly operate the System after termination of the Contract. Furthermore, Argentina had detected errors in the System and the source codes were necessary to correct SITS' work.

125. Argentina contends that, contrary to Siemens' claim that Argentina did not comply with the schedule provided for in the Contract to cease issuing DNIs manually, SITS had agreed to reformulate the terms of the Contract applicable to begin issuing new DNIs and consented to the extension of the term for the discontinuation of manual DNI issuance.

126. Argentina explains that the Contract did not amend the law regulating when DNIs are issued and updated. The law requires that a DNI be issued when a baby is born and this document is updated when the child reaches school age. Then a photograph is added to the identity document and the right thumb fingerprint is stamped on the document. This DNI is replaced when a person turns sixteen and a new photograph is taken. Then this DNI is updated when a person turns thirty. In order to determine whether the Project was economically advantageous, SITS should have calculated the number of DNIs that had to be replaced.

127. According to Argentina, the RNP sub-system was the most important undertaking since the revenues it would generate would guarantee the expected return on the investment made by Siemens, and it was precisely in the design of this sub-system that SITS failed to comply with its obligations. On February 23, 2000, the RNP head of the Aliens Division reported that federal police officers had discovered that on two DNIs belonging to foreigners the fingerprint was incorrectly identified, e.g., the left thumbprint was identified as the right thumbprint. Argentina explains that the technical report states that the fingerprint experts verified that the fingerprints had been correctly taken by RNP staff. The head of the RNP Aliens Division concluded that the error was in the design of the System which was entrusted exclusively to the Claimant, which defeated the purpose of implementing an information technology system to avoid the risk of human error.



128. Argentina contests that Article 17 of the Contract was applicable in that situation. Argentina explains that such article is intended to regulate the parties' conduct in the event of any possible physical error of the identity document and not an error involving the inappropriate design.

129. Argentina then turns to the 2000 Emergency Law and points out that this law provided that the events of *force majeure* foreseen in sections 53 and 54 of Law No. 13,064 were considered to have occurred, that within 30 days the Government should determine the contracts subject to the provisions of the 2000 Emergency Law, that government contracts would not be terminated if the continuation of the works or the performance of the contract was possible on the basis of the "shared sacrifice" principle, and that compensation payable in the case of those contracts revoked on grounds of convenience, merit and advisability would not include lost profit or unproductive expenses.

130. Argentina further points out that in no circumstances did the Contract entail the privatization of the System's operation and that the goal of the Commission established by Resolution No. 263/00 was to find a solution ensuring the continuity of the Contract given the crisis in Argentina. Argentina explains the doctrine of unforeseeability that would apply in the emergency situation:

"There is certainly no obligation for the Government to compensate the contractor as the events causing the contractual imbalance are totally beyond the Government's control. There is nothing that would prevent the strict and specific application of the contract provisions and thus the termination of the contract [...] However, no benefit for the public interest can be derived from this situation; quite the contrary, the public interest will not be satisfied by the abrupt interruption of the service provision. Thus, the doctrine of unforeseeability or unforeseeable risk may be applied to these cases. According to the doctrine, the Government has to provide assistance to the concessionaire, sharing the risks that

unpredictability might have arisen for purposes of avoiding a total collapse of the licensed service.”<sup>24</sup>

131. Argentina further explains that it is obliged to revoke a public contract when the public need that would be satisfied by the contract disappeared or new public demands require that it be terminated. Revocation by reason of public interest is one of the cases of a Government’s liability for lawful actions and entails the obligation to compensate the contractor whose individual right is sacrificed for the sake of the public, but compensation shall not include lost profits or unproductive expenses.

132. Argentina disputes Siemens’ affirmation that the Government took advantage of the passing of the 2000 Emergency Law allegedly to accelerate the implementation of the agreement concluded with Siemens. Argentina explains that it is correct that SITS participated in the report prepared by the Commission, but it is not correct that such report had to be considered by the Government and SITS as a formal and final renegotiation proposal. According to Argentina, the report was an initial contract renegotiation proposal which included the Contractor’s point of view.

133. Argentina also questions the position taken by Siemens in respect of the role of SIGEN and its refusal to furnish the cost structure of SITS’ services. According to Argentina, SIGEN was unable to determine the reasonableness of compensation to SITS because it had not access to conclusive information about the cost of the services. Argentina disputes the allegation that the reduction of the original DNIs price reflected SITS’ share of the sacrifice to continue with implementation of the Contract. Argentina recalls in this respect that Article 4.6.2 of the Contract required disclosure of SITS’ cost structure where extraordinary and unforeseeable events materially and adversely affect the original economic and financial equation of the Contract.

134. Argentina also takes issue with the characterization by the Claimant of the 2000 Emergency Law as an instrument devised to hurt the Claimant. Argentina also contests the truthfulness of the assertion by Siemens

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<sup>24</sup> E. García-Enterría and T. Ramón Fernández, *Curso de Derecho Administrativo* (1997), vol. I, p. 732. Counter-Memorial, para. 555.

that it has been penalized by pursuing this arbitration and lists a number of public sector contracts won by Siemens in recent years. According to Argentina, Siemens continued to do business with the Government and with other public sector players and provided new services after the termination of the Contract.

135. Argentina describes the steps involved in the reception of SITS' assets to justify the delay, which it also ascribes to lack of cooperation by SITS at that stage. Indeed, according to Argentina, SITS refused to participate in the asset verification process because the inventories already submitted by SITS included all necessary specifications for asset identification. In fact, according to Argentina, SITS' inventories in most cases referred to total quantities without a breakdown that would permit actual verification of the assets' existence and their relevance to the System. Argentina claims that, in contrast, the Notary General's Office recorded the asset verification proceedings, including a list of the assets present in the various agencies belonging to the System and unequivocal information regarding each and every asset.<sup>25</sup>

136. Argentina also refers to the issue of the verification of certain computer equipment stored at the Siemens National Route 8 plant in San Martin County in the Province of Buenos Aires. Argentina claims that the Government was only informed of the existence of such equipment in a presentation made by SITS to the Asset Reception Committee on September 4, 2001. Argentina explains the difficulties that this revelation presented for the Government as, among other matters, it was uncertain whether these assets were part of the assets to be transferred under Article 10.7 of the Contract and, if they were, it was unclear whether or not the Government should actually receive them because of SITS' refusal to transfer title to those assets until payment was made to SITS. The Asset Reception Committee decided to accept the National Route 8 assets on December 17, 2001 and that on December 20, 2001, both parties should agree on a procedure to receive them. The serious events that happened on that date led to the worst ever political and institutional crisis in Argentina, but once the new authorities were in place in Argentina, the Asset Reception

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<sup>25</sup> Exhibit 144 to the Counter-Memorial.

Committee continued with its work and requested the Tribunal de Tasaciones de la Nación (“TTN”) to appraise the assets.

137. Then Argentina describes the performance tests of the various sub-systems at RPN, DNE and DNM and affirms that in all three cases the technicians concluded that the sub-systems were not operative. Argentina explains that SITS was invited to attend the tests but refused the invitation. Furthermore, the tests had to be carried out without access to the source codes that SITS should have turned over to Argentina at Contract termination. According to Argentina, without the source codes it was not possible to determine the degree of progress by SITS regarding the purpose of the Contract and it was not possible to conduct an accurate appraisal.

138. Argentina provides the breakdown of the appraisal conducted by the TTN, which in the aggregate amounts to AR\$71,735,510, and explains that the items appraised would be valuable only if, among other matters, SITS would deliver the source codes, the licenses for basic software and databases, and the use of SITS’ software licenses. Argentina reports that the TTN pointed out that it was not certain that all licenses could be transferred as their respective contracts did not provide for such possibility.

139. As regards the performance bond, Argentina argues that it ends on termination of the Contract, provided that the Contractor has fulfilled its obligations under the Contract, which has not been the case. Argentina in this respect particularly emphasizes the fact that the source codes and the software licenses have not been delivered by SITS to the Government.

### **3. Reply**

140. In its Reply, the Claimant notes that Argentina recognizes the fundamental facts of the case and the events that frustrated Siemens’ investment. The Claimant takes issue with the argument that Argentina was the weaker party because of an alleged technology gap. The Claimant points out this cannot be true when Argentina had designed the Bidding Terms and Conditions, defined the characteristics of the service, and reserved the right to control and manage the tasks during Contract performance.

141. Siemens disputes that there was a mutually agreed renegotiation process. According to Siemens, the Government took advantage of the sunk cost of Siemens' investment to impose a renegotiation process not provided for in the Contract. Siemens also questions the arguments based on security concerns. Siemens first points out that lack of security or reliability of the System was not the subject of any discussion between the parties during the performance of the Contract, that these arguments were developed after the Contract termination, and that the only audit report issued during the term of the Contract on the security of the System was submitted to the authorities by the external security auditor appointed by the Government, which audit report concluded that the System reasonably complied with the security standards required by the Contract. According to Siemens, this is confirmed by the termination of the Contract with no finding of fault on the part of the Contractor (Decree 669/01) and the ratification of the termination in September 2001 after the SIGEN reports had been issued (Decree 1205/01).

142. Siemens also points out that the security concerns of the old system which motivated the tender (Decree 1310/94) for a new system are still valid, while the security and reliability of the System was never questioned before this arbitration. Siemens surmises that if the real concern had been security, then the logical course of action would have been to allow the Contract's performance, instead of discontinuing the Project and preserving the system that caused the documentary emergency from which Argentina is still suffering.

143. Siemens argues that Argentina distorts reality and deliberately intends to confuse the situation that led to the passage of the 2000 Emergency Law with the economic and political crisis that resulted in the enactment of Emergency Law No. 25,561 in 2002. Siemens explains that, contrary to the description made by Argentina, the 2000 Emergency Law only declared the fiscal accounts in emergency and empowered the new administration to repudiate certain contracts concluded by its predecessor. According to Siemens, the emergency was not related to "extraordinary and unforeseeable" events unrelated to the State as claimed by Argentina, because public deficits fail to

meet such qualifications: the events that led to the enactment of the 2000 Emergency Law were attributable exclusively to the State itself.

144. Siemens contests Argentina's allegations regarding its technical qualifications. Siemens recalls that in the bidding process SITS was allocated the best ratings in terms of experience in the implementation and or administration of the System, and in project integration and capacity to handle the Project. Siemens recalls that Argentina holds Siemens in such high regard that it has repeatedly requested its intervention in other public projects, even after the Contract's termination.

145. Siemens dismisses Argentina's allegations regarding defects in the Contract and recalls that, in compliance with Decree No. 1310/94, the Ministry of the Interior approved the Bidding Terms of Conditions through Resolution No. 2183/96, stating in the whereas clauses that RPN, DNM, DNE, the Ministry of the Interior, the Attorney General's office and SIGEN had been involved in their preparation. RPN, DNM and DNE prepared reports for the Technical Evaluation Committee which concluded: "it may be inferred from the technical reports received, from which contents this Committee finds no reasons to depart,"<sup>26</sup> that the bidders have complied with all the provisions referring to the items and amounts tendered, and that "it is appropriate to share the conclusions reached by the Technical Agencies consulted [RNP, DNM, DNE], that SIEMENS IT's rating is 13.03% higher than the rating [...]."<sup>27</sup> Furthermore, it is Siemens' contention that:

"Only Argentina was in a position to identify its own political, economic and social needs involved in the System. It was also the one that had the duty to set the requirements consistent with its own capabilities and limitations. Contrary to its claims, it was Argentina and not the Contractor that had the duty to inform its contractual party of the economic, political or social limitations that could be encountered in the design, implementation and subsequent development of the Project."<sup>28</sup>

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<sup>26</sup> Reply, para. 137.

<sup>27</sup> *Ibid.*, para. 138.

<sup>28</sup> *Ibid.*, para. 142.

146. As regards the delayed approval of the FOM and the allegation by Argentina that SITS lacked the technical capacity to perform the Contract, Siemens asserts that the reasons that delayed FOM approval were not of a technical nature that could be ascribed to SITS, but originated in the indolent attitude of the Government and its lack of cooperation with SITS.

147. Siemens contests the presentation made by Argentina on the failure of implementing the External Circuit and the implication that it was Siemens that designed this circuit and determined its need. According to Siemens, the model incorporating the External Circuit was created by Argentina taking into account the country's geographical extent and the rules applicable to its personal identification and registration activity. Furthermore, Argentina has justified not making the necessary budget allocations on the basis of ignorance of the characteristics required for the buildings allocated to the External Circuit. Siemens claims that this is not a valid reason because Argentina had all the information to purchase the properties and prepared a budget estimate months later when the System was paralyzed.

148. As regards the failure to discontinue the production of the old manually produced DNIs, Siemens recalls that the "cut-over" criterion was a basic commitment of Argentina under the Contract and an essential component of the Project, that, in any case, Argentina did not meet the new deadlines agreed reluctantly by SITS, and that the error detected by the police occurred several months after the original date of the "cut-over" and after the new deadlines.

149. Siemens contends that the decision to suspend the for-profit-operations of the System were arbitrary. In the case of the fingerprint error, Siemens insists that it originated in a mistaken software sentence found in the programming of one of the applications. According to Siemens, SITS acknowledged the error and offered to correct it immediately, but the Government decided to suspend provisionally the processing of DNIs for Argentine nationals and foreigners throughout the System. The decision remained in effect until the termination of the Contract.

150. Siemens contests the interpretation given by Argentina to Article 17 of the Contract. This Article does not distinguish between design errors and errors related to individual documents; it simply refers to a DNI that may have errors resulting from any cause, whether attributable to SITS or the Government.

151. Siemens recalls that the services provided by SITS to the DNM and DNE were accepted by the relevant agencies and that, in the case of the DNM sub-system, its operation was suspended because of the alleged lack of formal authorization for the launch of the sub-system after one day of operation and not because of the flaws that Argentina now points out, supported by a report of SIGEN of September 2001, four months after termination of the Contract and eighteen months after the suspension of the sub-system operation. According to Siemens, the sub-system is in use by DNM to this date.

152. Siemens questions the use of the technical studies presented by Argentina in this arbitration when the Government did not consider that SITS had committed breaches to allow the Contract's termination, nor did it ever notify SITS of the serious breaches now invoked in accordance with the procedures provided for in the Contract, nor imposed any sanctions whatsoever based on the alleged inconsistencies of the System. According to Siemens, SIGEN produced its reports months after the System had started to operate with express approval of RPN, and after the authorities had already decided to terminate the Contract. Siemens claims that Argentina did not convey the reports or their recommendations to SITS or Siemens and refers to Article 10.2 of the Contract, which provides that:

“Following Systems implementation, but prior to their being put into operation, the security and high degree of inviolability of the Systems shall be tested and certified by a world-class auditor appointed by mutual agreement of the parties. The inexistence of observations from the State's Security Officer shall imply the acceptance of the Systems' security and inviolability test results.”

153. Siemens affirms that the only auditing reports provided for in the Contract determined the reasonable accomplishment of the System's security



standards, including the initial stage, SITS' compliance with its contractual obligations, and the Government's non-compliance with theirs. Siemens points out that these reports were ignored by the Government and excluded from the administrative files, probably, Siemens surmises, because their outcome was deemed unfavorable to Argentina.

154. Siemens recalls that two months prior to the creation of the Commission, and days before the suspension of for-profit operations, the new authorities declared publicly before informing SITS of their intentions that the Contract had to be reviewed. Siemens also recalls that the technical aspects were irrelevant in the discussions to renegotiate the Contract, and that the issues discussed were limited to the reduction in the number of DNIs, migration proceedings prices, the redesign of the External Circuit, the progressive discontinuance of the manual system as opposed to the "cut-over", an increase in the amount of free-of-charge DNIs, etc. Siemens submits that these were not "external circumstances" or an "extraordinary and unforeseeable event that materially affected the equilibrium of the relationship", but reflected the opposition of the new Administration to the obligations undertaken by its predecessor. Siemens notes that, with a high degree of political opportunism, the Government took advantage of the fact that by then most of the investment for the Project had been made.

155. Siemens questions the correctness of the *ius variandi* as understood by Argentina. First, Siemens refers to the acknowledgement by Argentina that the power of the Government to vary the terms may be exercised only to the extent to which the economic balance of the contract is preserved. However, Siemens points out that Argentina neglects to mention the limitations to the *ius variandi*. Indeed, the authority of the State to modify the terms and conditions of the contract does not affect those provisions pertaining to compensation and financial advantages, since it would be contrary to the principle of good faith and to business security to allow the State to modify the contract unilaterally and reduce compensation. Siemens refers to the limitations imposed by the Argentine Constitution and law, in particular the property safeguard (Article 17 of the Constitution), the proportionality principle (Article 28

of the Constitution), the *pacta sunt servanda* rule (Article 1197 of the Civil Code) and the principle of good faith (Article 1198 of the Civil Code).

156. Siemens argues that, when Argentina called for foreign investment to carry out its public sector transformation in 1990, Argentina assumed that some of the legal features of the public contract could discourage investors and deliberately self-limited its public powers and prerogatives. Siemens points out that one of the most important limitations was directed at preventing the unilateral modification or termination of contracts, even if ostensibly in the ‘public interest.’<sup>29</sup> Thus Article 33.6 of the Contract provides that, “Any change or amendment to this Contract shall be agreed upon by the parties and set forth in writing.” Article 26.1 limits early termination by the State to cases of SITS’ fault, and Article 3.5.2 limits early termination by the State until all existing DNIs issued as of the date of the Contract had been replaced.

157. Siemens submits that “if the State does not comply with the previously described limitations, it would be in breach of its duties and it should be accountable for its wrongful acts by fully compensating the contractor for having deprived it of its vested rights and/or having frustrated its legitimate expectations (as appropriate).”<sup>30</sup> Siemens also points out that Argentina does not specify any new events that would justify a different assessment of the public interest as it was when the Contract was awarded; a change of Administration is not a valid legal ground. The renegotiation of the Contract was initiated, not as an exercise of Argentina’s discretionary powers, but as an attempt to depart from its contractual obligations.

158. Siemens insists that there was “no mutual will to renegotiate following a change in circumstances, but a coerced process involving substantial alterations of the initial conditions to the detriment of SITS, strongly conditioned by the fact that – the investment already being made – the State suspended the operations of the income generating systems [sub-systems] [...]”<sup>31</sup>

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<sup>29</sup> *Ibid.*, para. 225.

<sup>30</sup> *Ibid.*, para. 229.

<sup>31</sup> *Ibid.*, para. 242.

159. Siemens recalls the Argentine Supreme Court constitutionality test for emergency measures that restrict individual rights, namely, they may last only as long as necessary to allow the cause of the measures to disappear, and “Even where a more intense exercise of police power is recognized in emergency circumstances, the Supreme Court has repeatedly held that an individual’s own property cannot be taken without a declaration of public use and prior compensation.”<sup>32</sup> The application of the 2000 Emergency Law to terminate the Contract was a political decision and not, as alleged by Argentina, the result of events “absolutely alien and independent from the administrative activity.”<sup>33</sup>

160. Siemens contends that the disclosure of SITS’ cost structure was necessary only at a later stage and points out that, during the 14 months of negotiations prior to SIGEN’s report in March 2001, this issue was never raised. Furthermore, the Contract was based on a price cap and the cost to Argentina did not depend on SITS’ cost structure, the conditions of Article 4.6.2 of the Contract had not been met and the 2000 Emergency Law did not trigger them, and even the Draft Proposal of May 2001 did not require any disclosure.

161. Siemens notes that there was no “shared sacrifice” and that the burden was exclusively on SITS is particularly evident in the May 2001 Draft Proposal intended to provoke a rejection from SITS and to justify the termination of the Contract on the basis of the 2000 Emergency Law. Siemens asserts that its reply to the proposal was not a rejection, but that it only insisted on the need to reach a solution that would respect the parties’ rights and previous commitments, and requested the missing annexes for a correct assessment of the proposal.

162. Siemens recalls that the new Minister of the Interior ordered new reports from RNP, DNM and DNE and that these agencies issued reports in April 2001 that differ from those issued in December 2000, particularly in the case of RNP. The proposal of May 2001 shows that technical issues were not relevant and the disclosure of the cost structure was not required by the State at the time of formulating such proposal. The State had not required it as a condition of the

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<sup>32</sup> *Ibid.*, para. 259.

<sup>33</sup> *Ibid.*, para. 262.

Contract when it was awarded nor was it part of the November 2000 Contract Restatement Proposal.

163. Siemens points out that it was denied access to the administrative file until August 2001 –three months after termination of the Contract – and then it realized that: the file had been started on December 13, 2000, it included documents dated from as early as January 2000, and reports favorable to the Contract's continuation were absent. According to Siemens, such reports apparently had been included in the file and then removed without indicating the reason; notably, the SWIPCO reports were missing and were also ignored in the Counter-Memorial.

164. Siemens then refers to the contracts that Argentina has reported in the Counter-Memorial to have been terminated under the 2000 Emergency Law to respond to the claim of discrimination, and argues that these contracts were not comparable, that main contracts involving foreign investments had been formally excluded, that most of them had been renegotiated and not terminated and that the two public works terminated were in the end terminated because of the contractors' fault. Siemens points out that a passport contract between a local company and the State is not included in the list presented by Argentina, and was not subject to the 2000 Emergency Law notwithstanding how expensive it was.

165. Siemens claims that, after termination of the Contract, the behavior of Argentina was as arbitrary as before, namely, it denied access of SITS to the administrative file, subjected SITS' compensation to the performance and to the physical tests of the System after it had been in the power of the State since its transfer and over which SITS had lost control a long time before, excluded SITS from the tests at *Casa de Moneda*, and issued reports unfavorable to SITS without notifying SITS or including them in the administrative file. Siemens claims that Argentina's lack of good faith is confirmed by bringing before this Tribunal a large number of contractual breaches absent any actual decision of the Government pertaining to the Contract.

166. Siemens affirms that SITS took every possible action to overcome the difficulties placed in its way by Argentina and to avoid the expropriation of the Contract and recover its investment.

167. Siemens points out that it took Argentina 28 months to receive the assets transferred from SITS. Siemens recalls how Argentina did not take measures for the orderly transfer of the non-exclusive licenses for the use of the applications software or the contract for the supply of satellite link services, and all links between SITS' help desk and the System were cut in May 2001. Siemens claims that the passive behavior of Argentina caused losses and jeopardized the System. Hence, SITS could not agree to any physical, performance or functionality test carried out by the Government after its damaging attitude.

168. Siemens notes the positive results of the test at *Casa de Moneda* in order to verify the overall operation of the System. Siemens refers to the following statement in a letter provided by the President of *Casa de Moneda* to the Under-Secretary of the Interior reporting on the test results:

“As per your request, I would like to inform you the positive result of the verification test of the operativity [*sic*] of the General Persons Identification System that forms part of the Argentine and International Public Bidding Process No. 01/96, the contract of which was terminated by Decree 669/01.

[...]

Therefore, it has been verified that it is possible to print identity documents at the plant.”<sup>34</sup>

169. Siemens also points out that SITS' sub-contractors who were present at the tests reported that they “[...] evidenced the successful operation of the systems set up for the production of DNIs, and that pursuant to Section 2 of Decree No. 669/2001 those systems were received by the Government.”<sup>35</sup> Siemens refers to press reports on the satisfactory functioning of the System

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<sup>34</sup> *Ibid.*, para. 341, emphasis added by the Claimant.

<sup>35</sup> *Ibid.*, para. 342, quotation from a note from Imaging Automation.

notwithstanding attempts by officials of RNP to prevent its operation to the extent that floppy disks and software applications containing important information for the issuance of the DNIs mysteriously were lost.<sup>36</sup>

170. Siemens maintains that the source code issue lacks any merit. First, source codes were excluded from the Contract. The Government, prompted by a question of SITS seeking confirmation that the only right to be acquired by the Ministry of the Interior over the software would be a non-exclusive use license, replied: “The requirement included in the bidding terms and conditions related to the software is that the Ministry of the Interior be transferred a permanent and non-exclusive use license”, and “the bidder or contractor may assign all or a portion of the ownership rights over the software if it so accepted.”<sup>37</sup> Siemens affirms that there is no reference in the Contract to software source codes and, to have access to them, Argentina would need to negotiate directly with the software copyright owners.

171. Siemens recalls that software and source codes are protected by Argentine law and international law and that no third party has the right to access, reproduce, execute, adapt and modify them without the copyright holder’s express authorization.

172. Siemens notes that the Respondent never demanded compliance with Article 10.12 of the Contract prior to this arbitration. As the evidence attached to the Counter-Memorial shows, this article was invoked by Argentina for the first time in April 2002, nearly a year after Contract termination and after the provision had lost its effect. Furthermore, the allegation made by Argentina that defects had been detected in the System that require access to the source codes to be corrected is an argument first made by Argentina in its Counter-Memorial.

#### **4. Rejoinder**

173. In its Rejoinder, Argentina points out that it is striking that, notwithstanding the contractual concerns expressed by Siemens in this

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<sup>36</sup> *Ibid.*, paras. 344-345 and footnotes 402 and 403.

<sup>37</sup> *Ibid.*, para. 353, emphasis added by the Claimant.

arbitration, it never saw fit to initiate the dispute settlement provisions set out in Article 30 of the Contract. Argentina emphasizes the seriousness of the breaches of the Contract by SITS, and that Siemens agreed to renegotiate the Contract and to the application of the 2000 Emergency Law to the renegotiation. Siemens was aware of the consequences of renegotiating under that law. Argentina explains that the final proposal was prepared after receiving the opinions of the General Department of Legal Affairs of the Ministry of the Interior and of SIGEN. Argentina also points out that the delay in compensation can be attributed to institutional changes but also to the lack of cooperation of SITS with the Asset Reception Committee.

174. Argentina clarifies that it is true that Siemens won the bid on the basis of Siemens' qualifications as technology leader but the System failed to perform the task identifying and registering individuals pursuant to Law No. 17,671. Argentina affirms that the FOM was never approved and hence the System never existed, only some functions worked.

175. Argentina questions the political motivations alleged by the Claimant at each step of the way. Argentina points out that the FOM approval process already showed before the change of Government that SITS lacked the technical expertise required. The FOM was approved on November 26, 1999, subject to the observations made by RNP, and Argentina allowed SITS to start printing the DNIs beforehand so that SITS could recover its investment. As regards the External Circuit, Argentina clarifies that it was refused by the Provinces because of economic reasons, that it would have been irresponsible to oblige the Provinces considering how onerous the model was and the impossibility of continuing efficiently with the development of the Project, and that SITS agreed with the Government on November 26, 1999 to empower the project coordinator of RNP and the project manager of SITS, together with the Provincial Directors of Vital Records, to amend the schedules of implementation, composition and size of the Electronic Data Collection Centers and established December 20, 1999 as the deadline for implementation.

176. Argentina dismisses the contention that no budgetary allocations were made and refers to pertinent provisions of the budget laws for 1999, 2000

and 2001, and alleges that it would have been irresponsible on the part of Argentina to use the budget to develop a faulty product.

177. Argentina maintains that the manual system to issue DNIs could not be suspended because the System as such never worked. The mistake detected by Argentine police officers was not a minor mistake; it was a major design error in the sub-system. The DNM component also failed; it was installed in less than 10% of the places and presented gross validation mistakes. Argentina argues that SITS failed to bring any action against the measures taken and only objected to Decree 669/01 and then for reasons different from those adduced here.

178. Argentina insists that Article 17 of the Contract referred only to errors related to the physical support and not to the design of the software, that it was essential for the Government to secure the continuation of the System, that the interruption was not a penalty, and that the mistake in the fingerprint did not give rise to the revision of the Contract.

179. Argentina observes that Siemens has not objected to any of the safety-related questions in the report of SIGEN; it simply asserts that it was not notified. In respect of the date when the report was issued, Argentina dismisses the point made by Siemens since surely a report needs some time to be prepared and the date of the report is the date of its completion. Furthermore, Argentina notes that SITS was aware of the preparation of the report since its representatives attended the audit meetings organized by SIGEN.

180. Argentina asserts that at no time has it affirmed that the Contract was rescinded by the Contractor's fault. The reports of the various agencies were used to revise the Contract but the rescission was done under the 2000 Emergency Law. Argentina alleges that it did not inform SITS of any breaches nor imposed any sanctions because it was its intention to preserve the Contract and affirms that at all times it acknowledged that the rescission was a consequence of the economic and financial emergency.

181. Argentina affirms that it does not confuse the emergency of 2000 with that of 2002; the circumstances detected in 1999, which gave rise to the



2000 Emergency Law, are the background to the crisis that burst in December 2001. Argentina asserts that the two crises are linked, contrary to the argument made by Siemens.

182. Argentina explains that the Commission had no power to reach agreement with SITS and, therefore, it could not commit or oblige the State. Argentina describes the Contract Restatement Proposal prepared by the Commission as an internal preparatory document indicating SITS' point of view.

183. Argentina further explains that the report of SIGEN was an internal report of the Administration, and that due to their importance and effects some documents are published on its website. Thus there is nothing surprising that SITS learned of its existence that way rather than through a formal notice. Argentina understands the business reasons for SITS' disagreement with the changes resulting from SIGEN's report, but it does not understand the refusal of SITS to reveal its cost structure which would have assisted the Government in finding a more rapid and favorable solution for the parties.

184. Argentina takes issue with the statements by Siemens that only Siemens was required to do its part in aid of the shared sacrifice principle. To maintain the Contract as Argentina tried to do, adapting it to the economic circumstances of Argentina and its population represented a cost to Argentina over simply letting the Contract collapse.

185. Argentina argues that, when the Claimant did not accept 10 of the 21 points in the Draft Proposal, Argentina concluded that the points accepted by SITS were not sufficient to meet its savings expectations, and that Siemens may not argue now that it did not reject the proposal and that the State frustrated the Contract. Argentina recalls that SITS was informed that the 2000 Emergency Law had passed and that the Contract should not be excluded from it since the Contract was not a privatization contract, and affirms that the purpose of Argentina, when it included the Contract under the 2000 Emergency Law, was not to rescind the Contract but rather to reach an agreement that guaranteed its survival. According to Argentina, Resolution MI No. 1779/00 was clear in stating that the proposal made to the Contractor could be modified by the Contractor, but

in such case the Government could reject the modification and rescind the Contract.

186. Argentina recalls that the System never reached the C2 Security Level required under Annex II, Appendix I of the Contract for the configuration installed in the Document Production Centre (“DPC”) and the Central Scanning Center. Argentina explains that SIGEN security reports in respect of the RPN and DNM were started by SIGEN on December 21, 2000, and February 21, 2001, respectively. The reports show that the Contract needed to be revised and redrafted not only because of errors in the design related to printing of fingerprints but also because of failures in IT security. Argentina explains that, because the Contract was rescinded under the 2000 Emergency Law and not for non-performance reasons, it was not necessary to have the final conclusions of the three audits carried out by SIGEN. On the other hand, according to Argentina, the SIGEN audits are a relevant element to bear in mind for the appraisal of property and equipment delivered by SITS upon termination of the Contract.

187. Argentina argues that the scope of the audit conducted by Pistrelli was limited because of its terms and the time when it took place, and may not be used validly to refute the recourse to SIGEN. Pistrelli’s audit was in the nature of desk work and could analyze the System only in a preliminary phase because it had not started to operate as a whole. On the other hand, affirms Argentina, SIGEN carried out an integral audit after the System operated and the Project was halted due to a mistake in its design. Argentina recalls that RPN criticized the Pistrelli audit and requested elaboration of a number of points and that, as of April 17, 2000, the authorities had not been able to prove whether the security changes requested by RPN had been incorporated.

188. Argentina observes that SITS refused to participate every time tests were carried out in spite of several invitations made by the Government. Argentina also points out that SITS refused to participate in the asset reception process notwithstanding official invitations to this effect. Thus SITS did not participate in the physical cross-checking, operative cross-checking or performance cross-checking because: (i) the inventories of assets already

furnished contained accurate specifications, and (ii) since termination of the Contract it had not been in charge of the operation of the System, did not have access to the equipment and did not know the physical and operative situation.

189. Argentina acknowledges that SITS has the right to compensation and that it has taken all the measures leading to satisfy it.

190. Argentina confirms that the contractual performance bond has not been returned because there has been no compliance of SITS with Article 10.12 of the Contract regarding deposit of the source codes and with Article 10.7 regarding the delivery of licenses for the use of applications software. According to Argentina, the return of the performance bond is not required until the Asset Reception Committee issues a decision as to compliance by SITS with its contractual obligations.

191. Argentina maintains that the agreements between SITS and the sub-contractors have been transferred to the State and that the amount to be paid is included in the amount of compensation assessed by the TTN.

192. Argentina takes exception to the allegation that it has not been diligent in respect of the transfer of the non-exclusive licenses and the satellite links. Argentina contends that the licenses have not been delivered because delivery was subject by SITS to prior payment by the Government. As regards the assignment of satellite links, it was the choice of Argentina to continue or not with the same provider.

193. Argentina rebuts the statements of Siemens on the test of *Casa de Moneda*. In the first place, the test was conducted outside the asset reception process and there was no reason to invite SITS since the Contract by then had been terminated. Furthermore, Argentina affirms that the test was not as successful as the Claimant pretends since documents were printed only and not produced and, even with the assistance of sub-contractors, it was not possible to make the System work appropriately.

194. Argentina then turns to the source codes issue and re-affirms that the codes were necessary for the purpose of determining the extent of compliance by SITS with its obligations within the framework of the 2000

Emergency Law and Resolution ME No. 3/2001. Argentina also questions the statement of Siemens that Argentina had never raised the issue of compliance with Article 10.12. Argentina in fact requested the source codes at the request of the TTN and SITS breached Article 10.12 by not providing them. Argentina explains that the value of the source codes has been included in the assessment carried out by the TTN.

## **VI. Merits of the Dispute**

195. Argentina has based its defense on its submission that the claim of Siemens is grounded on issues of contractual performance, while Siemens maintains that its claim is based on breaches of the Treaty, including the breach of the umbrella clause – Article 7(2) of the Treaty. The Tribunal will address this question first and, before turning its attention to the other specific claims related to expropriation, fair and equitable treatment, and arbitrary and discriminatory measures, it will consider the relevance of SITS’ and Siemens’ agreement to the Contract Restatement Proposal and alleged agreement of SITS and Siemens to include the revision of the Contract under the framework of the 2000 Emergency Law.

### **1. Umbrella Clause**

#### **a) Positions of the Parties**

196. The Tribunal will start by recalling the specific arguments of the parties on the meaning of Article 7(2) of the Treaty. This article reads as follows:

“Each Contracting Party shall observe any other obligation it has assumed with regard to investments by nationals or companies of the other Contracting Party in its territory.”

197. Siemens argues that Argentina breached Article 7(2) of the Treaty by failing to comply with its obligations with regard to Siemens’ investment. According to Siemens, such obligations may be contractual obligations in agreements between States and investors or broader undertakings contained in the States’ national investment legislation. The effect of Article 7(2) is to protect investments against interferences with contractual rights and licenses elevating

them to violations of the Treaty regardless of breaches of Articles 2 and 4. Siemens observes that this conclusion is even more compelling if the State does so in bad faith, for political reasons and lacking public purpose. Siemens also finds that this conclusion is confirmed by Article 10(1), which covers all “[d]isputes concerning investments in the sense of this Treaty between a Contracting Party and a national or company of the other Contracting Party [...]”

198. In its Counter-Memorial, Argentina reviews the history of the umbrella clauses and in particular refers to the concept of the essential base of the claim introduced in *Woodruff v. Venezuela*<sup>38</sup> and used in *Vivendi II* for purposes of determining the validity of the forum choice in the contract. Argentina finds further support in its argumentation in *Ronald S. Lauder v. the Czech Republic*<sup>39</sup>, *Alex Genin, Eastern Credit Limited, Inc. and A.S. Baltoil v. the Republic of Estonia*<sup>40</sup>, *CMS Gas Transmission Company v. Argentine Republic*<sup>41</sup> and *SGS Société Générale de Surveillance S.A. v. Islamic Republic of Pakistan*.<sup>42</sup> In the latter case, Argentina points out that the tribunal insisted that the text of the clause has to be unambiguous and that there must be clear and convincing evidence of the purpose of the umbrella clause to elevate contractual claims to treaty claims. Argentina also finds support in *SGS Société Générale de Surveillance S.A. v. Republic of the Philippines* since both SGS tribunals were moved by the goal of preventing the transformation of contractual claims into international claims.

199. Argentina points out that the tribunal in *SGS v. Philippines* restricts the commitments to which the clause is applicable: “For Article X(2) to be applicable, the host State must have assumed a legal obligation, and it must have been assumed vis-à-vis the specific investment – not as a matter of the application of some legal obligation of a general character. This is very far from

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<sup>38</sup> *Woodruff v. Venezuela*, RIAA, Vol. IX, p. 213, AL RA No. 72.

<sup>39</sup> *Ronald S. Lauder v. the Czech Republic*, Award (September 3, 2001), published in [www.mfcr.cz/Arbitraz/en/FinalAward.doc](http://www.mfcr.cz/Arbitraz/en/FinalAward.doc), Siemens LA No. 6.

<sup>40</sup> *Alex Genin, Eastern Credit Limited, Inc. and A.S. Baltoil v. the Republic of Estonia*, ICSID Case No. ARB/99/2, Award (June 25, 2001), AL RA No. 73.

<sup>41</sup> *CMS Gas Transmission Company v. Argentine Republic*, ICSID Case No. ARB/01/8, Award (May 12, 2005), AL RA No. 64.

<sup>42</sup> *SGS Société Générale de Surveillance S.A. v. Islamic Republic of Pakistan*, ICSID Case No. ARB/01/13, Decision on Objections to Jurisdiction, 18 ICSID Review 307, para. 163, AL RA No. 74.

elevating to the international level all ‘the municipal, legislative or administrative or other unilateral measures of a Contracting Party.’<sup>43</sup> Furthermore, according to Argentina, if there is an exclusive contractual forum selection clause, the forum specified in the contract is the forum with jurisdiction over contractual matters.

200. Applying these considerations to the instant case, Argentina argues that “the clause can only be invoked *vis-à-vis* an Investment Agreement in the case of breach of the Agreement and not *vis-à-vis* a concession contract governed by domestic administrative law and containing an agreed upon forum clause. Siemens intentionally confuses the Investment Agreement with the investment, terms that are not equivalent and cannot be merged.”<sup>44</sup>

201. In its Reply, Siemens affirms that Article 7(2) includes obligations arising from a contract. Siemens finds that the attempt by Argentina to distinguish between an investment agreement and domestic utility contracts has no support under the terms of investment treaties or in their ordinary meaning. Siemens points out that Articles 7(2) and 10(1) use the term “investments”, which is broadly defined and that claims raised under an umbrella clause are additional to and independent of claims based on the other protections under the Treaty. According to Siemens, under an umbrella clause, “any violation of a contract thus covered, becomes a violation of the BIT. The consequence is that the BIT’s clause on dispute settlement becomes applicable to a claim arising from the breach of the contract.”<sup>45</sup>

202. Siemens argues that case law supports its claims under article 7(2) of the Treaty. First, it refers to the criticism of the *SGS v. Pakistan* in *SGS v. Philippines* which termed that decision unconvincing because it failed to give any clear meaning to the umbrella clause. Siemens points out that the facts of the instant case are different because *SGS v. Pakistan* did not involve any allegation of sovereign interference with the Contract. Second, Siemens recalls the conclusion of the tribunal in the Philippines case: “[the umbrella clause] makes it

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<sup>43</sup> *SGS Société Générale de Surveillance S.A. v. Republic of the Philippines*, ICSID Case No. ARB/03/10, Decision on Objections to Jurisdiction (January 29, 2004), para. 121, cited in the Counter-Memorial, para. 1039.

<sup>44</sup> Counter-Memorial, para. 1047.

<sup>45</sup> Reply, para. 591, citing Professor Schreuer’s legal opinion.

a breach of the BIT for the host state to fail to observe binding commitments, including contractual commitments, which it has assumed with regard to specific investments.”<sup>46</sup> Third, Siemens rebuts the argument of Argentina that a more specific provision shall take precedence over a more general one. Relying on the opinion of Professor Christoph Schreuer, Siemens contends that this argument in fact favors Siemens’ position:

“The dispute settlement clause in the BIT is merely a standing offer to investors. By accepting that offer an investor perfects a specific arbitration agreement. The ICSID arbitration agreement, as perfected through the institution of proceedings, applies only to the specific dispute. By contrast, the dispute settlement clause in the Contract refers to any dispute arising from the Contract. It follows that the ICSID arbitration agreement is the more specific one. The principle *generalia specialibus non derogant*, should work against the contractual forum selection clause and in favor of ICSID.”<sup>47</sup>

Fourth, Siemens rejects the arguments on the essential claim base and the contractual forum clause for having been already rejected by the Tribunal in its decision jurisdiction.

203. Argentina in its Rejoinder denies as a primary submission that there were any breaches of its obligations towards the Claimant and, if the Tribunal would consider otherwise, then these would be a contractual matter to be determined by the proper law of the Contract and not international law. Furthermore, Argentina contests the meaning attributed by the Claimant to the umbrella clause, and points out that, in the case of *SGS v. Philippines*, the wording of the clause was different and it referred to “specific” investments, and that, in any case, the tribunal found that the umbrella clause did not “convert the issue of the extent or content of such obligations into an issue of international law.”<sup>48</sup> Argentina explains that the case law provides very little authority to

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<sup>46</sup> *SGS v. Philippines*, para. 128, quoted in the Reply, para. 599.

<sup>47</sup> Legal opinion of Professor Schreuer, quoted in the Reply, para. 603.

<sup>48</sup> *SGS v. Philippines*, para. 128, quoted in the Rejoinder, para. 667.

support the approach embraced by the Claimant and that *SGS v. Pakistan* and *Salini v. Jordan*<sup>49</sup> are evidence of the unwillingness of arbitral tribunals to embark on the resolution of contractual disputes. Argentina concludes by reminding the Tribunal that the approach proposed by the Claimant would re-write the Treaty, depart from the classical approach to the arbitral function under international law, and bring into play the provisions of Article 52 of the Convention.

**b) Considerations of the Tribunal**

204. The Tribunal considers that Article 7(2) has the meaning that its terms express, namely, that failure to meet obligations undertaken by one of the Treaty parties in respect to any particular investment is converted by this clause into a breach of the Treaty. Whether an arbitral tribunal is the tribunal which has jurisdiction to consider that breach or whether it should be considered by the tribunals of the host State of the investor is a matter that this Tribunal does not need to enter. The Claimant is not a party to the Contract and SITS is not a party to these proceedings.

205. In regards to the scope of Article 10(1), the Tribunal concurs with the submission that reference to disputes related to investments would cover contractual disputes for purposes of the consent of the parties to arbitration given the wide meaning of the term “investments” and the terms of Article 7(2). However, to the extent that the obligations assumed by the State party are of a contractual nature, such obligations must originate in a contract between the State party to the Treaty and the foreign investor as, for instance, in the *SGS* cases.

206. The Tribunal does not subscribe to the view of the Respondent that investment agreements should be distinguished from concession agreements of an administrative nature. Such distinction has no basis in Article 7(2) of the Treaty which refers to “any obligations”, or in the definition of “investment” in the Treaty. Any agreement related to an investment that qualifies as such under the Treaty would be part of the obligations covered under the

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<sup>49</sup> *SGS v. Islamic Republic of Pakistan*, quoted in the Rejoinder, para. 673; *Salini v. Kingdom of Jordan*, ICSID Case No. ARB/02/13, Award (January 31, 2006), quoted in the Rejoinder, para. 673.



umbrella clause. The Tribunal does not find significant, for purposes of the ordinary meaning of this clause, that it does not refer to “specific” investments. The term “investment” in the sense of the Treaty, linked as it is to “any obligations”, would cover any binding commitment entered into by Argentina in respect of such investment.

## **2. Consent of Siemens and SITS**

207. The positions of the parties related to the argument advanced by Argentina to the effect that SITS or Siemens agreed to the measures taken by Argentina have already been described. The Tribunal recalls that such argument is based on the fact that SITS and Siemens agreed to the Contract Restatement Proposal in November 2000, that no administrative appeal was filed by SITS except with respect to Decree 669/01, and that they did not object to the ministerial Resolution placing the Contract under the regime of the 2000 Emergency Law.

208. As regards the agreement to the Contract Restatement Proposal, Argentina itself contends that it was a preliminary agreement that was not binding. In any case, Argentina modified the proposal and SITS did not accept certain terms of the revised proposal. Thus it is difficult to understand how it can be held that SITS or Siemens have agreed to the Contract Restatement Proposal if its terms were not an agreement but, as argued by Argentina, an internal document in which the views of the private party were expressed and Argentina did not accept them.

209. The argument on the consent of Siemens and SITS to the application of the 2000 Emergency Law to the Contract is even more puzzling to the Tribunal. It is expected that individuals and companies will obey the law; it is not a question of choice, as would be the option to accept a negotiated proposal.

210. It is a matter of dispute between the parties as to whether Siemens or SITS did not object to the application of the 2000 Emergency Law regime to the Contract because they were led to believe by the Respondent that this would speed up the administrative processing of the Contract Restatement Proposal. Whatever the reasons for not objecting, Argentina always had the

power to apply the 2000 Emergency Law to the Contract, irrespective of the position of Siemens or SITS on the matter, and it did. It is clear from the evidence that the expectation of Siemens was that the Contract Restatement Proposal would not be modified even if this may have been possible under the 2000 Emergency Law. It would lack logic that a high official of Siemens would be received by President de la Rúa to plead that a decree be issued on terms different from those negotiated.

211. To conclude, the Tribunal considers that, for purposes of evaluating the measures taken by Argentina in light of its commitments under the Treaty, the allegations based on the consent of Siemens or SITS are not relevant.

212. The Tribunal will now turn to the other specific commitments under the Treaty alleged by Siemens to have been breached by Argentina. Since the parties understand these commitments differently, not only as they apply to the facts of this case but also in their meaning, the Tribunal will describe first in respect of each commitment the arguments made by the parties on its scope and meaning.

### **3. Expropriation**

#### **a) Positions of the Parties**

213. Siemens argues that its investment has been expropriated indirectly as a result of measures taken by Argentina. According to Siemens, whether or not Argentina intended to expropriate its investment is irrelevant, what is of essence is the actual effect of the measures on the investors' property: "measures that indirectly, but effectively, deprive an investor of the use or enjoyment of its investment, including the deprivation of the whole or a significant part of the economic benefit of property, are as expropriatory as the seizure of an investor's formal title to its property."<sup>50</sup>

214. Siemens further argues that contractual rights and the right to complete a project are part of the property rights that may be expropriated and that government measures that frustrate such assurances and substantially

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<sup>50</sup> Memorial, para. 248.

deprive investors of their rights to have them respected amount to an expropriation.

215. According to Siemens, irrespective of whether or not the purpose of a State measure affects its legality, it does not affect the State's obligation to compensate the investor promptly, adequately and effectively; as plainly stated in Article 4(2) of the Treaty, the public purpose of expropriatory measures by either State party in no way alters the legal obligation to compensate investors affected by those measures. Failure to provide prompt, adequate and effective compensation renders the expropriation unlawful whether or not it is for a public purpose.

216. Siemens claims that the acts and omissions of Argentina were expropriatory measures that substantially deprived Siemens of the use and enjoyment of its investment, and significantly reduced its value without payment of any compensation. Siemens relied on the following assurances given and obligations undertaken by Argentina: (i) replacement of all DNIs previously issued by new DNIs issued through the System; (ii) discontinuation of the issuance of manual DNIs; (iii) implementation of the System on a nationwide basis; (iv) processing of immigration proceedings through the System and payment of the corresponding fees; and (v) adoption of all measures necessary to fulfill the obligations under the Contract and regular collection of SITS' revenues resulting from the fees and prices paid by the users.

217. According to Siemens, these assurances constituted essential conditions of its investment and Argentina was aware of its meaning as recognized in the report of the Commission:

“Progressive replacement of all DNIs [...] is actually the State's guarantee rather than an obligation of the contractor, and defines the value of the contract [...]

[...] the contract term, which is defined as a six-year term that may be extended for two three-year periods, prescribes a mechanism that guarantees returns on the investment made; this relates to the need to have all existing DNIs replaced by the ones dealt with in the contract

[...].”<sup>51</sup>

218. Siemens affirms that the acts and omissions of Argentina qualify as “measures” under Article 4(2) of the Treaty. According to Siemens, the term “measures” is an all encompassing term for any actions attributable to a State that may affect an investment and includes acts performed by its different organs and subdivisions. In the case of its investment, Siemens refers to the following measures that resulted eventually in its expropriation:

(i) From the date of execution of the Contract and up to August 1999 Argentina failed to meet the obligations it had undertaken to allow the performance of the Contract on schedule; it did not make the necessary budget allocations, it did not provide the funds and human resources necessary to make the system operational, it delayed approval of the FOM, it failed to execute agreements with the Provinces, and it did not adopt the statutory and executive measures necessary to carry out the replacement of existing DNIs by those issued through the System.

(ii) Argentina pressed SITS into postponing the initial date for DNI production because of the then upcoming elections and into agreeing to postpone until January 31, 2000 discontinuation of the manual issuance of DNIs.

(iii) Argentina failed: (A) to adopt alternative measures to implement the System throughout its territory even when the RNP had the exclusive power to issue the DNIs and gather the information to produce them, (B) to provide budget allocations for the Project for the year 2000, (C) to provide the technical definitions to complete implementation of the immigration proceedings system and the imposition of new requirements not included in the new Project, and (D) to provide the facilities to implement the External Circuit to extend the System throughout the national territory.

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<sup>51</sup> Quoted in para. 277 of the Memorial.

(iv) Argentina notified Siemens in January 2000 that it intended to reduce the originally agreed-upon prices in the Contract and that agreement to the reduction was a condition for the continuation of the Contract and, in February 2000, unjustifiably halted immigration processing and DNI production through the System.

(v) The negotiations that ensued were concluded in November 2000 with the promise that the System's revenue-generating operations would immediately resume, and to speed approval of the new contractual terms the Contract was subjected to the Emergency Law of 2000. Notwithstanding assurances of the President of the Republic that a decree would be issued approving the new terms before the end of the year, the new terms were never approved.

(vi) New terms were proposed by Argentina in May 2001 on a take it or leave it basis without providing the basic elements for an evaluation of the proposal. The new proposal was not acceptable to SITS, which indicated its willingness to consider alternatives. Argentina terminated the Contract on May 18, 2001 invoking the power granted under the 2000 Emergency Law and without reference to any technical or other reason related to the fulfillment of the Contract by SITS.

(vii) After termination of the Contract, Argentina failed to pay compensation, although it had acknowledged its obligation to do so, denied the right of defense to SITS when SITS filed an appeal against Decree 669/01, failed to receive the equipment, facilities and instruments used in Project execution, and refused to return the Contract performance bond although it was mandatory to return it at Contract termination.

(viii) Siemens' investment was the only foreign investment expropriated under the 2000 Emergency Law and the public purpose invoked to terminate the Contract was merely an excuse to legitimize the measure adopted by the Government for political convenience, since economic studies carried out by the Ministry of Economy had recommended renegotiation of the terms agreed by the parties.

219. Siemens concludes by affirming that the aggregate of these measures amounts to a creeping expropriation of its investment and submits that, notwithstanding that Argentina's conduct constitutes a case of creeping expropriation, it seems reasonable to consider May 18, 2001, the date of Decree 669/01, as the date of expropriation for valuation purposes. Siemens adds that the Treaty states that the value of an investment for purposes of compensation is determined by reference to the date before the intention to expropriate became known, and, therefore, the effects of the taking itself and any act related to the taking, including threats to take the asset concerned, that may have diminished the value of the property or enterprise on the date of the taking, shall not be considered in the valuation and that Siemens is entitled to compensation for any loss suffered before or after May 18, 2001 caused by Argentina's creeping expropriation.

220. In its Counter-Memorial, Argentina denies that it expropriated Siemens' investment and draws the Tribunal's attention to the following sentence of Article 4(2) of the Treaty: "The legality of the expropriation, nationalization or similar measure, and the amount of the indemnification should be reviewable through ordinary legal proceedings." Based on this sentence, Argentina asserts that it is entitled to apply this review option to any future decision of the Tribunal in connection with the alleged expropriation.

221. Argentina challenges the qualification of events by Siemens. It is Argentina's contention that for events to lead to an expropriation each one of them should affect the investment adversely. However, when the main feature of a contract is to provide one set of goods -the System in the instant case-, it is not possible to speak of successive acts, either the Contract is thwarted or not. Argentina argues that Siemens is unable to provide evidence that the alleged expropriatory events affected the investment adversely. In this respect, Argentina refers to the statement of Siemens that it agreed to renegotiate the Contract not only to save it but also because the Government had promised to resume the System's operation. This means, according to Argentina, that the Contract would not have been thwarted and there could not be a creeping expropriation. Argentina finds support for its line of argument in *Generation Ukraine, Inc. v.*

*Ukraine*, which admitted difficulty in finding many cases that fall under the creeping expropriation category and stated:

“A plea of creeping expropriation must proceed on the basis that the investment existed at a particular point in time and that subsequent acts attributable to the State have eroded the investor’s rights to its investment to an extent that is violative of the relevant international standard of protection against expropriation.”<sup>52</sup>

222. Argentina then develops the argument that Siemens’ claim is a purely contractual claim and international law does not include regulations on contracts, as acknowledged in *Saudi Arabia v. Arabian American Oil Company (Aramco)*, *Robert Azinian, Kenneth Davitian & Ellen Baca v. The United Mexican States*<sup>53</sup>, and by Professor Brownlie<sup>54</sup>. Furthermore, Siemens has not contributed evidence showing, as stated by the Annulment Committee in *Vivendi II*, clear conduct contrary to the relevant standard in the circumstances of the case. Argentina disputes the relevance of the Iran-US Claims Tribunal case law because the law applicable to the cases before that tribunal is different from the law applicable in this arbitration. That tribunal has to rule on contractual disputes, can apply commercial usages and has highly discretionary powers in deciding the applicable law. Argentina reminds the Tribunal that the applicability of the legal principles developed by the Iran-US Claims Tribunal was explicitly rejected in *Pope & Talbot, Inc. v. Canada*<sup>55</sup> and *S.D. Myers, Inc. v. The Government of Canada*<sup>56</sup>. Argentina also argues in detail the inapplicability to the instant case of holdings by the tribunals adduced by Siemens regarding acquired international rights: (i) *Aramco* was concerned with the application of international law to a contract that included its own stabilization clause, (ii) *Revere Cooper & Brass*,

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<sup>52</sup> *Generation Ukraine, Inc. v. Ukraine*, ICSID Case No. ARB/00/9, Award (September 16, 2003), para. 20.26, quotation in the Counter-Memorial, para. 911.

<sup>53</sup> *Saudi Arabia v. Arabian American Oil Company (Aramco)*, 27 I.L.R. 117, 165, AL RA No. 45; *Robert Azinian, Kenneth Davitian & Ellen Baca v. The United Mexican States*, ICSID Case No. ARB (AF)/97/2, Award (November 1, 1999), ICSID Review, Foreign Investment Journal 1, 25, AL RA No. 47, cited in the Claimant’s Memorial, para. 917, 919.

<sup>54</sup> I. Brownlie: *Principles of Public International Law*, Oxford University Press, 5<sup>th</sup> ed., 1998, 550, 551, AL RA No. 46, cited in the Claimant’s Memorial, para. 918.

<sup>55</sup> *Pope & Talbot, Inc. v. Canada*, Interim Award (September 13, 2001), AL RA No. 50, cited in the Counter-Memorial, para. 926.

<sup>56</sup> *S.D. Myers, Inc. v. The Government of Canada*, Partial Award (November 13, 2000), cited in the Counter-Memorial, para. 926.

*Inc. v. Overseas Private Investment Corporation*<sup>57</sup> was a classic investment agreement protecting the investment differently from an investment treaty and it was internationalized by a stabilization clause, (iii) *Antoine Goetz et consorts v. Republic of Burundi*<sup>58</sup> was concerned with the revocation of a permit to operate in a free trade zone, (iv) *CME Czech Republic B.V. (the Netherlands) v. The Czech Republic*<sup>59</sup> was not concerned with contractual guarantees by a State, and (v) the findings of *CME* were contradicted by *Lauder*.

223. Argentina questions how Siemens has drawn the line to delimit the State's legitimate actions from actions entitling an investor to compensation. Argentina argues that, if the effect of depriving a person of its property is the criterion for this purpose, then any regulation would be expropriatory because regulations have a damaging effect on regulated parties. Argentina refers to the proportionality test advanced by *Tecmed* between the measures taken and the public interest pursued by them, and to the deference due to the State when it defines issues of public policy. Thus this requires a more complex analysis than proposed by Siemens.

224. Argentina finds support in recent arbitral awards - *Consortium RFCC v. Royaume du Maroc*<sup>60</sup>, *Waste Management, Inc. v. United Mexican States*<sup>61</sup>, *Generation Ukraine, SGS v. Philippines* - for arguing that a breach of treaty is not a breach of contract, it is not enough to qualify a contractual breach as a treaty violation, there should be a reasonable effort by the investor to obtain compensation through the domestic channels under the law applicable to the contract, and the State should not have used its sovereign powers to amend pre-existing legal situations and the parties' rights and obligations. In this respect, Argentina affirms that:

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<sup>57</sup> *Revere Copper and Brass, Inc. v. Overseas Private Investment Corporation*, Award (August 24, 1978).

<sup>58</sup> *Antoine Goetz et consorts v. Republic of Burundi*, ISCID Case No. ARB/95/3, Award (September 2, 1998).

<sup>59</sup> *CME Czech Republic B.V. (The Netherlands) v. The Czech Republic*, Partial Award (September 13, 2001).

<sup>60</sup> *Consortium RFCC v. Royaume du Maroc*, ICSID Case No. ARB/00/6, Award (December 22, 2003), para. 38 (AL RA 60), cited in the Counter-Memorial, para. 972.

<sup>61</sup> *Waste Management, Inc. v. United Mexican States*, ICSID Case No. ARB(AF)/00/3, Award (April 30, 2004), para. 171 (AL RA 61).



“(a) it did not act under its *ius imperii* powers; (b) it terminated the contract with SITS under the habitual and ordinary forms provided therefor by Argentine law; (c) such act did not thwart any right granted to the investor or its affiliate under the law of the Contract; and (d) after the termination of the Contract it was not engaged in any acts aimed at thwarting the rights agreed upon with SITS for the termination.”<sup>62</sup>

225. Argentina also affirms that, like the Philippines in the *SGS* case, it had “not issued any act (law or decree in sovereign function) aimed at disregarding the possible contractual rights of SITS. Should there be any debt, it would still exist.”<sup>63</sup>

226. Argentina requests the Tribunal to focus on two aspects of *Generation Ukraine*. First, arbitral tribunals do not exercise the function of an administrative review agency. Second, arbitral tribunals should consider the changes in the economy of the State hosting the investments when assessing the investor’s legitimate expectations. Argentina also calls the attention of the Tribunal to the holding in *Waste Management II*, to the effect that international expropriation law is not meant to eliminate the ordinary risk assumed by foreign investors, and to the fact that, under the Contract, SITS took responsibility for the business risk.

227. Argentina denies that it gave Siemens any warranty or profitability assurance, and claims that Siemens agreed to revise the Contract when faced with the failure of the essential features of the System and the substantial alteration of the economic conditions under which the Contract was intended to be carried out. Argentina contends that Siemens must comply with the Contract before requesting its fulfillment and lists as breaches of the Contract concealed from the Tribunal the following: delay in the design of the FOM and the Security Operating Model, the imperfect designs for the Security Operating Model, the External Data Capture Circuit and fingerprint taking, ignorance of the Argentine personal identification system, failure to deliver the source codes, vulnerability of

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<sup>62</sup> Counter-Memorial, para. 969.

<sup>63</sup> *Ibid.*, para. 986.

the System, and the hindrances placed by SITS during the entire reception process, including its refusal to participate.

228. In any case, pleads Argentina, even if the arguments of Argentina were rejected, the mere “effect” criterion applied by the Iran-US Claims Tribunal would not result in an expropriatory effect of the alleged actions of Argentina under Argentine law applicable to the Contract.

229. In its Reply, Siemens rejects the allegation of Argentina that, under Article 4(2), it has the right to submit to review before the local courts the potential award of this Tribunal. Siemens explains that this Article grants the investor, who is the only party affected by the expropriation measures, the right to challenge the legality of the expropriation and the amount of the compensation in ordinary judicial proceedings.

230. Siemens then questions the definition of expropriation used by Argentina in its allegations, namely, that expropriation may occur only directly or through measures that autonomously and independently affect the investment adversely, that deprivation of or substantial interference with contractual rights does not constitute an expropriation under international law, and that the effect of the measure should completely thwart the investment or be unreasonable,

231. Siemens notes that the Treaty includes measures tantamount to expropriation and explains that provisions on indirect expropriation are usually generic statements given the great variety of possible measures. Siemens refers to the findings by the tribunals in *Compañía del Desarrollo de Santa Elena S.A. v. The Republic of Costa Rica*,<sup>64</sup> *CME, Metalclad Corporation v. The United Mexican States*,<sup>65</sup> *Tippetts, Abbett, McCarthy, Stratton v. TAMS-AFFA Consulting Engineers of Iran*,<sup>66</sup> *Middle East Cement Shipping and Handling Co.*

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<sup>64</sup> *Compañía del Desarrollo de Santa Elena S.A. v. The Republic of Costa Rica*, ICSID Case No. ARB/96/1, Award (February 17, 2000).

<sup>65</sup> *Metalclad Corporation v. The United Mexican States*, ICSID Case No. ARB(AF)/97/1, Award (August 30, 2000).

<sup>66</sup> *Tippetts, Abbett, McCarthy, Stratton v. TAMS-AFFA Consulting Engineers of Iran*, Case No. 7, Award No. 141-7-2- (June 22, 1984), 6 IRAN-U.S. C.T.R. (1986), 219, at pa. 225, Legal Authorities No. 23, cited in the Memorial, para. 243.

*S.A. v. Arab Republic of Egypt*<sup>67</sup> and *Tecmed* to show the endorsement of the notion of indirect expropriation by arbitral tribunals; such expropriation takes place by a variety of measures that by themselves would not necessarily be expropriatory or adversely affect the investment, nor would they need to be intended to be expropriatory. Siemens refers to scholarly opinion on the notion of creeping expropriation:

“In some, if not most other, creeping expropriations, however, that intent [to expropriate], though possibly present at some level of the host state’s government, will be difficult, if not impossible to discern. Discrete acts, analyzed in isolation rather than in the context of the overall flow of events, may, whether legal or not in themselves, seem innocuous vis-à-vis a potential expropriation. Some may not be expropriatory in themselves. Only in retrospect will it become evident that those acts comprised part of an accretion of deleterious acts and omissions, which in the aggregate expropriated the foreign investor’s property rights.”<sup>68</sup>

232. Siemens alleges that an analysis of *Biloune and Marine Drive Complex Ltd. v. Ghana Investments Centre*,<sup>69</sup> *Tradex Hellas S.A. v. Republic of Albania*,<sup>70</sup> *Santa Elena*, *Tecmed*, *Generation Ukraine* and Iran-US Claims Tribunal jurisprudence shows that expropriatory measures that take place step by step should be analyzed in their aggregate effects and not “autonomously and independently” as argued by Argentina. Siemens concludes that the termination of the Contract was not the only expropriatory step but the last of a clear chain of measures taken by Argentina since 1999 that destroyed the value of Siemens’ investment.

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<sup>67</sup> *Middle East Cement Shipping and Handling Co. S.A. v. Arab Republic of Egypt*, ICSID Case No. ARB/99/6, Award (April 12, 2002).

<sup>68</sup> M. Reisman *et al*, “*Indirect Expropriation and its Valuation in the BIT Generation*”, 74 *BYIL* (2003) pp. 123-124, cited in the Reply, para. 422, emphasis added by the Claimant.

<sup>69</sup> *Biloune and Marine Drive Complex Ltd. v. Ghana Investments Centre*, Award on Jurisdiction and Liability (October 27, 1989), 95 *Int’l Law Reports* (1994), 184, at pa. 210-11, Claimant’s Legal Authorities No. 35, cited in the Memorial, para. 372.

<sup>70</sup> *Tradex Hellas S.A. v. Republic of Albania*, ICSID Case, No. ARB/94/2, Award (April 29, 1999).

233. Siemens disputes Argentina's assertion that there cannot be expropriation following contractual breaches and repudiation of the Contract. Siemens refers to the opinion of Professor Schreuer, who states that:

“[...] the mere fact that the investment was made on the basis of a contract does not preclude a violation of the BIT [the Treaty]. Nor does an allegation of contract violations mean that a BIT claim cannot arise from the same facts. The standards are simply different. It is incumbent upon the Claimant to demonstrate a violation of the BIT. This task is not made impossible or more onerous by the simultaneous existence of contract violations.”<sup>71</sup>

234. Siemens further disputes the argument that, when a contract is subject to a domestic legal system, expropriation of rights under the contract would be precluded. Siemens maintains that the law governing a particular contract and whether contractual rights may be expropriated are two distinct and unrelated questions; contractual rights may be expropriated as tangible property may be expropriated. Siemens also questions the argument that a contract cannot be governed by international law unless it contains a stabilization clause: “the decisive point is that the absence of a stabilization clause does not mean that the contract cannot be the object of an expropriation. The expropriation of rights under a contract containing a stabilization clause would merely give rise to an additional claim for violation of that clause.”<sup>72</sup>

235. Siemens recalls that Article 1 of the Treaty defines as protected investments “every kind of asset” and specifically “rights to funds used to create economic value or to any performance with an economic value” and “concessions conferred by public law entities.” Siemens alleges that judicial practice unanimously supports a wide concept of property that includes rights under contract, e.g., the decisions in *Rudloff*<sup>73</sup>, *Norwegian Shipowners*<sup>74</sup>, *Factory at Chorzów*<sup>75</sup>, and the case law of the Iran-US Claims Tribunal.

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<sup>71</sup> Reply, para. 433.

<sup>72</sup> *Ibid.*, para. 438, quotation from Professor Schreuer's legal opinion.

<sup>73</sup> *Rudloff Case*, Interlocutory Decision, 1903, 9 Reports of International Arbitral Awards (RIAA) 244, 250 (1959), Legal Authorities 40, quoted in the Reply, para. 442.

236. According to Siemens, a breach of contract or actions affecting contract rights may constitute an expropriation when: (i) the breach consists of one or part of a series of acts that combine to effect a creeping expropriation; (ii) the breach is of such fundamental nature that it goes to the heart of the promised performance and adversely affects the continuance of the project concerned; (iii) regulatory conduct denies contract rights or requires their alteration; (iv) specific contract rights or rights under a contract as a whole are repudiated, and (iv) a stabilization clause is breached. Siemens affirms that most of these situations apply in the instant case.

237. As regards the argument that Argentina did not act in its sovereign capacity, Siemens finds the argument implausible given termination of the Contract by decree, rejection of the appeal by decree, and termination based not on contractual grounds but on the 2000 Emergency Law. Furthermore, Argentina has argued that a decisive reason for the termination was that a substantial number of Provinces refused to participate in the implementation of the Project.

238. Siemens explains that the purpose of the measures is not a criterion to determine whether an expropriation has occurred. Under Article 4(2) of the Treaty, public purpose is a criterion for the expropriation's legality, "Similarly, proportionality and reasonableness may play a role in assessing whether the power to expropriate has been exercised properly. But these criteria do not affect the question whether an expropriation exists or not."<sup>76</sup> Commenting on the cases relied on by Argentina, Siemens observes that they relate to regulatory takings, while Siemens was deprived of its investment through measures taken directly against it and not through regulatory measures.

239. Siemens rejects the argument that it needed to seek prior recourse through domestic channels and observes that this is an attempt to reintroduce an argument already put forward at the jurisdictional stage. Siemens

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<sup>74</sup> *Norwegian Shipowners' Claims (Norway v. United States)*, Award (October 13, 1922), 1 *RIAA* 307, p. 325.

<sup>75</sup> *Certain German Interests in Polish Upper Silesia (Germany v. Poland)*, Judgment (May 25, 1926), *PCIJ Series A, No. 7*, p. 44.

<sup>76</sup> Reply, para. 465, quotation from Professor Schreuer's legal opinion.

explains that, under Article 26 of the Convention, the Contracting Parties waive the local remedies rule unless they state otherwise, which Argentina has not done and, in any case, SITS and the Claimant made every reasonable effort to obtain correction of Argentina's measures through domestic means, including an administrative appeal against Decree 669/01. Contrary to the factual situation in the cases of *Waste Management II* and *Generation Ukraine* adduced by Argentina, in the instant case Siemens' loss is persistent, irreparable, caused by the Government and not by low-level officials whose acts of maladministration might easily be corrected.

240. Siemens also dismisses the argument that it may not be entitled to claim under the Treaty because it allegedly failed to perform its own obligations. Siemens observes that Article 4(2) does not impose any duty with regard to the investor; there is no defense based on the failure to comply with the other party's duties.

241. Argentina in its Rejoinder affirms that Siemens fails to draw the line between a contractual breach and the expropriation of an agreement, and clarifies that it referred to *Waste Management II* in its argument because the tribunal in that case established criteria for expropriation of an agreement, namely, an effective repudiation of the property rights of the investor which prevents it from exercising them entirely or to a substantial extent, and not redressed by remedies available to the claimant. Argentina emphasizes the reasonableness of the measures taken as part of the expropriation concept and as held by the European Court of Human Rights and *Tecmed*.

242. Argentina contends that the measures were taken under the usual and ordinary forms of terminating an agreement and Siemens failed to reply to its arguments and focused instead on whether the measures were taken in the exercise of its *ius imperium*. Argentina insists that there is a requirement of making a reasonable effort on the part of the investor to obtain correction in the domestic jurisdiction, and that this is a substantive requirement to distinguish between an act of maladministration from an act which constitutes an expropriation, "not because there is a requirement of *exhaustion* of local remedies but because the very reality of conduct tantamount to expropriation is

doubtful in the absence of a *reasonable* – not necessarily exhaustive – effort by the investor to obtain correction.”<sup>77</sup> In this respect, Argentina argues that SITS failed to comply with its essential duties and agreed to re-negotiate the Contract to conform to the fiscal possibilities of the State and the pocketbook of the people.

243. Argentina takes issue with the contention of Siemens that the defense of non-performance does not apply because investors may assert their rights under the Treaty. Argentina argues that the exception *non adimpleti contractus* is equally a principle of international law. Argentina maintains that the conditions set in *Waste Management II* for contract expropriation are not met in this case. According to Argentina, the actions taken before Decree 699/01 were in response to technical errors and failures to deliver on the part of SITS and its sub-contractors. Argentina insists that the termination of the Contract by Decree 669/01 was not only based on economic considerations but also on technical grounds after receiving independent advice. Therefore, Decree 669/01 was a legitimate, rational and proportionate response to a disappointing and inadequate performance of SITS’ contractual obligations; it was not an expropriatory measure since “[i]t left intact the Claimant’s contractual rights, and in particular the ability to have recourse to the national courts of Argentina to challenge acts of its contractual partner which it considered to have breached the Contract.”<sup>78</sup>

244. Argentina further develops the argument that investment treaties are not a guarantee of profits to foreign investors and contends that if Decree 669/01 were to be considered expropriatory by the Tribunal, then the expropriation is a lawful expropriation because “it was a reasonable and proportionate response to a national fiscal crisis; it was carried out for a public purpose; it was not discriminatory on national or any grounds; and the decree contained within its terms provision for compensating SITS for cancellation of the Contract.”<sup>79</sup> Argentina explains that there were at least two major public policy reasons for the termination of the Contract: the massive fiscal crisis which necessitated cutting back projects involving a high level of public expenditure,

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<sup>77</sup> *Generation Ukraine*, para. 20.30, quoted in Rejoinder para. 544.

<sup>78</sup> Rejoinder, para. 571.

<sup>79</sup> *Ibid.*, para. 572.

and the inability or unwillingness of a substantial number of Provinces to participate in the Project given the fiscal crisis.

**b) Considerations of the Tribunal**

245. Before considering the arguments dealing with expropriation proper, the Tribunal will address the issue of contractual claims as opposed to treaty claims which has been argued by the parties in the context of the asserted breach of Article 4(2) and also of Article 7(2) (the umbrella clause). Subsequently, the Tribunal will discuss whether under Article 4(2) the findings of this Tribunal are subject to review by the ordinary courts, whether each individual measure in a creeping expropriation needs to be considered autonomously, whether the proper law of the Contract is relevant for purposes of expropriation, whether intent of the State to expropriate is necessary or only the effects of the State's measures need to be considered, whether an expropriation has taken place, and, if so, whether it conformed with the Treaty requirements.

**i) Treaty claims and Contract Claims**

246. Argentina has argued that at no time in the course of the dispute with SITS it took measures that could be regarded as an exercise of its police powers as a State, including when it terminated the Contract under the 2000 Emergency Law. The Tribunal considers that Argentina's view of when a State acts *iure imperii* is exceedingly narrow and inconsistent with the arguments advanced by Argentina itself.

247. The distinction between acts *iure imperii* and *iure gestionis* has its origins in the area of immunity of the State under international law and it differentiates between acts of a commercial nature and those which pertain to the powers of a State acting as such. Usually States have been restrictive in their understanding of which activities would not be covered by their immunity in judicial proceedings before the courts of another State. Here we have the reverse situation where the State party posits a wide content of the notion of *iure gestionis*.

248. In applying this distinction in the realm of investor-State arbitration, arbitral tribunals have considered that, for the behavior of the State as



party to a contract to be considered a breach of an investment treaty, such behavior must be beyond that which an ordinary contracting party could adopt and involve State interference with the operation of the contract:

“ Pour qu’il y ait droit à compensation il faut que la personne de l’exproprié prouve qu’il a été l’objet de mesures prises par l’Etat agissant non comme cocontractant mais comme autorité publique. Les décisions aux cas d’expropriation indirecte mentionnent toutes l’ ‘interférence’ de l’Etat d’accueil dans l’exercice normal, par l’investisseur, de ses droits économiques. Or un Etat cocontractant n’ ‘interfère’ pas, mais ‘exécute’ un contrat. S’il peut mal exécuter ledit contrat cela ne sera pas sanctionné par les dispositions du traité relatives a l’expropriation ou à la nationalisation à moins qu’il ne soit prouvé que l’Etat ou son émanation soit sorti(e) de son rôle de simple cocontractant(e) pour prendre le rôle bien spécifique de Puissance Publique. ”<sup>80</sup>

249. *Waste Management II* distinguished a number of categories to determine whether it was faced with a matter of contract non-performance or expropriation. In the first category are those cases “where a whole enterprise is terminated or frustrated because its functioning is simply halted by decree or executive act, usually accompanied by other conduct.”<sup>81</sup> In the second category fall instances of “acknowledged taking of property, and associated contractual rights are affected in consequence.”<sup>82</sup> The third category includes cases “where the only right affected is incorporeal.”<sup>83</sup> In the latter cases, “the mere non-performance of a contractual obligation is not to be equated with a taking of property, nor (unless accompanied by other elements) is it tantamount to expropriation. Any private party can fail to perform its contracts, whereas nationalization and expropriation are inherently governmental acts.”<sup>84</sup>

250. The tribunal in *SGS v. Philippines* excluded as a treaty claim the debt owed to SGS because there had not been a “law or decree enacted by the

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<sup>80</sup> *Consortium R.F.C.C. v. Kingdom of Morocco*, ICSID Case No.ARB/00/6, Award (December 22, 2003), para. 65.

<sup>81</sup> *Waste Management II*, para. 172.

<sup>82</sup> *Ibid.*, para. 173.

<sup>83</sup> *Ibid.*, para. 174.

<sup>84</sup> *Idem.*

Philippines attempting to expropriate or annul the debt, nor any action tantamount to an expropriation [...] A mere refusal to pay a debt is not an expropriation of property, at least where remedies exist in respect of such a refusal.”<sup>85</sup>

251. In the *Jalapa Railroad* case, the US-Mexican Mixed Claims Commission decided: “Here the Government of Veracruz stepped out of the role of contracting party and sought to escape vital obligations under its contract by exercising its superior governmental power.”<sup>86</sup>

252. In *Salini v. Jordan*, the tribunal held:

“Only the State, in the exercise of its sovereign authority (*puissance publique*), and not as a Contracting Party, has assumed obligations under the bilateral agreement. [...] In other words, an investment protection treaty cannot be used to compensate an investor deceived by the financial results of the operation undertaken, unless he proves that his deception was a consequence of the behavior of the receiving State acting in breach of the obligations which it had assumed under the treaty.”<sup>87</sup>

253. What all these decisions have in common is that for the State to incur international responsibility it must act as such, it must use its public authority. The actions of the State have to be based on its “superior governmental power”. It is not a matter of being disappointed in the performance of the State in the execution of a contract but rather of interference in the contract execution through governmental action.

254. In the instant case, what actions did Argentina take to step out of its role as a contractual party? In the first place, Argentina issued Decree 669/01 on the basis of the 2000 Emergency Law. Argentina has advanced the argument that termination of the Contract by Decree 669/01 was based not only on the fiscal emergency but also on the failures of the Contractor. This is not a credible argument inasmuch as Decree 669/01 and Decree 1205/01 did not provide for

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<sup>85</sup> *SGS v. Philippines*, para. 161.

<sup>86</sup> Referred to in Professor Schreuer’s legal opinion, p. 50. Whiteman, *Digest of International Law* (1976), vol. 8, pp. 908-909.

<sup>87</sup> *Salini v. Jordan*, para. 155.

termination based on non-performance and Argentina itself has manifested in these proceedings that at no time had it affirmed that the Contract was rescinded by the Contractor's fault.<sup>88</sup>

255. Argentina itself has argued that the Tribunal should defer to Argentina in deciding what is in the public interest of Argentina, and should consider the measures taken by Argentina – the 2000 Emergency Law and Decree 669/01 - as a response by the State to the impending financial and social crisis. The Tribunal has no intention of second guessing the considerations that led Argentina to declare a fiscal emergency in 2000. At this stage, the Tribunal simply notes that this argument is not consistent with the submission that Decree 669/01 was a measure taken as a simple contracting party. Whether Decree 669/01 is a measure in breach of the Treaty is a question that the Tribunal will address later.

256. In the view of the Tribunal, Decree 669/01 is not the only measure that can be attributed to Argentina as a State. Argentina used its governmental authority on other occasions. First, Argentina interfered in the contractual relationship with SITS by requiring changes in the economic equation when the change of Government occurred and nearly a year before the fiscal emergency was declared. Argentina has claimed that, as a State, it has a right under administrative law to request changes in a contract. The Tribunal considers that, irrespective of whether the changes requested were or were not within the *ius variandi* of the State (a disputed matter between the parties), this is a right that Argentina claims as a State in order to control the deteriorating fiscal situation in the country. This is an assessment by the State related to the public interest and not one that would pertain to a regular contractual party.

257. Second, Argentina failed to enter into the agreements with the Provinces related to the External Circuit. The Tribunal considers this matter to be beyond a contractual breach because Argentina relies on its political structure to excuse itself from the obligation undertaken and because it relied on it as a matter of policy for terminating the Contract. As a State, Argentina should know

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<sup>88</sup> Paras. 222 and 232 of the Rejoinder.

what is possible for it to do (or not to do) with respect to its Provinces and the extent to which it may honor its commitments because of its own political structure.

258. Third, the *permanent* suspension of the two main components of the Project –the RPN sub-system and the DNM sub-system – also falls in the non-contractual category. The fact that an authorization was needed and never given for the immigration component is clearly a governmental act which had no basis in the Contract and its need came to light only when the DNM sub-system started to operate and in the context of Argentina expressing its intention to renegotiate the Contract. The alleged authorization requirement is suspect because the Contract had been drafted by Argentina and all the agencies that were involved later when the Contract was in effect had previously reviewed the terms of the Contract. The “provisional” suspension of the RPN sub-system is reasonable in terms of checking and correcting errors; what exceeds the contractual role and does not fit with Argentina’s legitimate security concerns is that SITS was not allowed to correct the error and that the manual system is still in effect as it was when the Contract was open for bids. During the Contract renegotiation, the resumption of the RPN sub-system was not linked to security concerns.

259. Fourth, Decree 669/01 provides for compensation to be paid. Argentina has not paid compensation, using arguments that go beyond its rights under the Contract. We refer to the issue of the source codes. SITS may or may not have complied with Article 10.12. At this stage it is immaterial because the Contract has been terminated and this article only required that the source codes be deposited with a notary public until the termination of the Contract. There is no provision of the Contract that requires delivery of the source codes to Argentina at Contract termination. There are provisions covering delivery of non-exclusive licenses but not of source codes. This is such an important matter in the technology field, as Argentina itself has argued, that it could not have been left to interpretation and guesswork. If it had been really intended *ab initio* that the source codes would have to be delivered to Argentina, the Contract would have specifically provided for this obligation. This is confirmed by the answer given by

the Ministry of the Interior to Question No. 48 of SITS during the bidding stage of the Contract. The Minister had been asked to confirm that, under Article 95 of the Contract, the Ministry of the Interior's only right in respect of the software would be a non-exclusive license to its use. The Minister replied that the Bidding Terms and Conditions required that a permanent and non-exclusive license of use of the software be transferred to the Ministry. The Minister added: "This notwithstanding the bidder or the contractor may transfer in full or in part the property rights to the software if it would be acceptable [to the bidder or the contractor]." <sup>89</sup>

260. The Tribunal concludes that, in the actions listed above, Argentina acted in use of its police powers rather than as a contracting party even if it attempted at times to base its actions on the Contract. As to the other allegations made by Siemens, they relate to delays, non-budgetary allocations, or continuation of the manual system to issue DNIs and are actions that, in the context, could be construed as acts of a contractual party or of the sovereign acting as such. They are not essential to a finding of expropriation and the Tribunal will not consider them.

**ii) Ordinary Courts' Review of the Legality of the Expropriation and of the Amount on Account of the Compensation under Article 4(2) of the Treaty**

261. Article 4(2) provides that the legality of the expropriation, nationalization or equivalent measure, and the amount of compensation, may be subject to review by the ordinary courts. Argentina has reserved its right to apply this review option to any future decision of the Tribunal in connection with the expropriation. The context of the sentence does not support any right of Argentina in that respect. Article 4(2) is concerned with expropriation, nationalization or measures tantamount to either taken by the parties to the Treaty, and with the compensation paid. It is that expropriation or nationalization or compensation that is subject to the review of the ordinary courts, not a

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<sup>89</sup> Exhibit 94 to the Memorial, emphasis added by the Tribunal. Translation by the Tribunal.

decision by this Tribunal. The objective of the sentence in question is to ensure that the investor has access to the ordinary local courts to review actions by the Government. It is a right that the parties accord to the investor, not to themselves, in relation to decisions of this Tribunal.

### **iii) Autonomy of the Measures constituting Creeping Expropriation**

262. Argentina has argued that each measure alleged by the Claimant to be part of the process that results in a creeping expropriation must have an adverse effect on the investment, and that in the instant case it is not possible to speak of successive acts because if agreement had been reached on the renegotiated Contract, the Contract would not have been thwarted, to use Argentina's own words.

263. By definition, creeping expropriation refers to a process, to steps that eventually have the effect of an expropriation. If the process stops before it reaches that point, then expropriation would not occur. This does not necessarily mean that no adverse effects would have occurred. Obviously, each step must have an adverse effect but by itself may not be significant or considered an illegal act. The last step in a creeping expropriation that tilts the balance is similar to the straw that breaks the camel's back. The preceding straws may not have had a perceptible effect but are part of the process that led to the break.

264. We are dealing here with a composite act in the terminology of the Draft Articles. Article 15 of the Draft Articles provides the following:

“(1) The breach of an international obligation by a State through a series of actions or omissions defined in aggregate as wrongful occurs when the action or omission occurs which, taken with the other actions or omissions, is sufficient to constitute the wrongful act”.

265. As explained in the ILC's Commentary on the Draft Articles:

“Paragraph 1 of Article 15 defines the time at which a composite act 'occurs' as the time at which the last action or omission occurs which,

taken with the other actions or omissions, is sufficient to constitute the wrongful act, without it necessarily having to be the last of the series.”

266. The concept could not be better explained.

#### **iv) Expropriation of Contractual Rights and Proper Law of the Contract**

267. Argentina has linked the argument about expropriation of contractual rights and the law applicable to the Contract and assumes that unless a contract is internationalized through a stabilization clause, it is not susceptible of expropriation. The fact that the Contract is subject to Argentine law does not mean that it cannot be expropriated from the perspective of public international law and under the Treaty. The two issues are unrelated. The Contract falls under the definition of “investments” under the Treaty and Article 4(2) refers to expropriation or nationalization of investments. Therefore, the State parties recognized that an investment in terms of the Treaty may be expropriated. There is nothing unusual in this regard. There is a long judicial practice that recognizes that expropriation is not limited to tangible property. The Tribunal will refer, for the sake of brevity, to the findings of the Permanent Court of Arbitration (“PCA”) in the case of the *Norwegian Shipowners’ Claims* and the Permanent Court of International Justice (“PCIJ”) in the *Factory at Chorzów Case*.

268. The PCA held that “[...] whatever the intentions may have been, the United States took, both in fact and in law, the contracts under which the ships in question were being or were to be constructed.”<sup>90</sup> The PCIJ found that:

“[...] it is clear that the rights of the Bayerische to the exploitation of the factory and to the remuneration fixed by the contract for the management of the exploitation and for the use of its patents, licenses, experiments, etc., have been directly prejudiced by the taking over of the factory by Poland. As these rights related to the Chorzów factory and were, so to speak, concentrated in that factory, the prohibition contained in the last

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<sup>90</sup> Norwegian Shipowners’ Claims (Norway v. United States), p. 325.

sentence of Article 6 of the Geneva Convention applies in all respects to them.”<sup>91</sup>

269. These findings on the issue are conclusive and have been followed by ICSID and NAFTA tribunals, and the Iran-US Claims Tribunal. The Respondent has taken exception to the relevance of cases decided by the latter tribunal on the basis of the law applicable to those cases. The Tribunal considers that the findings of that tribunal are significant in that they show the consistency of approach on this matter by different international jurisdictions.

**v) Intent to Expropriate**

270. Argentina has argued against taking into consideration only the effect of measures for purposes of determining whether an expropriation has taken place. The Tribunal recalls that Article 4(2) refers to measures that “a sus efectos” (in its Spanish original) would be equivalent to expropriation or nationalization. The Treaty refers to measures that have the effect of an expropriation; it does not refer to the intent of the State to expropriate. The quotation of the finding of the PCA in *Norwegian Shipowners* refers to “whatever the intentions”<sup>92</sup> of the US were when the US took the contracts. A different matter is the purpose of the expropriation, but that is one of the requirements for determining whether the expropriation is in accordance with the terms of the Treaty and not for determining whether an expropriation has occurred.

**vi) Was the Investment Expropriated?**

271. The Tribunal has identified a series of measures that Argentina took which cannot be considered as measures based on the Contract but on the exercise of its public authority. Of all these measures, Decree 669/01 by itself and independently can be considered to be an expropriatory act. It was not based on the Contract but on the 2000 Emergency Law, it was a permanent measure and the effect was to terminate the Contract. Had it not been for Decree

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<sup>91</sup> *Certain German Interests in Polish Upper Silesia (Germany v. Poland)*, Judgment (May 25, 1926), *PCIJ Series A, No. 7*, p. 44.

<sup>92</sup> *Norwegian Shipowners' Claims*, p. 325.



669/01, and if a revised contract proposal had been agreed, the measures taken previously by themselves might not have had the effect and permanence required to be considered expropriatory, but, as no agreement was reached and the measures were never revoked, they stand as part of a gradual process which, with the issuance of Decree 669/01, culminated in the expropriation of Siemens' investment.

272. Contrary to the facts of the cases adduced by Argentina, the acts identified by the Tribunal as measures leading to the expropriation are acts of Argentina, decided at the highest levels of government, and not "simple acts of maladministration by low level officials." For that reason, Argentina's argument that simple acts of maladministration by low-level officials should be pursued in the local courts lacks validity in the circumstances of the instant case.

**vii) Was the expropriation in accordance with the Treaty?**

273. The Treaty requires that the expropriation be for a public purpose and compensated. The Tribunal finds that there is no evidence of a public purpose in the measures prior to the issuance of Decree 669/01. It was an exercise of public authority to reduce the costs to Argentina of the Contract recently awarded through public competitive bidding, and as part of a change of policy by a new Administration eager to distance itself from its predecessor. On the other hand, the public purpose of the 2000 Emergency Law was to face the dire fiscal situation of the Government. This is a legitimate concern of Argentina and the Tribunal defers to Argentina in the determination of its public interest. However, while the Tribunal would be satisfied in finding that an expropriation has occurred based only on Decree 669/01, and that the public purpose pursued by this Decree, in the context of Argentina's fiscal crisis and the 2000 Emergency Law, would be sufficient to meet the public purpose requirement of expropriation under the Treaty, the Tribunal cannot ignore the context in which Decree 669/01 was issued, nor separate this Decree from the other measures taken by Argentina in respect of the investment that culminated in its issuance. Decree 669/01 became a convenient device to continue the process started more than a year earlier long before the onset of the fiscal crisis. From this perspective, while

the public purpose of the 2000 Emergency Law is evident, its application through Decree 669/01 to the specific case of Siemens' investment and the public purpose of same are questionable. In any case, compensation has never been paid on grounds that, as already stated, the Tribunal finds that are lacking in justification. For these reasons, the expropriation did not meet the requirements of Article 4(2) and therefore was unlawful. The Tribunal will examine the issues of compensation after addressing the alleged breaches of other obligations of Argentina under the Treaty.

#### **4. Fair and equitable treatment**

##### **a) Positions of the Parties**

274. Siemens argues that the obligation to treat an investment fairly and equitably requires arbitral tribunals to take into account the totality of the circumstances in each case. The proposition that investments shall have fair and equitable treatment and full protection and security constitutes the “overriding obligation”, and other standards must be applied as part of this general one. According to Siemens, fair and equitable treatment and full protection and legal security are intended to accord foreign investors broad protection, including a stable and predictable investment environment. Predictability is an essential element of stability, the rules and practices that affect investments must be predictable. A State violates the fair and equitable treatment standard when it fails to respect the specific assurances that it had given to investors as an inducement to invest and on which investors relied in making the investment

275. Siemens contends that Argentina provided assurances that SITS would be allowed to complete the Project and obtain the earnings that were the price of the System in an investment environment that was and would remain stable and predictable. To induce Siemens to invest in the Project, Argentina granted SITS the right to implement the complete and integral provision of the System and to issue all the DNIs to replace those existing on the date of the Contract, and all new DNIs and their renewals after the System entered into operation. The investment logically had to be made before the System startup

and the return on the investment was dependent on the issuance of the DNIs and the processing of immigration proceedings.

276. According to Siemens, the acts and omissions previously described destroyed irreparably the legal framework for Siemens' investment, and at all times prior to the unilateral termination of the Contract Argentina promised that the Project would continue and the operation of the System would be resumed. Furthermore, due to Siemens' claim for compensation, Siemens has faced serious problems in other activities in Argentina.

277. Siemens argues that the standard of just and equitable treatment requires stable investment environments by ensuring transparency and predictable rules and practices, which in turn mean that the investor may rely on the undertakings made by the State to the investor. Additionally, fair and equitable treatment means freedom from coercion and harassment, due process and good faith. According to Siemens, RNP interposed serious obstacles to the regular performance of the DNI sub-system, the new authorities after the elections abused the vulnerable position of SITS and the renegotiation process announced in January 2000 was carried out under the threat of the early cancellation of the Contract. Siemens claims that Argentina committed gross procedural improprieties by interrupting the income generating activities, by denying SITS' access to the administrative records, by denying SITS the right to be heard on the May 2001 proposal and withholding information necessary for the decision of SITS on the proposal, by failing to meet the core requirements for terminating the Contract under the 2000 Emergency Law, and by removing administrative files pointing to the Government's failures. Furthermore, after termination of the Contract, SITS was denied information on the background of Decree 669/01 and evidence in support of its position, internal reports were issued without notice to SITS or without recording them in the administrative file, and SITS was excluded from the DNI sub-system test carried out together with SITS' former sub-contractors.

278. According to Siemens, the actions referred to above show also lack of good faith in the conduct of Argentina; in particular, the May 2001 proposal was done in bad faith to trigger the Contract's termination. Siemens

adds non-payment of compensation, keeping the Contract performance bond, not taking responsibility for the sub-contractors' claims and the fact that all the alleged contractual breaches on which Argentina bases its defense were never notified to SITS or Siemens.

279. In its Counter-Memorial, as regards the violation of the full protection and security obligation, Argentina argues that the Claimant has failed to allege how this breach had taken place and affirms that this obligation refers only to physical damage. Then Argentina objects to the concept of fair and equitable treatment advanced by Siemens. Argentina argues that fair and equitable treatment means no more than the minimal treatment afforded by international law. It certainly does not mean that it gives arbitral tribunals the power to decide on the basis of equity. Argentina refers approvingly to the interpretation on this point by the NAFTA Free Trade Commission ("FTC"), recent investment treaties signed by the US and the findings of tribunals in *Genin, S.D. Myers* and *Azinian*.

280. Argentina disagrees with Siemens on the application of the standard of just and equitable treatment to the facts of the case. Argentina refers to the principle of good faith enshrined in this standard, how this standard applies equally to investors and States and how Siemens breached it during the failed negotiation that led to the rescission of the Contract. Thus Siemens systematically refused to reveal its cost structure; and "[i]n a demonstration of bad faith, Siemens went along with negotiations with the Commission named by the Argentine Government, by successive reductions in the final price of IDs."<sup>93</sup> Siemens also accepted the inclusion of the Contract in the 2000 Emergency Law and is prevented now by the doctrine of *estoppel* to claim that it was unaware of the implications, for "if its intention was to save the contract, it should have undertaken to bear the consequences that resulted from this emergency and adjust its expectations and claims so as to reach the shared burden of sacrifice" established by this law.<sup>94</sup> The need for shared sacrifice, according to Argentina, stems from the good faith that the parties owe each other, and fair and equitable

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<sup>93</sup> Counter-Memorial, para. 1079.

<sup>94</sup> *Ibid.*, para. 1080.

treatment “in essence constitutes a guarantee of appropriate and reasonable treatment and that this should be viewed and analyzed taking into consideration the concrete and specific historical circumstances of the treatment. Fair and equitable treatment contains elements of good faith, consistency and reasonableness, which should be evaluated always bearing in mind the events that originated this arbitration.”<sup>95</sup>

281. Argentina also contends that the System did not provide the intended security and refers the Tribunal to the multiple security deficiencies pointed out in the audit performed by the Argentine authorities. In this respect, Siemens is responsible for SITS’ failures. It is not possible to make a claim for events affecting the subsidiary and at the same time avoid the legal consequences of the subsidiary’s acts.

282. As a final argument under this heading, Argentina alleges that SITS and Siemens consented to the 2000 Emergency Law in a case of normative acquiescence. Argentina refers in this respect to the *Preah Vihear Temple* case where the ICJ found: “It is an established rule that the plea of error cannot be allowed as an element vitiating consent if the party advancing it contributed by its own conduct to the error, or could have avoided it, or if the circumstances were such as to put that party on notice of a possible error.”<sup>96</sup> Argentina argues that Thailand, the party pleading error, can be substituted by the Claimant and SITS, which “accepted the emergency and their incorporation to the emergency legal system.”<sup>97</sup>

283. In its Reply, Siemens affirms that the allegation of Argentina that the conduct of SITS or Siemens lacks good faith because of the failure to reveal the cost structure is misplaced. Indeed, Article 2(1) addresses the duties of the State to the investors and not the reverse, and neither the Contract nor the 2000 Emergency Law required such disclosure. As for the doctrines of *estoppel* and acquiescence invoked by Argentina, Siemens points out that both doctrines had their origins in inter-State relations and it is doubtful that they can be extended to

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<sup>95</sup> *Ibid.*, para. 1082.

<sup>96</sup> *Temple of Preah Vihear (Cambodia v. Thailand)*, ICJ Reports (1962) p. 26, cited in para. 1090 of Counter-Memorial.

<sup>97</sup> *Ibid.*, para. 1092.

the area of investor-State relations. Siemens claims that there is no statement of fact by Siemens on which Argentina could have relied to its own detriment, and as regards acquiescence to the law, Siemens observes that the applicability of legislation does not depend on the assent or protest of foreign investors or of any other party subject to the law, and the fact that SITS did not take legal action against Resolution No. 1779/00 of the Ministry of the Interior does not mean that Siemens waived its rights under the Treaty against an uncompensated expropriation or other actions violating the Treaty's substantive standards.

284. Siemens denies that the protection accorded by the standard of fair and equitable treatment is the minimum required of States under international law:

“An interpretation that is in accordance with the BIT’s object and purpose would also have to give some independent meaning to the fair and equitable treatment standard. An interpretation that reduces its meaning to standards that are contained already in customary international law would deprive it of any independent meaning and would make the provision redundant. The application of the general principles of international law is already mandated by Article 10, paragraph 5 of the BIT. If Article 2(1) of the BIT providing for fair and equitable treatment is to have an independent meaning it must be in addition to the general principles of international law.”<sup>98</sup>

285. Siemens points out that the *Neer* standard has been rejected consistently in recent decisions: (i) in *ELSI*, the ICJ considered that to be a breach of the standard State conduct needs to show “a willful disregard of the process of law, an act which shocks, or at least surprises, a sense of judicial propriety”, (ii) in *Mondev Intl. Ltd. v. The United States of America* and *Loewen Group, Inc. and Raymond L. Loewen v. the United States of America*, the tribunals used the adjectives “improper and discreditable”, (iii) in *Loewen, Waste Management* and *MTD*, the tribunals considered discrimination against foreigners an important indicator of failure to respect fair and equitable treatment,

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<sup>98</sup> Reply, para. 504, quotation of Professor Schreuer’s legal opinion.

and (iv) in *Waste Management* and *MTD* the tribunals used terms such as arbitrariness, idiosyncrasy, injustice, lack of good faith, lack of due process and proportionality.<sup>99</sup>

286. As regards the views of Argentina on the scope of “full protection and security”, Siemens observes that the Treaty goes further than most investment treaties when it refers to “legal” security and this reference is “a strong indication that the provision, as contained in the BIT [Treaty], goes beyond mere physical violence and extends to the investor’s legal position.”<sup>100</sup> Siemens refers to the following measures or omissions that deprived it of its protection and legal security: failure to make the budgetary allocations, suspension of the income-generating activities, renegotiation of the Contract under extreme pressure, and abusive use of the 2000 Emergency Law to terminate the Contract.

287. In its Rejoinder, Argentina argues that, given the failure of SITS to perform its obligations under the Contract and the circumstances of fiscal stringency, the issuance of Decree 669/01 could not be considered an arbitrary, grossly unfair, idiosyncratic measure, nor did it involve lack of due process. Argentina contests the broad interpretation of fair and equitable treatment by Siemens and takes issue with the approach taken by *Tecmed* and *MTD* in applying this standard of protection. Argentina considers that the standard applied by these tribunals does not reflect an accurate international standard. Argentina submits that fair and equitable treatment does not encompass the protection of legitimate expectations and the establishment of a stable investment environment.

288. Argentina also submits that, even if the Tribunal were to apply an expanded concept of fair and equitable treatment, there was no violation of this

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<sup>99</sup> Reply, para. 506, quotation of Professor Schreuer’s legal opinion, para. 299 et seq., where reference is made to: (1) *Neer v. Mexico*, Opinion, United States-Mexico, General Claims Commission, October 15, 1926, 21 AJIL 555 (1927); (2) *Eletronica Sicula S.p.A.* (ELSI) (United States of America v. Italy), International Court of Justice, Judgment, July 20, 1989, ICJ Reports 1989; (3) *Mondev Intl. Ltd. v. The United States of America*, Award, October 11, 2002, 42 ILM85 (2003); (4) *Loewen Group, Inc. and Raymond L. Loewen v. the United States of America*, Award, (June 26, 2003);

<sup>100</sup> *Ibid.*, para. 559, quotation from Professor Schreuer’s legal opinion, emphasis added by the Claimant.

standard by Argentina. Argentina refers to the fact that the Claimant had never raised the political motivation of Argentina's acts before this arbitration and had consented to the acts that it now questions. Argentina submits that Siemens agreed on the laws that it now questions and that is, among other reasons, why there was no violation of the Treaty by Argentina. Argentina wonders what legitimate expectation can be affected by acts of the State to which the investor has consented.

**b) Considerations of the Tribunal**

289. The parties' allegations raise issues about the scope of standard of fair and equitable treatment and full protection and security and its relevance in this case. As regards the scope, the parties hold different views on whether the obligation to treat an investment fairly and equitably refers to the minimum standard of treatment of aliens under customary international law or requires from the State a higher standard of conduct more in consonance with the objective of the Treaty. They also differ on whether "security" refers to physical security or to security in a wider sense. The Tribunal will first address these two issues.

290. In their ordinary meaning, the terms "fair" and "equitable" mean "just", "even-handed", "unbiased", "legitimate".<sup>101</sup> As expressed in the Treaty preamble, it is the intention of the State parties to intensify their economic cooperation, and their purpose to create favorable conditions for the investments of the nationals of a party in the territory of the other, while recognizing that the promotion and protection of such investments by means of a treaty may serve to stimulate private initiative and improve the well being of both peoples. It follows from the ordinary meaning of "fair" and "equitable" and the purpose and object of the Treaty that these terms denote treatment in an even-handed and just manner, conducive to fostering the promotion and protection of foreign investment and stimulating private initiative. The parties to the Treaty show by their intentions and objectives a positive attitude towards investment. Terms such as "promote" or "stimulate" are action words that indicate that it is the intention of

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<sup>101</sup> *The Oxford English Dictionary*. Similarly defines these terms *Diccionario de la Lengua Española*, 22nd edition, at [www.rae.es](http://www.rae.es).



the parties to adhere to conduct in accordance with such purposes. This understanding is confirmed by Article 2(1) of the Treaty, whereby each party even undertakes to promote the investments of nationals or companies of the other party.

291. The specific provision of the Treaty on fair and equitable treatment is found also in Article 2(1) after the commitment to promote and admit investments in accordance with the law and regulations and as an independent sentence: “In any case [the parties to the Treaty] shall treat investments justly and fairly (“En todo caso tratará las inversiones justa y equitativamente”).”<sup>102</sup> There is no reference to international law or to a minimum standard. However, in applying the Treaty, the Tribunal is bound to find the meaning of these terms under international law bearing in mind their ordinary meaning, the evolution of international law and the specific context in which they are used.

292. Argentina has indicated its support for the interpretation of Article 1105 of NAFTA by the FTC. The Tribunal observes first that this article bears the heading “Minimum Standard of Treatment.” Paragraph 1 of this article states: “Each Party shall accord to investments of investors of another Party treatment in accordance with international law, including fair and equitable treatment and full protection and security.” As interpreted by the FTC and as indicated in the title of the article, the standard of treatment is the minimum required under customary international law.

293. The question whether fair and equitable treatment is or is not additional to the minimum treatment requirement under international law is a question about the substantive content of fair and equitable treatment. In 1927, the US-Mexican Mixed Claims Commission considered in the *Neer* case that a State has breached the fair and equitable treatment obligation when the conduct of the State could be qualified as outrageous, egregious or in bad faith or so below international standards that a reasonable and impartial person would easily recognize it as such. This description of conduct in breach of the fair and equitable treatment standard has been considered as the expression of

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<sup>102</sup> Article 2(1) of the Treaty.

customary international law at that time. For the Tribunal the question is whether, at the time the Treaty was concluded, customary international law had evolved to a higher standard of treatment.

294. It will be useful for this purpose to review the cases referred to by the parties in support of their differing positions. Argentina has particularly relied on *Genin*. In that case, the tribunal without engaging in a textual analysis of the fair and equitable treatment clause in the US-Estonia BIT considered this requirement to be an international minimum standard, which could only be breached by “a wilful neglect of duty, an insufficiency of action falling far below international standards, or even subjective bad faith.”<sup>103</sup> That tribunal found that, in the circumstances of the case, Estonia did not breach the duty of fair and equitable treatment; however, it hoped that the “Bank of Estonia will exercise its regulatory and supervisory functions with greater caution regarding procedure in the future,”<sup>104</sup> and observed that “the awkward manner by which the Bank of Estonia revoked EIB’s license, and in particular the lack of prior notice of its intention to revoke EIB’s license and of any means for EIB or its shareholders to challenge that decision prior to its being formalized, cannot escape censure.”<sup>105</sup>

295. After the interpretation of the FTC, several tribunals established under NAFTA have held that the customary international law to be applied is the customary international law as it stood when that treaty was concluded and not in 1927. In *Mondev*, the tribunal held that “the content of the minimum standard today cannot be limited to the content of customary international law as recognized in arbitral decisions in the 1920s.”<sup>106</sup> The same tribunal noted that the State party in the dispute agreed that the international standard of treatment has evolved as all customary international law has, and that the two other State parties to NAFTA also agreed with this point.<sup>107</sup> Therefore, that tribunal considered that:

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<sup>103</sup> *Genin*, para. 367.

<sup>104</sup> *Ibid.*, para. 372.

<sup>105</sup> *Ibid.*, para. 381.

<sup>106</sup> *Mondev Intl. Ltd. v. United States of America*, ICSID Case No. ARB(AF)/99/2, Award (October 11, 2002), para. 123.

<sup>107</sup> *Ibid.*, para. 124.

“the FTC interpretations incorporate current international law, whose content is shaped by the conclusion of more than two thousand bilateral investment treaties and many treaties of friendship and commerce. Those treaties largely and concordantly provide for ‘fair and equitable’ treatment of, and for ‘full protection and security’ for, the foreign investor and his investments.”<sup>108</sup>

And found that “To the modern eye, what is unfair or inequitable need not equate with the outrageous or the egregious. In particular, a State may treat foreign investment unfairly and inequitably without necessarily acting in bad faith.”<sup>109</sup>

296. The tribunal in *Loewen* came to a similar conclusion: “Neither State practice, the decisions of international tribunals nor the opinion of commentators support the view that bad faith or malicious intention is an essential element of unfair and inequitable treatment or denial of justice amounting to a breach of international justice.”<sup>110</sup>

297. After reviewing arbitral awards under NAFTA, the tribunal in *Waste Management II* reached the conclusion that:

“the minimum standard of treatment of fair and equitable treatment is infringed by conduct attributable to the state and harmful to the claimant if the conduct is arbitrary, grossly unfair, unjust or idiosyncratic, is discriminatory and exposes the claimant to sectional or racial prejudice, or involves a lack of due process leading to an outcome which offends judicial propriety – as might be the case with a manifest failure of natural justice in judicial proceedings or a complete lack of transparency and candour in an administrative process. In applying this standard it is

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<sup>108</sup> *Ibid.*, para. 125.

<sup>109</sup> *Ibid.*, para. 116. The tribunal in *ADF* affirmed the same point: “what customary international law projects is not a static photograph of the minimum standard of treatment of aliens as it stood in 1927 when the Award in the *Neer* case was rendered. For both customary international law and the minimum standard of treatment of aliens it incorporates, are constantly in a process of development.” *ADF Group, Inc. v. United States of America*, ICSID Case No. ARB(AF)/00/1, Award (January 9, 2003), para. 179.

<sup>110</sup> *Loewen*, párr. 132.

relevant that the treatment is in breach of representations made by the host State which were reasonably relied on by the claimant.”<sup>111</sup>

298. The parties have also referred to *Tecmed*, which describes just and equitable treatment as requiring:

“treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment. The foreign investor expects the host State to act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor, so that it may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investment and comply with such regulations.”<sup>112</sup>

299. It emerges from this review that, except for *Genin*, none of the recent awards under NAFTA and *Tecmed* require bad faith or malicious intention of the recipient State as a necessary element in the failure to treat investment fairly and equitably, and that, to the extent that it has been an issue, the tribunals concur in that customary international law has evolved. More recently in *CMS*, the tribunal confirmed the objective nature of this standard “unrelated to whether the Respondent has had any deliberate intention or bad faith in adopting the measures in question. Of course, such intention and bad faith can aggravate the situation but are not an essential element of the standard.”<sup>113</sup> That tribunal also understood that the conduct of the State has to be below international standards but not at their level in 1927 and that, as in *Tecmed* and *Waste Management II*, the current standard includes the frustration of expectations that the investor may have legitimately taken into account when it made the investment.

300. The Tribunal has already noted that the standards of conduct agreed by the parties to the Treaty indicate a favorable disposition to foreign investment. The purpose of the Treaty is to promote and protect investments. It

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<sup>111</sup> *Waste Management II*, para. 98.

<sup>112</sup> *Tecmed*, para. 154. Unofficial translation from the Spanish original published by ICSID on its web site.

<sup>113</sup> *CMS*, para. 280.

would be inconsistent with such commitments and purpose and the expectations created by such a document to consider that a party to the Treaty has breached its obligation of fair and equitable treatment only when it has acted in bad faith.

301. The Tribunal will now turn to the question of the meaning of full protection and security. According to Argentina, “security” refers only to physical security while the Claimant attributes to this term a wider meaning, in particular because the Treaty refers to “legal security.”

302. The Tribunal first notes that, although the parties have argued the application of this standard as a single standard, the Treaty provides for the fair and equitable treatment and full protection and security under two different Articles. The parties do not seem to have found this separation to be significant and the Tribunal will not dwell further on this point. The Tribunal also notes that Argentina in its arguments did not address the fact that security was qualified by “legal” in this instance.

303. As a general matter and based on the definition of investment, which includes tangible and intangible assets, the Tribunal considers that the obligation to provide full protection and security is wider than “physical” protection and security. It is difficult to understand how the physical security of an intangible asset would be achieved. In the instant case, “security” is qualified by “legal”. In its ordinary meaning “legal security” has been defined as “the quality of the legal system which implies certainty in its norms and, consequently, their foreseeable application.”<sup>114</sup> It is clear that in the context of this meaning the Treaty refers to security that it is not physical. In fact, one may question given the qualification of the term “security”, whether the Treaty covers physical security at all. Arguably it could be considered to be included under “full protection”, but that is not an issue in these proceedings.

304. Based on this understanding of fair and equitable treatment and full protection and legal security, the Tribunal will now consider whether the

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<sup>114</sup> *Diccionario de la lengua española*, 22<sup>nd</sup> edition, at [www.rae.es](http://www.rae.es). Translation by the Tribunal. The original text in Spanish reads as follows: “cualidad del ordenamiento jurídico que implica la certeza de sus normas y, consiguientemente, la previsibilidad de su aplicación.”

actions of Argentina, identified by the Tribunal as actions taken by Argentina acting as a State, constitute a breach of this obligation.

305. Argentina has argued that Siemens and its subsidiary, for whose conduct Siemens is responsible, acted in bad faith because they accepted the laws of Argentina and alleged before this Tribunal political motives which were never denounced during the long lasting re-negotiation of the Contract. Siemens has argued likewise that it was never notified under the Contract of all the failures that have been alleged by Argentina in these proceedings. The parties' response to these arguments is similar: both parties were intent on reaching a renegotiated agreement that ultimately proved elusive.

306. The Tribunal considers that neither party may hold against the other positions that it may have taken during a good faith negotiation.<sup>115</sup> In any case, acceptance of laws or regulations should not be held against a company which has accepted them by the Government that adopted them. As stated elsewhere by the Tribunal, to comply with the law is not understood to be an optional matter. In this respect, the arguments advanced by Argentina on acquiescence and *estoppel* are misplaced and have already been dealt with by the Tribunal.

307. On the other hand, the Tribunal finds without merit the argument made by Siemens that since filing its claim Siemens has encountered difficulties to operate in Argentina. This statement is contradicted by the affirmation in Siemens' Reply that Argentina holds Siemens in such high regard that it has repeatedly requested its intervention in other public projects, even after the Contract's termination

308. To conclude, the Tribunal finds that the initiation of the renegotiation of the Contract for the sole purpose of reducing its costs, unsupported by any declaration of public interest, affected the legal security of Siemens' investment. The Tribunal also finds that when a government awards a

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<sup>115</sup> In the *Factory at Chorzów* case, the PCIJ pointed out that it could not "take into account declarations, admissions or proposals which the Parties may have made during direct negotiations between themselves, when such negotiations have not led to a complete agreement." *Merits, PCIJ, Series A* (1928), p. 51.

contract, which includes among its critical provisions an undertaking of that government to conclude agreements with its provinces, the same government can not argue that the structure of the State does not permit it to fulfill such undertaking. This runs counter to the principle of good faith underlying fair and equitable treatment. The arguments made to justify delay in paying compensation without basis in the Contract or Decree 669/01 and the denial of access to the administrative file for purposes of filing the appeal against Decree 669/01 show lack of transparency of Argentina in respect of the investment, particularly when Argentina itself has manifested in these proceedings that at no time had it affirmed that the Contract was rescinded due to the Contractor's fault.<sup>116</sup>

309. For these reasons, the Tribunal finds that the full protection and legal security and fair and equitable treatment obligations under the Treaty have been breached by Argentina.

## **5. Arbitrary and Discriminatory Measures**

### **a) Positions of the Parties**

310. Siemens argues that, based on the plain meaning of "arbitrary", the measures adopted towards Siemens' investment meet the test of arbitrariness: "not governed by any fixed rules or standard", "performed without adequate determination of principle and one not founded in nature of things", "without cause based upon the law", or "failure to exercise honest judgment", "characterization of a decision or action taken by an administrative agency [...] [as] willful and unreasonable action without consideration or in disregard of facts or law or without determining principle."<sup>117</sup>

311. According to Siemens, the intentional frustration of the performance of the Contract when all the investment had been made to put the System into operation was arbitrary. The measures were unreasonable, taken unilaterally without due cause or justification. They caused serious damage to Siemens for which it has not been compensated. The measures were also

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<sup>116</sup> Rejoinder, paras. 222 and 232.

<sup>117</sup> Memorial, para. 337, citing *Black's Law Dictionary*, 1990, sixth edition, p. 104.

discriminatory in intent and effect. No other investor was treated like Siemens, no measures such as those imposed on Siemens' investment were adopted by Argentina concerning contracts or investments of similar importance, in particular, no other public contract was terminated by Argentina under the 2000 Emergency Law and compensation has never been paid. These discriminatory measures impaired Siemens' ability to manage, use and enjoy its investment.

312. In its Counter-Memorial, Argentina argues that the measures it adopted were reasonable in proportion to their purpose and of general application. Thus, they were neither arbitrary nor discriminatory. Argentina refers to the concept of arbitrariness defined by the ICJ in *ELSI*: "It is a willful disregard of due process of law, an act which shocks, or at least surprises, a sense of juridical propriety;"<sup>118</sup> and the arbitral tribunal in *Genin*: "any procedural irregularity that may have been present would have to amount to bad faith, a willful disregard of due process of law or an extreme insufficiency of action."<sup>119</sup> According to Argentina, the measures it took were in defense of vital security of the State, to keep the data on its inhabitants secure since otherwise it would violate rights enshrined in international treaties on the protection of human rights.

313. Argentina also questions the qualification as arbitrary of the delay in approving the FOM. The FOM presented by SITS was not in a condition to be approved and Argentina showed diligence by requesting in advance information that would have helped in speeding up the approval process and that SITS did not provide. According to Argentina, a government may not be accused of being arbitrary when it tries to protect and preserve the confidentiality of the data on its inhabitants.

314. As to the meaning of "discriminatory", Argentina contends, based on *ELSI* and *S.D. Myers*, that, for a measure to be discriminatory, the measure has to be harmful, favor a national against a foreign investor and be intended to discriminate. Argentina argues that the measures it took were intended to protect its citizens and as such could not be considered discriminatory. Furthermore, the measures taken in relation to Siemens' investment had nothing to do with any

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<sup>118</sup> *Genin*, Counter-Memorial, para. 1108 citing *ELSI*, *ICJ Reports* (1989), para. 128.

<sup>119</sup> *Ibid.*, para. 1110 citing *Genin*, para. 371.



differential treatment vis-à-vis any other investor group in the same situation because Siemens was in a unique situation.

315. In its Reply, Siemens insists that in terms of Article 2(3) of the Treaty actions are arbitrary if they are opposed to the rule of law or surprise a sense of juridical propriety, or if a measure harming an investor cannot be justified in terms of rational reasons that are related to the facts. Siemens contests the argument of “voluntary consent” or “acquiescence” by SITS and affirms that what occurred was an abusive exercise of the State’s authority that left SITS powerless. According to Siemens, Argentina’s measures were “arbitrary because they dismantled the entire legal framework that had led Siemens to conduct its investment, contrary to the expectations of any reasonable and impartial person. The political motivation behind Argentina’s actions only serves to emphasize the arbitrariness of the measures adopted.”<sup>120</sup>

316. As regards discriminatory treatment, according to Siemens, the criterion is whether the foreign investor has been treated less favorably than domestic investors or investors of other nationalities; *de facto* discrimination is sufficient even without violation of the host State’s domestic law. Siemens argues that the measures taken towards Siemens’ investment were not of a general nature; the Contract is the only significant contract terminated which involved a foreign investor and the only foreign investment terminated unilaterally under the 2000 Emergency Law.

317. In its Rejoinder, Argentina recalls that the Contract was unique in terms of its scope, importance, duration and expense. Argentina explains how the Contract could not be compared to the passport issuance contract that the Claimant adduced as evidence of discrimination. Passports are not obligatory, while DNIs are. In the face of an economic crisis, Argentina had a right to protect its interests and those of its citizens. The measures taken by Argentina in response to “the fiscal emergency were of general operation, for a public purpose and did not introduce unreasonable discrimination.”<sup>121</sup> Argentina further explains that the fact that public utilities were excluded from the 2000 Emergency law

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<sup>120</sup> Reply, para. 571.

<sup>121</sup> Rejoinder, para. 643.

does not mean that the crisis did not impact their rights, e.g., foreign companies that invested in the natural gas transport and distribution agreed to defer adjustment of their fees as permitted in their contracts sixteen months before the termination of the contract. Argentina concludes by asserting that, given the enormous costs of the Contract, “it cannot be said that the measures taken to terminate it early were unfair, unjust or disproportionate to the extent of the problem in hand.”<sup>122</sup>

#### **b) Considerations of the Tribunal**

318. In its ordinary meaning, “arbitrary” means “derived from mere opinion”, “capricious”, “unrestrained”, “despotic.”<sup>123</sup> *Black’s Law Dictionary* defines this term as “fixed or done capriciously or at pleasure; without adequate determining principle”, “depending on the will alone”, “without cause based upon the law.” There is also abundant case law on the interpretation of this term to which the parties have referred. The Tribunal considers that the definition in *ELSI* is the most authoritative interpretation of international law and it is close to the ordinary meaning of the term emphasizing the willful disregard of the law. The element of bad faith added by *Genin* does not seem to find support either in the ordinary concept of arbitrariness or in the definition of the ICJ in *ELSI*.

319. In the instant case, certain measures taken by Argentina do not seem to be based on reason. Argentina has explained that an authorization was needed to start the operation of the DNM sub-system, but has failed to explain why the authorization was never given after the investment was made and the DNM sub-system had started to operate. Similarly, the Tribunal does not question the importance to the vital interests of Argentina to have secure identification of individuals, but applied to the suspension of the RPN sub-system such argument would have justified requiring an immediate correction of the error. No evidence has been submitted that the error could not be corrected. Instead, SITS was denied the possibility of correcting the error. While the Tribunal could accept that there may have been reasons to justify the temporary

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<sup>122</sup> *Ibid.*, para. 657.

<sup>123</sup> *The Oxford English Dictionary*. This term is similarly defined in the *Diccionario de la Lengua Española*, 22<sup>nd</sup> edition, at [www.rae.es](http://www.rae.es).

suspension of the DNM and RPN sub-systems, the Tribunal finds its permanent suspension arbitrary.

320. As to discriminatory measures, under Article 3(1) and (2) of the Treaty, the parties undertook to treat each other's nationals and companies not less favorably than they treat their own investors or those of a third party. Whether intent to discriminate is necessary and only the discriminatory effect matters is a matter of dispute. In *S.D. Myers*, the tribunal considered intent "important" but not "decisive on its own."<sup>124</sup> On the other hand, the tribunal in *Occidental Exploration and Production Company v. Republic of Ecuador* found intent not essential and that what mattered was the result of the policy in question.<sup>125</sup> The concern with the result of the discriminatory measure is shared in *S.D. Myers*: "The word 'treatment' suggests that practical impact is required to produce a breach of Article 1102, not merely a motive or intent." The discriminatory results appear determinative in *Marvin Roy Feldman Karpa v. United Mexican States*,<sup>126</sup> where the tribunal considered different treatment on a *de facto* basis to be contrary to the national treatment obligation under Article 1102 of NAFTA.

321. The Tribunal concurs that intent is not decisive or essential for a finding of discrimination, and that the impact of the measure on the investment would be the determining factor to ascertain whether it had resulted in non-discriminatory treatment. The Claimant has based its arguments mainly on the fact that the Contract was the only major contract, and the only contract with a foreign investor, terminated under the 2000 Emergency Law, while the contract of the Government with an Argentine national to issue passports was allowed to stand notwithstanding the high costs associated with it. The Respondent has explained to the Tribunal that the Contract was unique and that the mandatory nature of DNI justified the difference in treatment. The Tribunal considers that, while there are aspects in the actions of Argentina that seem discriminatory, the allegations of the Claimant have not been fully substantiated. Given the holdings

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<sup>124</sup> *S.D. Myers*, para. 254.

<sup>125</sup> *Occidental Exploration and Production Company v. Republic of Ecuador*, LCIA case No. UN3467, Award (July 1, 2004), para. 177.

<sup>126</sup> *Marvin Roy Feldman Karpa v. United Mexican States*, ICSID Case No. ARB(AF)/99/1, Award (December 16, 2002), para. 184.

of the Tribunal under other protections of the Treaty, the Tribunal finds it unnecessary to determine whether Argentina breached the non-discriminatory treatment obligation.

## **VII. Compensation**

### **1. Positions of the Parties**

322. Siemens claims that it is entitled to receive full and comprehensive compensation for the breaches of the Treaty and to recover the fair market value of its wrongfully expropriated investment, calculated for valuation purposes immediately before the date of expropriation of May 18, 2001; the loss of profits or *lucrum cessans* and the additional damage caused as a result of the expropriatory measures and acts, including those damages claimed by subcontractors and suppliers of Siemens and/or SITS regarding the Project and caused by Argentina's expropriation. In addition, Siemens claims pre and post-award interest of 6% compounded annually.

323. Siemens argues that the expropriation was unlawful because it did not meet the conditions of the Treaty and international law, namely, it did not serve a public purpose, it did not satisfy the formal and substantive requirements of due process, it did not comply with the legal standards of treatment set forth in the Treaty and no compensation was paid. Based on the *Factory at Chorzów* case, Siemens pleads that an illegal dispossession leads to a twofold obligation: first, the obligation to restore the property in question or, if this is not possible, to pay compensation corresponding to its value; and second, there is an obligation to pay damages for any additional losses sustained as a consequence of the taking.

324. Siemens observes that the value of the asset expropriated is not affected by whether or not an expropriation is lawful, but the amount of compensation due to an investor may be significantly affected. In the instant case, Siemens claims that the value of the property at the moment of the taking plus interest to the day of payment is a legal floor, and calls upon the Tribunal to add any potential consequential damages so as to "wipe out all the

consequences of the illegal act and reestablish the situation which would, in all probability, have existed if that act had not been committed.”<sup>127</sup>

325. Siemens considers as appropriate the definition of fair market value in *Starrett Housing Corp. v. The Islamic Republic of Iran*: “[T]he price that a willing buyer would pay to a willing seller in circumstances in which each had good information, each desired to maximize his financial gain, and neither was under duress or threat.”<sup>128</sup>

326. Siemens argues that the fair market value includes the lost future profits that the enterprise would have gained had it been allowed to continue to operate, points out that SITS was a single project company, and affirms that its future revenues and profits were ascertainable on the basis of the commitments made by Argentina. Siemens refers to *Norwegian Shipowners, LETCO* and the concurring opinion of Judge Brower in *Amoco International Finance Corporation*, which stated that “[...] where the expropriated property consists of contract rights, the compensation must be defined by the anticipated net earnings that would have been realized, as well as one can judge, had the contract been left in place until completion.”<sup>129</sup>

327. Siemens claims that SITS, as a single project company, had foreseeable and ascertainable revenues and profits based on the commitments made by Argentina. Furthermore, any negative effect of the taking itself or the measures related to the taking must be excluded from the valuation. According to Siemens, a State may not reduce its obligation to pay compensation simply by creating a situation in which expropriation is to be feared before it occurs or by breaching contractual obligations or other duties to the foreign investor.

328. According to Siemens, the appropriate method of valuation is the book value method in its variant of actual investments. Based on this method, Siemens claims that, as of May 17, 2001, the value of its investment amounts to US\$283,859,710. Siemens affirms that this amount is comparable to the

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<sup>127</sup> Memorial, para. 392 citing the *Factory at Chorzów* case, *Merits, PCIJ, Series A*, 1928, p. 47,

<sup>128</sup> *Ibid.*, para. 394, citing *Starrett Housing Corp. v. the Islamic Republic of Iran*, Case No. 24, Final Award No. 314-24-1, (August 14, 1987), Claimant’s Legal Authorities No. 52.

<sup>129</sup> *Ibid.*, para. 402.

amounts that could be obtained with the application of other alternative methods of valuation. In addition, Siemens claims to be entitled to US\$124,541,000 on account of *lucrum cessans*.

329. Siemens also claims additional damages based on the unlawful nature of the expropriation measures and the behavior of Argentina prior to and after the date of expropriation. On this account, Siemens claims: (i) the costs incurred for maintaining a skeleton operation in Argentina to allow the conclusion of the Project, (ii) storage costs because of a 20-month delay in the transfer of assets to the Government, (iii) training costs and costs of technical support services provided by SITS during a period in excess of 75 days after May 18, 2001 pursuant to Article 26.3 of the Contract, (iv) damages claimed or that may be claimed by subcontractors involved in the Project's execution as a result of the expropriation, (v) unpaid invoiced services of SITS to the DNE agency in 1999, and (vi) the costs of this arbitration and of counsel. According to Siemens, subcontractors' damages amount to US\$44,678,462 and the aggregate amount of the other items is US\$9,397,899.

330. Siemens claims pre-award compounded interest at the rate of 6% per annum so that it is fully compensated for the loss suffered and considers that May 18, 2001 should be the date of expropriation for valuation purposes, including for the assessed value of the lost profits. In the case of the additional damages, interest shall be applied from the dates in which they have been caused.

331. Argentina argues in its Counter-Memorial that Siemens is not entitled to the compensation it has claimed: First, the Treaty in Article 4(2) states that compensation shall correspond to the value of the investment expropriated. Argentina interprets the reference to "value" of the investment – as opposed to "fair market value" - to exclude future profits. To support this point, Argentina reviews its own treaty practice and offers examples in four categories ranging from compensation on the basis of fair market value of the investment to the classical Hull formula, or a partial Hull formula or "the value" of the investment as in the case of the Treaty. Argentina alleges that there is no uniformity in the doctrine on the level of compensation.

332. Argentina questions the cases relied on by Siemens to argue the extent of the damages claimed. According to Argentina, in *Maffezini*, neither *lucrum cessans* nor future profits were redressed, and full compensation awarded in the *Factory at Chorzów* case does not correspond to fair market value. Argentina requests the Tribunal to apply the principles of *Tecmed*, a case that Argentina finds strikingly similar to this case and quotes approvingly its reasoning under Mexican law. Argentina affirms that Argentine law applicable to this case and the 2000 Emergency Law to which Siemens consented do not grant the compensatory right claimed by Siemens.

333. Argentina also questions the currency of the claimed compensation. Argentina argues that it did not guarantee the value of the investment in terms of dollars. Argentina points out that the Contract was not a dollar contract and that Siemens entered into a forward dollar contract to secure US\$190 million, the same amount of the alleged loans made by the parent company to its Argentine affiliate. The existence of such contract, according to Argentina, proves that Siemens never intended to enter into a contract with Argentina in a foreign currency.

334. Argentina explains that under Decree 669/01 for Siemens to be compensated in the amount calculated by the Appraisals Tribunal in accordance with the Contract, the applicable law and the Treaty, Siemens has to deliver real assets in condition to be used, otherwise Argentina would not receive any consideration for its compensation. To achieve this objective, the Appraisals TTN established the following conditions: delivery of the source codes, executable programs correctly set up and approved, delivery of the licenses for base software, databases and other necessary utilities, delivery of the licenses for application software of the sub-contractors, delivery of documentation related to applications, systems and training proved as to its usefulness, and ability to use the Contractor's software licenses.

335. Argentina criticizes the valuation carried out by Siemens' expert. Argentina points out that: (i) he did just office work and had not checked the market values to confirm that the amounts charged by suppliers to SITS reflect the usual market practices, (ii) he did not consider whether the intra-Siemens

Group transfers were carried out at arm's length, (iii) he did not carry out the task personally and did not perform any due diligence, (iv) he accepted all of Siemens' assumptions at face value without verifying them, (v) he affirms to have applied the book value method when he never analyzed where the alleged funds of Siemens were invested and the same analysis should have been done in respect of SITS' liabilities, (vi) he maintains that the book value method and the discounted cash flow analysis reach the same result when the figures are different, and (vii) he made a number of mistakes in calculating future income. Furthermore, the supporting documentation of the valuation is lacking.

336. In its Reply, Siemens argues that it is entitled to full compensation and that "investment value" has to be given its plain and ordinary meaning. Siemens points out that: (i) the Treaty does not qualify the reference to investment value, (ii) "value" in its ordinary meaning is defined as "[t]he monetary worth or price of something; the amount of goods, services, or money that something will command in an exchange," and (iii) in a free market economy the exchange is conducted on the market. Therefore, "the plain and ordinary meaning of 'value' is what one may expect to obtain in exchange for something, that is to say its 'fair market value.'"<sup>130</sup>

337. Siemens observes that the legal authorities referred to by Argentina relate to the general debate on the extent of compensation under customary international law and not to the interpretation of the Treaty which contains a clear standard of full compensation. Siemens refers to *CME* where the tribunal, drawing its conclusions from the *Factory at Chorzów* case, ruled that "genuine value" in Article 5 of the Netherlands-Czech Republic BIT meant the fair market value of the investment. Siemens also refers to *Biloune* which held that the fair market value, which takes into account future profits, is the most accurate measure of value of the expropriated property.

338. On the issue of future profits, Siemens draws the attention of the Tribunal to how the ILC has expressed the principle that lost profits are awarded where there is a reliable basis for the expectation of future income:

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<sup>130</sup> Reply, para. 620.



“In cases where lost future profits have been awarded, it has been where an anticipated income stream has attained sufficient attributes to be considered a legally protected interest of sufficient certainty to be compensable. This has normally been achieved by virtue of contractual arrangements or, in some cases, a well-established history of dealings.”<sup>131</sup>

According to Siemens, the contractual provisions concerning the production, issuance and price of the DNIs and other fees constituted a “legally protected interest of sufficient certainty.”<sup>132</sup>

339. Siemens points out that Argentina refers to documents which are 30 and 45 years old and pertain to debates already settled. Furthermore, in *Tecmed*, and contrary to what Argentina has alleged, the tribunal awarded compensation in accordance with the provisions of the relevant investment treaty, on the basis of the market value of the assets concerned, lost profits and compound interest.

340. Siemens argues that, for purposes of Siemens’ claim of expropriation under international law, the domestic law of Argentina and the provisions of the 2000 Emergency Law are irrelevant.

341. Siemens also contends that, in any case, it is entitled to fair market value on the basis of the Treaty’s most-favored-nation clause and other investment treaties signed by Argentina that specifically provide for such valuation of expropriated assets.

342. Siemens contests the affirmation by Argentina that there was no unlawful expropriation and affirms that the requirements of public benefit, compensation and compliance with the general principles of treatment provided for in the Treaty had not been respected by Argentina. Siemens insists on full damages and, given the unlawful nature of the expropriation, consequential damages all paid in dollars. In this respect, Siemens recalls that the investment was made in dollars and argues that the forward contract itself proves this point. Siemens adds that it is entitled to the value of the investment immediately before

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<sup>131</sup> *Ibid.*, para. 632.

<sup>132</sup> *Ibid.*, para. 633.

the date of the taking when the peso had parity with the dollar. Siemens also recalls that, as it explained at the jurisdictional stage, its right to compensation under the Treaty is distinct from SITS' rights under the Contract and domestic law, and that Argentina never offered nor even approved any compensation under the 2000 Emergency Law.

343. Siemens points out the shortcomings of the valuation report of the TTN, among others: (i) it was never submitted to SITS for consideration, (ii) it was prepared long after termination of the Contract and a long time after SITS lost control and supervision of the System, (iii) it evaluated items individually rather than the System as a whole, and (iv) it was not done in the currency of the investment. According to Siemens, the appraisal done by the TTN does not even reflect the compensation due to SITS under the 2000 Emergency Law.

344. Siemens further points out that Argentina fails to provide a proper response for the sub-contractors' claims and the excuses for withholding the performance bond under the Contract are unsustainable and constitute another arbitrary measure taken by Argentina.

345. As regards Argentina's criticisms of the valuation report prepared by Siemens' expert, Siemens argues that Argentina has misunderstood the task of the expert, which was to evaluate the loss suffered by Siemens on the investment and not to evaluate SITS' loss under the Contract under Argentine law. According to Siemens, it was not the task of this expert to value individual assets: "Valuing hardware and software on a part by part basis, when the very condition of those items are now the result of the expropriation, would provide no support in valuing Siemens A.G.'s investment in the contractual right to operate the System and to generate revenue and return on its investment."<sup>133</sup> Siemens adds that Argentina ignores the fact that the financial statements and accounting records relied on by the expert had been audited by a leading auditing firm – KPMG -, and refers to case law showing the appropriateness of the use of audited accounting records to carry out a valuation task. According to Siemens, Argentina also ignores the fact that SITS was a single project company, which

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<sup>133</sup> Reply, para. 699. Quotation from Expert Lemar's Rebuttal Report.

should answer the criticism that the expert never examined where the alleged funds of Siemens were invested. Regarding the costs of the investment, Siemens contends that, if Siemens' global price was the lowest in the bidding for the Contract, the individual cost and prices of the components would also be lowest or extremely competitive compared to other tenders.

346. In its Rejoinder, Argentina argues that the fair market value of an expropriated property as the measure of compensation for an expropriated investment is not always applicable when an expropriation becomes necessary for social policy reasons. If this would not be the case, it would be a serious limitation on State sovereignty, and no social or economic reforms could be accomplished by poorer nations. Argentina maintains that it had effectively become bankrupt, and that to maintain that an expropriation is only lawful if full market compensation is payable is incompatible with the principle of self-determination. Argentina refers in this respect to professor Brownlie's statement that: "The principle of nationalization unsubordinated to a full compensation rule may be supported by reference to principles of self-determination, independence, sovereignty and equality."<sup>134</sup> Argentina also refers to the statement of the European Court of Human Rights in *James v. UK*, which held that Article 1 of the First Protocol does not "guarantee a right to full compensation in all circumstances. Legitimate objectives of 'public interest' such as pursued in measures of economic reform or measures designed to achieve greater social justice, may call for less than reimbursement of full market value."<sup>135</sup>

347. Argentina affirms that these considerations are applicable to the situation in Argentina and are entirely consistent with the Treaty. Argentina concludes that, even if there was an expropriation, the Claimant would not be entitled to more than the direct losses and not to the *lucrum cessans*.

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<sup>134</sup> Rejoinder, para. 575.

<sup>135</sup> *James v. UK*, *European Court of Human Rights*, 1986, 8, EHRR 123, para. 48, Respondent's Legal Authorities No. AL RA 86, quotation in the Rejoinder, para. 577. Emphasis added by the Respondent.

## 2. Considerations of the Tribunal

348. The Tribunal will address the following issues raised by the parties: applicable law for purposes of determining compensation, the meaning of “value” of the investment, currency of compensation, whether compensation should include *lucrum cessans* and consequential damages, on what evidence it should be based, the amount of compensation, the applicable rate of interest, and whether it should be simple or compound interest.

### a) Applicable Law

349. The Tribunal has found that Argentina took measures that had the effect of expropriating the investment and that such expropriation is in breach of the Treaty, and hence unlawful. The Tribunal has also found that the Respondent breached its obligations to provide fair and equitable treatment and full protection and security and that it adopted arbitrary measures in respect of the investment. The law applicable to the determination of compensation for a breach of such Treaty obligations is customary international law. The Treaty itself only provides for compensation for expropriation in accordance with the terms of the Treaty.

350. The Draft Articles are currently considered to reflect most accurately customary international law on State responsibility. Article 36 on “Compensation” provides:

“1. The State responsible for an internationally wrongful act is under an obligation to compensate for the damage caused thereby, insofar as such damage is not made good by restitution.

2. The compensation shall cover any financially assessable damage including loss of profits insofar as it is established.”

351. This Article relies on the statement of the PCIJ in the *Factory at Chorzów* case on reparation:

“The essential principle contained in the actual notion of an illegal act – a principle which seems to be established by international practice and in particular by the decisions of arbitral tribunals – is that reparation must, so far as possible, wipe out all the consequences of the illegal act and

reestablish the situation which would, in all probability, have existed if that act had not been committed.”<sup>136</sup>

352. The key difference between compensation under the Draft Articles and the *Factory at Chorzów* case formula, and Article 4(2) of the Treaty is that under the former, compensation must take into account “all financially assessable damage” or “wipe out all the consequences of the illegal act” as opposed to compensation “equivalent to the value of the expropriated investment” under the Treaty. Under customary international law, Siemens is entitled not just to the value of its enterprise as of May 18, 2001, the date of expropriation, but also to any greater value that enterprise has gained up to the date of this Award, plus any consequential damages.

**b) Value of the Investment**

353. In the *Factory at Chorzów* case, the PCIJ asked the experts to calculate the value of the undertaking as of the date of the taking and as of the later date of its prospective judgment, and such value to include the lands, buildings, equipment, stocks and process, supply and delivery contracts, goodwill and future prospects. It is only logical that, if all the consequences of the illegal act need to be wiped out, the value of the investment at the time of this Award be compensated in full. Otherwise compensation would not cover all the consequences of the illegal act. While the Tribunal has determined that the Treaty does not apply for purposes of determining the compensation due to Siemens, which is governed by customary international law as reflected in *Factory at Chorzów*, it is worth noting that the PCIJ, as the Treaty itself, refers to the value of the investment without qualification. To reach its conclusion, the PCIJ did not need to have “value” qualified by “full”. The Tribunal is satisfied that the term “value” does not need further qualification to mean not less than the full value of the investment. Having reached this conclusion, it is unnecessary for the Tribunal to discuss the argument advanced by the Claimant that it is entitled to

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<sup>136</sup> *Factory at Chorzów, Merits, PCIJ, Series A, No. 17, 1928, p. 47.*

the fair market value of its investment on the basis of the MFN clause in the Treaty.

354. Argentina has pleaded that, when a State expropriates for social or economic reasons, fair market value does not apply because otherwise this would limit the sovereignty of a country to introduce reforms in particular of poor countries. Argentina has not developed this argument, nor justified on what basis Argentina would be considered a poor country, nor specified the reforms it sought to carry out at the time. Argentina in its allegations has relied on *Tecmed* as an example to follow in terms of considering the purpose and proportionality of the measures taken. The Tribunal observes that these considerations were part of that tribunal's determination of whether an expropriation had occurred and not of its determination of compensation. The Tribunal further observes that Article I of the First Protocol to the European Convention on Human Rights permits a margin of appreciation not found in customary international law or the Treaty.

**c) Method of Valuation**

355. The Claimant has proposed that compensation be calculated on the book value of the investment and that *lucrum cessans* be arrived at through discounting an estimate of profits calculated as a percentage of the revenues that SITS would have received if the Project would have run its course on the basis of the prices for its services set forth in the Contract. Usually, the book value method applied to a recent investment is considered an appropriate method of calculating its fair market value when there is no market for the assets expropriated. On the other hand, the DCF method is applied to ongoing concerns based on the historical data of their revenues and profits; otherwise, it is considered that the data is too speculative to calculate future profits. Normally the two methods are regarded as alternative means of valuing the same object. Here, however, Siemens's expert has applied the two in tandem because, under the terms of the Contract, all Siemens' costs would be incurred before the first peso of revenue would be realized. Therefore, Siemens has calculated its claimed loss of profits by applying a notional profit percentage to its projected future net revenues under the Contract, and then discounting those claimed profits to their present value via the DFC method, to which it then has added the

book value of its costs actually incurred, i.e., its “sunk costs”, which due to the actions of Argentina never will be able to produce the projected (or any) revenues. In other words, Siemens claims: (i) the present value of its estimated lost profits or *lucrum cessans*, plus (ii) the costs it actually incurred, which were “wasted” in the effort to produce the revenues from which those profits would have been derived.

356. Siemens has defended its approach on the basis that SITS had already by May 18, 2001 incurred most Project development costs, the future costs could be estimated with reasonable certainty based on existing service contracts, and the prices for the delivery of SITS’ services were known as were the number of DNIs to be produced. For these reasons, Siemens has argued that an estimate of the present value of future profits could be calculated to complement the book value of the investment. In this respect, the Lemar Report uses the rate of profits on sales projections presented to the board of Siemens at the time the Project was proposed for approval. At that time, the estimated profit rate was 18%. Expert Lemar reduces it to 16% because of developments during the first year of the Contract. Furthermore, Siemens’ expert compares this estimated profit rate to other companies operating in Argentina with prices subject to State regulation, substantial upfront infrastructure investment cost to deliver the service, and the intention of the Government that they would produce a reasonable return to the owners of the investment.<sup>137</sup> For this purpose, the expert uses information from the Argentine *Comisión Nacional de Valores*, Bloomberg Services and the National Gas Authority of Argentina. Mr. Lemar arrives at a cross-sector average profit rate of 16%.<sup>138</sup> Thus similar to that projected by Siemens as adjusted.

357. While the Tribunal understands the reasons for the admittedly unusual approach followed by Siemens and considers that it has merit in the particular circumstances of this case, it has some concerns, as later explained, about how the valuation has been calculated, including the valuation of the *lucrum cessans*.

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<sup>137</sup> Expert Lemar Report attached to the Memorial (“Lemar Report”), p. 23.

<sup>138</sup> *Ibidem*.

**d) Evidence**

358. The parties have taken different approaches in respect of what is the adequate evidence of Siemens' investment. For the Claimant, the audited financial statements of SITS are sufficient evidence of the amounts invested. For Argentina, there is a need to show how each dollar or peso was spent and relate each dollar or peso to the item financed with it. Argentina has insisted that the Tribunal use an expert to analyze the accounts of SITS and ensure that the amounts spent by SITS were spent for purposes of carrying out the Project.

359. The Claimant has pointed out that the Project consisted of a made-to-order integrated system to be carried out by a single purpose company –SITS- as required by Argentina itself. Siemens contends that the financial statements properly audited are sufficient evidence of Siemens' investments, that the financial statements of SITS were audited by KPMG, and that no evidence has been presented to question KPMG's audit.

360. The approach advanced by Argentina responds to the need to assess the value to Argentina of Siemens' investment for purposes of applying Decree No. 669/01. The Tribunal has to apply customary international law. Accordingly, the value of the investment to be compensated is the value it has now, as of the date of this Award, unless such value is lower than at the date of expropriation, in which event the earlier value would be awarded. It is not the value of the investment to Argentina but the value of the investment in terms of the sums invested in the Project. The Project had started to operate and no convincing evidence has been submitted showing that the funds intended for the Project made available to SITS, as loans or equity, were not used for the intended purpose. The valuation made by the Respondent was made from a perspective different from that required under customary international law months after the Contract was terminated. For these reasons, the Tribunal saw no merit in prolonging the proceedings and engaging an expert to analyze the accounts of SITS and where the funds had been invested.



**e) Currency of Compensation**

361. Argentina has argued that the Contract is denominated in pesos and that it had not guaranteed to Siemens the parity of the peso in effect at the time it entered into the Contract. This assertion is correct but it has to be considered in the context of the requirement that the consequences of the illegal act be wiped out. It would be hardly so if the parity of the currency would be added as yet another risk to be taken by the investor after it has been expropriated. In the instant case, the Claimant has pleaded that the Tribunal accept May 18, 2001 as the date of expropriation. The Tribunal has considered that the issuance of Decree 669/01 was determinant for purposes of its finding of expropriation and it is also the date that would be in consonance with Article 15 of the Draft Articles on the date of occurrence of a composite act. On May 18, 2001, the peso was at par with the dollar. If such obligation would have been met, the Claimant would have been compensated in pesos convertible at that rate. Therefore, the Tribunal concludes that compensation shall be paid in dollars.

**f) Amount of Compensation**

362. Siemens claims \$283,859,710 as the book value of the investment to May 17, 2001.

363. Under the Contract (Annex VIII), SITS committed itself to invest \$201,486 million ("Plan de Inversiones" dated June 25, 1998 ("the Investment Plan")) and the variable costs such as satellite links, distribution costs of documents, overheads and operational expenses listed in page 2, paragraph 1.1 of Annex VIII. It is clear from the Contract that the total investment would include the items for which an amount is specified in the Investment Plan and those variable costs for which no estimated amount is given.

364. At the time of the 2000 SWIPCO audit, financed by SITS but carried out for the account of the Respondent, SITS had spent 126,235,000 pesos compared with the 241,486,000 envisaged in the Investment Plan. Both figures are exclusive of the variable costs for which no amount was specified in the Investment Plan.

365. After termination of the Contract and for purposes of the valuation carried out by the TTN, SITS claimed to have invested AR\$158,106,542. As explained in the report of the TTN of December 27, 2002,<sup>139</sup> AR\$47,237 pesos of that amount correspond to subcontractors' invoices and the remainder to invoices of companies in the Siemens group. In addition, SITS claimed "non-productive expenses" (AR\$44,452,193), interest on investments and "non-productive expenses" (AR\$25,260,008 and AR\$8,332,985, respectively), capital contributions (AR\$27 million), close-down costs (AR\$31 million), certain paid and unpaid invoices (AR\$13,100,000), subcontractors' claims (AR\$40 million) and *lucrum cessans* (AR\$254,942,070), for a total in excess of AR\$444 million. The TTN considered, pursuant to the terms of Decree 669/01, only the AR\$158,106,542 on account of investments and valued them at AR\$72,161,510.

366. Argentina in its comments of November 23, 2005 on the accounting information provided by Siemens asserts that the investment made reached AR\$107,472,398.23. The Claimant disputes the amount and currency of the latest value attributed to the investment by Argentina, and of the valuation of the TTN. The Claimant also points out, *inter alia*, that "non-productive expenses" and interest have been excluded, notwithstanding the submission of the related invoices by SITS to the Ministry of the Interior on July 22, 2001.

367. Mr. Lemar, the Siemens' expert, has concentrated on the financing of SITS and has calculated the book value by adding Siemens' capital contributions, the loans made to SITS and the corresponding interest, as recorded in SITS's financial statements for 2001. Mr. Lemar concludes that the book value of Siemens' investment at May 17, 2001 was \$283,859,710.

368. The Tribunal observes, that except for Mr. Lemar's, none of the valuations listed above respond to the criteria that need to be applied by the Tribunal and, as explained forthwith, the Tribunal has difficulty in accepting the value of the investment as calculated by Mr. Lemar. The Tribunal will use as a starting point SITS' audited financial statements. They have been audited by a highly qualified firm of independent auditors, which confirmed the reliability of the

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<sup>139</sup> Exhibit 161 to the Counter-Memorial.

accounting records, and no evidence has been submitted to the Tribunal which proves otherwise. Mr. Lemar has capitalized all interest paid by SITS. *Prima facie*, capitalization of interest during the development phase of an investment is normal practice. However, the financing of the Project was highly leveraged. Siemens paid-in 27 million pesos in equity and financed the rest primarily by three-month credit at 12.08% in 1999, twelve-month credit at 9% in 2000 and again with three-month credit at 14% in 2001. The high interest charged to the Project and the short-term nature of the credit raise the issue of the extent to which it is appropriate to recognize the full amount of interest claimed as part of the value of the investment since it is a way of building into book value what otherwise would have to be earned as profits. The Tribunal considers that it is appropriate to capitalize interest on loans made to SITS for the Project, but in case of loans made by Siemens or its subsidiaries such interest should reflect the actual cost of funds to Siemens because the Tribunal's task is to determine the loss of Siemens itself. Therefore, the Tribunal will proceed to calculate<sup>140</sup> the respective percentage of loans made to SITS by third parties, and Siemens and its subsidiaries and the costs of funds to the latter.

369. According to the funding data in the table in paragraph 3.7 of the Lemar Report, total loan funding by Siemens and its subsidiaries was AR\$224,906,029 and loan funding by others AR\$12,194,531 up to April 30, 2001, and AR\$225,726,812 and AR\$17,241,306 up to May 31, 2001. The Tribunal has adjusted these figures to May 17, 2001 by assuming that debt funding by Siemens, its subsidiaries and third parties increased at a steady daily rate during the month of May. The result is debt funding to May 17 of AR\$225,356,136 by Siemens and its subsidiaries, and AR\$14,962,117 by third parties. Therefore, Siemens and its subsidiaries provided 93.8% of all loans made to SITS and third parties provided 6.2%.

370. For purposes of determining an appropriate interest rate on loans made by Siemens or its subsidiaries, the Tribunal observes that, as a general matter, corporations of Siemens' size and creditworthiness hedge a substantial portion of the interest rate risk inherent in their fixed rate borrowings through

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<sup>140</sup> Amounts have been rounded to the nearest integer.

floating interest rate swaps. Hence, the cost of borrowing that should be taken into account is the floating rate that Siemens could have achieved using interest rate swaps during the life of the Contract from November 26, 1998 to May 17, 2001. The average of such interest rate during this period was 2.35%.<sup>141</sup>

371. Now the Tribunal turns to the percentage of interest payments made to Siemens and its subsidiaries that would be appropriate to capitalize based on the assumed cost of funds to Siemens in addition to interest payments paid to third parties. To arrive at such percentage, it is necessary to calculate the ratio of 2.35% to the annual average interest rate charged to SITS as reflected in SITS' financial statements.<sup>142</sup> Thus, 2.35% is: (i) 18.35% of 12.08% (the average interest rate charged in fiscal year 1998-1999), (ii) 26.11% of 9% (the average interest rate charged in fiscal year 1999-2000), and (iii) 16.78% of 14% (the average interest rate charged in fiscal year 2000-2001). Therefore, the percentage of interest payments to be capitalized out of payments made to Siemens and its subsidiaries is 18.35% in 1998-1999, 26.11% in 1999-2000 and 16.78% in 2000-2001.

372. As recorded in its financial statements, SITS paid on account of interest: AR\$150,828 in fiscal year 1997-1998, AR\$1,383,596 in fiscal year 1998-1999, AR\$12,156,499 in fiscal year 1999-2000 and AR\$16,950,704 up to May 17, 2001,<sup>143</sup> for a total of AR\$30,642,627. Of that amount, 93.8% would correspond to payments made to Siemens and its subsidiaries: AR\$1,297,813 in fiscal year 1998-1999,<sup>144</sup> AR\$11,402,796 in fiscal year 1999-2000 and AR\$15,899,760 in fiscal year 2000-2001 up to May 17, 2001, for a total of AR\$28,600,639. The remainder AR\$2,041,988 was paid by SITS to third parties. The Tribunal will now apply to the amounts paid by SITS to Siemens and its

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<sup>141</sup> Calculation based on data published by Bloomberg.

<sup>142</sup> Annex C of the financial statements.

<sup>143</sup> During the full fiscal year 2000-2001 SITS paid AR\$27,017,497 on account of interest. This amount needs to be adjusted to May 17, 1991 because SITS' fiscal year ran until September 30. For this purpose, the Tribunal has assumed that interest accrued at the same rate each day, divided the amount of interest payments made by 365, multiplied the daily rate by the number of days between May 17 and September 30 -136 days- and deducted the result -AR\$10,066,793- from the amount of interest paid that fiscal year. This brings the amount of interest payments between October 1, 2000 and May 17, 2001 to AR\$16,950,704.

<sup>144</sup> No interest payments to Siemens and its subsidiaries are recorded in the financial statements for fiscal year 1997-1998.

subsidiaries the yearly percentages arrived at in the preceding paragraph with the following results: AR\$234,255 represents 18.35% of the interest paid to Siemens and its subsidiaries in fiscal year 1998-1999, AR\$2,977,270 represents 26.11% of such payments made in fiscal year 1999-2000 and AR\$2,667,979 represents 16.78% of those made in fiscal year 2000-2001 up to May 17, 2001. These three items add up to AR\$5,879,504. The Tribunal will allow that amount of interest paid to Siemens and its subsidiaries plus AR\$2,041,988 paid to third parties for a total of AR\$7,921,492 to be capitalized for purposes of the calculation of the book value of Siemens' investment. Therefore, the book value calculated by Siemens' expert Lemar should be reduced by the difference between the aggregate amount of interest payments made to Siemens and its subsidiaries - AR\$28,600,369 - and AR\$5,879,504, namely, AR\$22,720,865.

373. The book value calculation by Mr. Lemar includes two other items that the Tribunal finds inappropriate. First, in note 5 to SITS' financial statements for fiscal year 2000-2001 under the heading of "Resultados extraordinarios", there is an entry on "Constitución previsión de otros créditos" with an amount of AR\$42,253,305. This item cross-refers to note 4.5, which explains that this amount corresponds to tax credits that have been provisioned in full because of the uncertainty regarding their recoverability and have been charged as extraordinary losses. The Tribunal holds the opinion that it is incorrect to include this amount in the book value of SITS for purposes of compensation. Indeed, the tax credits had not been realized because of SITS' lack of revenues. Hence, the amount of AR\$42,253,305 should also be subtracted from the calculation of the book value.

374. Second, the Tribunal refers again to note 5 to the financial statements of SITS for fiscal year 2000-2001 and to the item on "Constitución previsión para riesgos relacionados con la rescisión del contrato" under the heading of "Resultados extraordinarios." An entry of AR\$10,445,000 is listed on that account. Since the Tribunal has allowed compensation for consequential damages, as explained later, the provisioning for risks related to Contract termination would lead to double counting and is disallowed for purposes of the book value calculation.

375. To conclude the book value calculation, the Tribunal decides that such value is the value claimed by Siemens minus the amounts disallowed above on account of excessive interest rates, tax credits and risks associated with Contract termination. The amounts corresponding to these items add up to AR\$75,419,170, which when subtracted from AR\$283,859,710 claimed by Siemens reduce the book value of the investment to AR\$208,440,540.

376. As the Tribunal has noted, it has been a matter of controversy whether to use funds invested as a measure of the value of the investment or how these funds have been used. The Tribunal has looked into the use of funds as recorded in the financial statements themselves and the result of such examination confirms the adjusted book value set forth above. The Tribunal has taken into account the items in the financial statements that correspond to the Project as such, “bienes de uso”, intangible assets and “project cost”. It emerges from note 5 to SITS’ 2001 audited financial statements (“Estado de resultados” under the heading of “Resultados extraordinarios”) that, in 2001 and because of the termination of the Contract, SITS wrote off AR\$39,777,220 of intangible assets, AR\$49,678,876 of “bienes de uso” and AR\$123,127,297 of “project costs”. These three items add up to AR\$212,583,393.

377. The audited financial statements reflect the financial situation of SITS on September 30, 2001 and the Tribunal has the task to value the investment of Siemens at May 17, 2001. Therefore, the Tribunal has considered it appropriate to compare the aggregate amount of funds applied to “bienes de uso”, intangible assets and “project cost” between September 2000 and September 2001, to assume that these funds were applied at the same daily rate through the period, and to subtract from the difference the amount corresponding to the 136 days between May 17 and September 30, 2001. These assumptions correspond, *mutatis mutandis*, to those applied by expert Lemar to the sources of funds to calculate the value of the investment to May 17, 2001. The financial statements for 2001 show that SITS spent AR\$20,741,994 in “project cost” during the year and AR\$8,973,678 on “bienes de uso” (no funds were applied to intangible assets). These two items add up to AR\$29,715,672. This amount prorated by 365 days results in a daily application of funds to such items of

AR\$81,412.8, which multiplied by 136 is equal to AR\$11,072,140. The subtraction of this amount from AR\$212,583,393 (the sum expended on account of “bienes de uso”, intangible assets and “project cost”) results in AR\$201,511,253, which the Tribunal considers a reasonable approximation to the amount applied to “bienes de uso”, intangible assets and “project cost” up to May 17, 2001. When the allowed capitalized interest of AR\$7,921,492 is added to this amount we arrive at AR\$209,432,745. A result slightly higher than the book value, which can be explained by the adjustments that need to be made to reflect the value of the investment on May 17, 2001.

378. Siemens further claims \$124,541,000 on account of loss profits before taxes.

379. The Tribunal considers that the amount claimed on account of lost profits is very unlikely to have ever materialized for the following reasons:

380. First, in considering the estimated rate of profit on sales, the Tribunal recalls that the calculation of the Claimant assumes the issuance of 33 million DNI. The Tribunal considers that this amount is excessive taking into account that the Claimant accepted to make the investment with a guaranteed minimum of 24 million DNI (Article 16(b) of the Contract).<sup>145</sup> Therefore, the estimated amount of revenues of AR\$889,147,000 calculated by the Claimant needs to be reduced by AR\$270 million (30 pesos per each DNI multiplied by 9 million) to AR\$619,147,000.

381. Second, the amount of AR\$619,147,000 includes a 21% value added tax (Article 4.4 of the Contract) equal to AR\$107,455,000, which needs to be subtracted and results in AR\$511,692,000. Applying to this amount the 16% profit rate results in profits before applicable taxes of AR\$81,870,000 over the life of the Contract.

382. Third, the discount rate to be applied to the estimated profits should reflect the cost of money and the country and business risks. According to Siemens' own expert, this should be a rate within a range of 11% and 15%. Mr.

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<sup>145</sup> The TTN points out in its report that the license of Printrak that SITS held to print DNIs was valid for printing only 24 million documents. Exhibit 161 to the Counter-Memorial, folio 15.

Lemar himself has offered a calculation using a rate in the middle of such range - 13%. The Tribunal considers this rate appropriate taking into account the country and business circumstances of the operation and the cost of funds.

383. Fourth, Siemens' expert has discounted the profits over the expected life of the Contract assuming that it would not be extended. It was possible for the Contract to be extended for an additional six years. It would not be unreasonable to assume that delays would have occurred in the normal course of Project operation given the novelty and complexity of the Project; it is undisputed by the parties that it was the first of its kind. Furthermore, the analysis performed by Mr. Lemar to take into account the three-month delay in Project start-up shows the sensitivity of profits to delays in the timing of revenues. A delay of three months resulted in a drop of 2% in the profit rate notwithstanding the addition of AR\$29 million in revenues for printing of electoral roles which had been underestimated in an earlier calculation. An extension of the Contract to 9 or 12 years would have had devastating effects on the profit rate.

384. Fifth, the profits would have been subject to a corporate profits tax.

385. For these reasons, the Tribunal concludes that Siemens is not entitled to any compensation on account of profit loss.

386. Additionally, Siemens has claimed \$9,178,000 for post-expropriation costs incurred by SITS in continuing a skeleton operation, \$219,899 for unpaid invoices by the Government in relation with the voters list of 1999, \$44,678,462 for sub-contractors' claims, and the return of the performance bond.

387. The Tribunal considers that the claim on account of post-expropriation costs is justified in order to wipe out the consequences of the expropriation. As regards the sub-contractors' claims, Argentina has affirmed to have taken the necessary measures to ensure that these claims are transferred to Argentina. The Tribunal acknowledges this affirmation and decides that Argentina shall hold the Claimant, its subsidiaries and affiliates, wherever located, harmless from, and indemnify same in respect of, any claims heretofore



or hereafter asserted against any of them by any of the following subcontractors to SITS in relation to the Contract: Boldt S.A., Correo Argentino S.A., Printrak International/Printrak de Argentina S.R.L., Imaging Automation Inc., Impsat S.A., SWIPCO Argentina S.A., Mojacar S.A., Indra Spain and Indra Argentina, and Oracle.

388. Since the Contract was terminated on grounds other than performance, it is congruent that the performance bond be returned promptly to Siemens or SITS, as its agent for this purpose. Should the bond not have been returned 30 days after the date of this Award, Argentina shall pay the Claimant the amount of the bond.

389. As for the amount claimed on account of services rendered and unpaid, the Tribunal considers that, since such amount is not disputed and would normally be considered an asset forming part of the value of the investment, the Respondent shall compensate Siemens for the full amount claimed.

**g) Interest**

390. The Claimant has requested that the Tribunal award compound interest at the rate of 6% per annum and that interest accrue as from May 18, 2001 for compensation on account of the expropriated investment and as from the date costs were incurred in the case of compensation for additional damages. The Lemar Report takes into account a number of options before arriving at the conclusion that 6% would be an appropriate rate to apply based on the consideration that this is the rate that Siemens used as its average corporate borrowing rate in appraising investments and in considering funding costs in 2001-2003. The rate of 6% has also been advanced in Professor Schreuer's opinion on the basis of arbitral practice.

391. In its Counter-Memorial, the Respondent does not comment on the issue of the applicable rate of interest. In its Rejoinder, Argentina simply disputes the rate of interest claimed since the Treaty provides that interest be paid at "the usual bank rate." No alternative interest rate is proposed nor is any reason adduced to question how the Claimant has arrived at that rate. Argentina

seems to presume that “the usual bank rate” would be different but without specifying what this bank rate should be.

392. In its Rejoinder, the Respondent objects to the award of compound interest, it considers that this is an inappropriate case for awarding compound interest without offering reasons why this would be so, and responds to the Claimant’s assertion that compounding of interest is in line with the principle of full damages as follows:

“That may theoretically be the case if in fact the investor has borrowed elsewhere to make good the loss of the money which it is said it should have received. But nowhere is it claimed that this Claimant was obliged to make good any financial losses by itself borrowing money at compound interest rates from banks. Thus, the claim for loss of the interest on interest which it is said would have been earned is unfounded in fact as well as being entirely speculative. This element of the Claim amounts to an attempt by the Claimant to unjustly enrich itself in the circumstances of this case.”<sup>146</sup>

393. Argentina further objects to the date of May 18, 2001 as the date from which interest would accrue. It argues that, since the Treaty is silent on this point, it would be artificial to attribute most losses as from that date and speculative and complex to establish dates when the additional damages occurred.

394. The Tribunal will address first the applicable rate of interest, then turn to the questions of the date as from which interest should accrue and whether interest should be simple or compounded.

395. As an expression of customary international law, Article 38 of the Draft Articles states:

“1. Interest on any principal sum payable under this Chapter shall be payable when necessary in order to ensure full reparation. The interest rate and mode of calculation shall be set so as to achieve that result.

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<sup>146</sup> Rejoinder, para. 727. Footnote deleted.

2. Interest runs from the date when the principal sum should have been paid until the date the obligation to pay is fulfilled.”

396. Thus, in determining the applicable interest rate, the guiding principle is to ensure “full reparation for the injury suffered as a result of the internationally wrongful act.”<sup>147</sup> The Tribunal considers that the rate of interest to be taken into account is not the rate associated with corporate borrowing but the interest rate the amount of compensation would have earned had it been paid after the expropriation. Since the awarded compensation is in dollars, the Tribunal considers that the average rate of interest applicable to US six-month certificates of deposit is an appropriate rate of interest. The average of such rate from May 18, 2001 to September 30, 2006 is 2.66%.<sup>148</sup>

397. For purposes of erasing the effects of the expropriation, interest should accrue from the date the Tribunal has found that expropriation occurred, namely, May 18, 2001, in respect of the book value of the investments made for the Project up to that date. Compensation for post-expropriation costs incurred after May 18, 2001 should accrue interest as from the date on which they were incurred. Since this would not be practical for calculation purposes given the multiple dates involved, the Tribunal considers that interest on post-expropriation costs shall accrue as of January 1, 2002, date by which most of these costs had been incurred (\$9,339,863 out of a total claimed of \$9,807,638). As for interest on unpaid Government bills, interest should accrue from January 1, 2000 since they relate to services rendered in 1999.

398. In the eventuality that Siemens or any of its affiliates or subsidiaries would be held liable for any of the claims of the sub-contractors related to the Contract, interest shall accrue from the date of payment of any such claim. Furthermore, in the eventuality that the performance bond is not returned by the Respondent within 30 days of the dispatch of this Award to the parties, interest shall accrue on the amount of the bond as from 30 days after the

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<sup>147</sup> J. Crawford, *The International Law Commission's Articles on State Responsibility. Introduction, Text and Commentaries* (2002) p. 239.

<sup>148</sup> Calculated on the basis of data published by Bloomberg.

date of dispatch of this Award to the parties and until such amount has been fully paid.

399. As regards compounding of interest, the question is not, as argued by Argentina, whether Siemens had paid compound interest on borrowed funds during the relevant period but whether, had compensation been paid following the expropriation, Siemens would have earned interest on interest paid on the amount of compensation. It is in this sense that tribunals have ruled that compound interest is a closer measure of the actual value lost by an investor. As expressed by the tribunal in *Santa Elena*:

“[w]here an owner of property has at some earlier time lost the value of his asset but has not received the monetary equivalent that then became due to him, the amount of compensation should reflect, at least in part, the additional sum that his money would have earned, had it, and the income generated by it, been reinvested each year at generally prevailing rates of interest.”<sup>149</sup>

400. Similarly have held the tribunals in *Metalclad* and *Wena Hotels*. The *Ad Hoc* Committee in *Wena Hotels* decided that it was within the tribunal’s power to take the option of compound interest as an alternative compatible with the objectives of prompt, adequate and effective compensation and compensation that reflects the market value of the investment immediately before the expropriation.<sup>150</sup>

401. For these reasons, the Tribunal concludes that interest shall be compounded and be compounded annually.

### **VIII. Costs**

402. In order to take into account that the Claimant has not fully prevailed in these proceedings, the Tribunal determines that each party shall bear its own legal costs, and that Argentina and Siemens shall be responsible for 75% and 25%, respectively, of the fees and expenses of the Tribunal and the costs of the ICSID Secretariat.

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<sup>149</sup> *Santa Elena*, para. 104.

<sup>150</sup> *Wena Hotels*, paras. 52-53.

## **IX. Decision**

403. Having carefully considered the parties' arguments in their written pleadings and oral submissions and for the reasons above stated the Tribunal unanimously decides:

1. that the Respondent breached Article 4(2) of the Treaty by expropriating Claimant's investment without complying with its terms;
2. that the Respondent breached Articles 2(1) and 4(1) of the Treaty by failing to accord fair and equitable treatment and full protection and legal security to the investment of the Claimant;
3. that the Respondent has breached Article 2(3) of the Treaty by the arbitrary measures taken in respect of the investment of the Claimant;
4. that the Respondent shall pay forthwith to the Claimant compensation in the amount of \$208,440,540 on account of the value of its investment, \$9,178,000 on account of consequential damages and \$219,899 on account of unpaid bills for services rendered by SITS to the Government;
5. that the Respondent shall forthwith, and in no event later than thirty (30) days from the date of dispatch of this Award to the parties, deliver to Claimant (or SITS as its agent for this purpose) the Contract performance bond provided by SITS (insurance policy No. 000589772) for an amount of \$20 million);
6. that the Respondent shall hold the Claimant, its subsidiaries and affiliates, wherever located, harmless from, and indemnify same in respect of, any claims heretofore or hereafter asserted against any of them by any of the following subcontractors to SITS in relation to the Contract: Boldt S.A., Correo Argentino S.A., Printrak International/Printrak de Argentina S.R.L., Imaging Automation Inc., Impsat S.A.,

SWIPCO Argentina S.A., Mojacar S.A., Indra Spain and Indra Argentina, and Oracle;

7. that the Respondent shall pay to the Claimant interest compounded annually on the sums listed in point 4 of this decision at the rate of 2.66%, which is the average rate applicable to US six-month certificates of deposit from May 18, 2001 to September 30, 2006; such interest to accrue as from May 18, 2001 in the case of compensation on account of the value of the investment, January 1, 2000 in the case of compensation on account of unpaid bills by the Government, and January 1, 2002 in the case of compensation on account of consequential damages, all until the date of dispatch of this Award to the parties;
8. that, in the eventuality that the Respondent had not paid in full the sums referred to in this decision thirty (30) days after the date of dispatch of this Award to the parties, the Respondent shall pay to the Claimant interest compounded annually on the unpaid sum at the rate set forth in point 7 of this decision; such interest to accrue as from thirty (30) days after the date of dispatch of this Award to the parties until such amount has been fully paid;
9. that the Respondent shall, in the eventuality that the Respondent has not delivered the bond referred to in point 5 of this decision to the Claimant (or SITS as its agent) thirty (30) days after the date of dispatch of this Award to the parties, forthwith pay to the Claimant the full amount of the bond. Such amount to bear interest compounded annually at the rate set forth in point 7 of this decision until fully paid;
10. that the Respondent shall, in the eventuality that Siemens or any of its affiliates or subsidiaries would be held liable for any claims of the sub-contractors listed above, pay interest

compounded annually at the rate set forth in point 7 of this decision on any amount paid to satisfy such liability; such interest to accrue from the date of payment of any such amount;

11. that any funds to be paid pursuant to this decision shall be paid in dollars and into an account outside Argentina indicated by the Claimant and net of any taxes and costs;
12. that each party shall bear its own costs and counsel fees;
13. that the Respondent and the Claimant shall be responsible for 75% and 25%, respectively, of the fees and expenses of the arbitrators and the costs of the ICSID Secretariat; and
14. that all other claims are dismissed.

Made in Washington, D.C., in English and Spanish, both versions equally authentic.

*(signed)*  
Judge Charles N. Brower  
Arbitrator

*(signed)*  
Professor Domingo Bello Janeiro  
Arbitrator

Date: 4 Jan. 2007

Date: 11 enero 2007

*(signed)*  
Dr. Andrés Rigo Sureda  
President

Date: January 17, 2007



# The Law of Investment Treaties

Second Edition

JESWALD W. SALACUSE

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Italy–Venezuela Mixed Claims Commission in 1903 had to adjudicate whether Venezuela was monetarily liable to Italian nationals for damage resulting from the acts of revolutionaries operating in Venezuelan territory. Article 4 of the Italy–Venezuela Treaty of 1861 stated that each state's citizens should enjoy 'the fullest measure of protection and security of person and property, and should have in this respect the same rights and privileges accorded to nationals' of the territory. The umpire in the case declared that he 'accepts the rule that if in any case of reclamation submitted to him it is alleged and proved that Venezuelan authorities failed to exercise due diligence to prevent damages from being inflicted by revolutionists, that country should be held responsible'.<sup>15</sup> He ultimately denied Italy's claims that the treaty imposed strict liability.

Probably the most authoritative case interpreting the FCN treaty provisions on protection and security was a 1989 decision of a chamber of the International Court of Justice (ICJ) in the *ELSI* case.<sup>16</sup> In that case, the United States brought a claim against Italy under the US–Italy FCN treaty for injuries incurred by Raytheon, a US company, with respect to its subsidiary in Sicily. A factory of Raytheon's subsidiary in Palermo was taken over by workers and then requisitioned by the mayor in order to forestall its closure by the investor for economic reasons. The United States alleged that such actions violated Italy's obligation to give US investors 'the most constant protection and security', as required by Article V(1) of the FCN treaty. The United States did not contend, however, that the obligation constituted a guarantee resulting in strict liability. Instead, it pointed to the 'well-established aspect of the international standard of treatment... that States must use "due diligence" to prevent wrongful injuries to the person or property of aliens within their territory'. The ICJ Chamber found that the Italian government had taken adequate measures to protect the investor and its property, stating that '[t]he reference in Article V to the provision of "constant protection and security" cannot be construed as the giving of a warranty that property shall never in any circumstances be occupied or disturbed'.<sup>17</sup>

In general, jurisprudence relating to the FCN provisions on protection and security recognizes that this standard requires host countries to take steps to protect investors against physical injury to their persons or properties, whether by government agents or third persons. However, the FCN provision does not make the host state a guarantor of the safety of the investor or its property. It requires only that the host state exercise due diligence in carrying out its obligations under the treaty. As one commentator has observed, the decisions of tribunals and the other sources offer no definition of 'due diligence', noting: 'No doubt the application of this standard will vary according to the circumstances, yet, if "due diligence" be taken to denote a fairly high standard of conduct the exception will overwhelm the rule'.<sup>18</sup> A host state satisfies its due diligence obligation when it

<sup>15</sup> *ibid* 534.

<sup>16</sup> *Eletronica Sicula SpA (ELSI) (United States v Italy)* (Judgment) (20 July 1989) [1989] ICJ Rep 15.

<sup>17</sup> *ibid* ¶108, p 65.

<sup>18</sup> J Crawford, *Brownlie's Principles of Public International Law* (8th edn, OUP, 2012) 552.

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takes all the reasonable measures of protection that a well-administered government would take in a similar situation.<sup>19</sup>

### (c) Full protection and security in the modern era

With the development of bilateral and other investment treaties since 1960, the inclusion of provisions granting investors some form of protection and security has become standard. It can thus be found in countless BITs, NAFTA,<sup>20</sup> the Energy Charter Treaty (ECT),<sup>21</sup> and the 2009 ASEAN Comprehensive Investment Agreement,<sup>22</sup> among others. These provisions have also been the basis of several investor–state arbitrations, and so arbitral tribunals have had to interpret and apply them in a new era. In doing so, contemporary tribunals have relied on the jurisprudence interpreting FCNs to a significant extent but have also extended the scope of protection in certain instances.

The first such BIT case was *Asian Agricultural Products Limited v Sri Lanka (AAPL)*.<sup>23</sup> In *AAPL*, an ICSID tribunal considered the claims of a UK investor in shrimp farming in Sri Lanka which had suffered injuries as a result of the destruction of its facilities by Sri Lankan security forces during an alleged operation against rebels. The claimant maintained that the UK–Sri Lanka BIT's provision guaranteeing 'full protection and security' went beyond the minimum standard of customary international law and imposed an unconditional obligation of protection on the host country. Therefore, failure to comply with the obligation entailed 'strict or absolute liability' for the host state once damage to the investor's property was established. In response, Sri Lanka contended that the 'full protection and security' standard incorporates, rather than supplants, the customary international legal standard of responsibility requiring due diligence on the part of states and reasonable justification for the destruction of property, but not

<sup>19</sup> On the meaning of due diligence, tribunals and scholars have often referred to the statement of Professor AV Freeman in his lectures at the Hague Academy of International Law: 'The "due diligence" is nothing more nor less than the reasonable measures of prevention which a well-administered government could be expected to exercise under similar circumstances.' AV Freeman, 'Responsibility of States for the Unlawful Acts of Their Armed Forces' (1956) 88 *Receuil des Cours* 261. See also *Asian Agricultural Products Ltd v Sri Lanka*, ICSID Case No ARB/87/3 (Final Award) (27 June 1990) ¶ 170.

<sup>20</sup> NAFTA, Art 1105, entitled 'Minimum Standard of Treatment', provides: '1. Each Party shall accord to investments of investors of another Party treatment in accordance with international law, including fair and equitable treatment and full protection and security.'

<sup>21</sup> ECT, Art 10, entitled 'Promotion, Protection, and Treatment of Investments', provides in part in para 1: '[s]uch investments shall enjoy the most constant protection and security'.

<sup>22</sup> Art 11(1), on the Treatment of Investments states: 'Each member state shall accord to covered investments of investors of any other member state fair and equitable treatment and full protection and security.' Art 11 (2) further provides: 'For greater certainty... (b) full protection and security requires each Member State to take such measures as may be reasonably necessary to ensure the protection and security of covered investments.'

<sup>23</sup> *Asian Agricultural Products Ltd v Sri Lanka*, ICSID Case No ARB/87/3 (Final Award) (27 June 1990). The Sri Lanka–United Kingdom Agreement on the Promotion and Protection of Investments (entered into force 18 December 1980) (1980) 19 ILM 886.

KLUWER LAW INTERNATIONAL

**General Principles of EC Law  
"in a Process of Development"**

Reports from a conference in Stockholm,  
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the Swedish Network for European Legal Studies

Edited by

**Ulf Bernitz**

**Joakim Nergelius**

**Cecilia Cardner**

**in association with Xavier Groussot**



**Wolters Kluwer**

Law & Business

institution's decision. Through the duty to give reasons, the private party can force the institution to explain clearly on what grounds it has based its decision. A common objective of the umbrella-principle of good administration may be defined as promoting transparency, legal certainty and predictability within administrative procedures.

### 3.2.2.1.1 The Principle of Due Diligence

The principle of due diligence has been applied by Community courts in a wide range of situations and under varying forms. The name of the principle has also varied. The obligations incumbent on the institutions discussed here have been labelled as due diligence,<sup>13</sup> principle of care,<sup>14</sup> and principle of good,<sup>15</sup> proper,<sup>16</sup> or sound<sup>17</sup> administration. Its core can be described as a procedural tool for private parties to ensure that Community institutions handle the affairs of individuals with care, by giving individuals a right to influence the basis for the public authority's decisions both as to how the matter is handled and how the substantive aspects are assessed and weighed by the institutions. In two cases establishing the principle of due diligence in the early 1990:s, *TU München* and *Nölle*, the European Court of Justice held that the institutions have a duty to examine carefully and impartially all the relevant aspects of the individual cases<sup>18</sup> and to give special attention to aspects that speak for private parties.<sup>19</sup> The field of application of the principle of due diligence can thus be divided into two types of situations. Firstly, from the demand to *examine carefully and impartially all the relevant aspects*, follows a duty for the institutions to handle matters diligently and to carefully follow any procedures laid down in secondary legislation or as general principles. Secondly, *to give special attention to aspects that speak for private parties* includes a duty to use the principle of due diligence as a counterweight to the discretionary powers of the institutions in the decision-making process itself.

When applied in the first manner, the principle of due diligence functions as a standard for the good behaviour of institutions. In the *Fresh Marine Company*-case, the Commission received a report from a Norwegian salmon company in an anti-dumping matter that contained some unclear figures. The Commission proceeded by unilaterally changing the figures, with the result that the Norwegian company appeared to have transgressed the anti-dumping agreement. It was later shown

13. See case C-49/88 Al-Jubail v Council ECR 1991, p. I-3187, para. 17.

14. See case T-167/94 Nölle v Council and Commission ECR 1995, p. II-2589, paras 68 and following.

15. See case 223/85 RSV v Commission ECR 1987, p. 4617, para. 12.

16. See case T-105/96 Pharos v Commission ECR 1998, p. II-285, para. 73.

17. See case C-29/05 P Office for Harmonisation in the Internal Market v Kaul AG ECR 2007, p. I-2213 para. 47.

18. See case C-269/90 TU München v Hauptzollamt München-Mitte ECR 1991, p. I-5469, para. 14.

19. See case C-16/90 Nölle v Hauptzollamt Bremen-Freihafen ECR 1991, p. I-5163, para. 35.

that the changes made by the Commission were inaccurate. The Court of First Instance held that there was a duty of diligence incumbent upon the Commission and that the error committed by the Commission was such that it 'would not have been committed in similar circumstances by an administrative authority exercising ordinary care and diligence'.<sup>20</sup> The European Court of Justice, in plenum, came to the same conclusion regarding the action of the Commission, even though the Court of Justice did not explicitly refer to the principle of due diligence.<sup>21</sup>

Similarly, Community institutions must be careful to observe and fulfil more general duties laid down in secondary legislation, so that mistakes and substandard practises of the institutions will not adversely affect private parties in individual matters. The Court of First Instance in several cases has applied the principle of due diligence to customs cases, where the Commission has an obligation to monitor trade between the EU and third countries. In the *Eyckeler & Malt*-case regarding the import of Hilton beef from Argentina, the Court of First Instance found that the Commission had failed in its obligation, leading to a breach of Article 211 EC and of the principle of good administration.<sup>22</sup> In the area of Community trade mark law, the European Court of Justice held equally in the *Bayer*- case that the principle of sound administration, as it was referred to, together with the principle of legal certainty, implied a duty to uphold time-limits and procedural rules in such a way as to ensure the proper conduct and effectiveness of proceedings.<sup>23</sup> A third example can be taken from the area of classification and control of foodstuffs, veterinary and medical matters, where the Commission enjoys a role as a legislator. Here, the Court of First Instance has applied the principle of due diligence or good administration as a standard in liability cases, *CEVA Santé Animale* and *Monsanto Company*.<sup>24</sup> In the both cases, the European Court of Justice, in plenum, overturned the verdicts of the Court of First Instance. In *Ceva Santé Animale*, the European Court of Justice did not review the principle of sound administration in itself, but held that that Court of First Instance had erred when it had not established what scope of discretion the Commission enjoyed.<sup>25</sup> In *Monsanto Company*, the European Court of Justice referred to the principle of

20. See case T-178/98 *Fresh Marine Company v Commission* ECR 2000, p. II-3331, paras 81–82.

21. See case C-472/00 P *Commission v Fresh Marine Company* ECR 2003, p. I-7541, paras 30–31. A further example of the principle of due diligence being applied in this context is the case T-231/97 *New Europe Consulting v Commission* ECR 2003, p. 9189, paras. 163–165.

22. See Case T-42/96 *Eyckeler & Malt v Commission* ECR 1998, p. II-401, para. 165. For similar cases, See case T-329/00 *Bonn Fleisch Ex- und Import v Commission* ECR 2003, p. II-287, paras. 64 and 89, case T-330/99 *Spedition Wilhlem Rotermund v Commission* ECR 2001, p. II-1619, paras. 52–53 and case T-186/97 *Kaufring v Commission* ECR 2001, p. II-1337.

23. See case C-29/05 P. *Bayer*, paras. 47–48. See also case C-104/01 *Libertel* ECR 2003, I-3793, para. 59, regarding the principle of sound administration and the interest of ensuring that trade marks whose use could successfully be challenged before the courts are not registered.

24. See case T-112/97 *Monsanto Company v Commission* ECR 1999, p. II-1277 and case T-344/00 *CEVA Santé Animale v Commission* ECR 2003, p. II-229. On the other hand, See case T-13/99 *Pfizer Animal Health v Council* ECR 2002, p. II-3305, where the Court of First Instance in a similar type of question in an action for annulment applied the principle of due diligence as a counterweight to the discretion of the Commission in scientific matters.

25. See case C-198/03 P *Commission v CEVA Santé Animale* ECR 2005, p. I-6357, paras 69–71.

sound administration and the duty of care, but found, in contrast to the Court of first Instance, that the Commission was not in breach of the principle. The European Court of Justice performed a more individualised test of the principle, as described below, balancing the interest of the private parties concerned against the interest of the Commission. The European Court thus held that in the present case, Monsanto Company had not established, or even sought to establish, that the decision at issue was adopted in disregard of the principle of sound administration and the duty of care.<sup>26</sup> In what circumstances the principle is to be understood as a standard or as an individual guarantee does not seem to be clear at all.

When the principle of due diligence is applied in the second manner as described above, the principle functions as a counterweight to the discretionary powers of the institutions. The principle gives the private party a tool to influence the substantive outcome of the decision-making procedure, by enabling the party to give input to the basis of the decision and to how it should be assessed. In this form, the principle of due diligence is a procedural rule with a close connection to the substantive evaluation of the case, as the duty to investigate carefully necessarily will be closely connected to the interpretation of the legal question at stake. Substantively irrelevant circumstances need not to be investigated as carefully.<sup>27</sup> The principle of due diligence can further be used as a supplementary tool to other procedural guarantees, such as the right to be heard, in order to ensure that Community institutions give appropriate attention to the arguments put forward by private parties. This may be useful for private parties who do not enjoy a formal standing in the administrative procedure, such as third parties. This application of the principle was described by Advocate General Poiares Maduro, in *max.mobil*:<sup>28</sup>

In the case-law, these safeguards are understood as a means, first, of laying down limits to the Commission's discretionary power and, second, of protecting third parties whose interests are affected but who have no procedural protection equal to that of persons to whom decisions are addressed.

Advocate General Maduro referred to *Schlüsselverlag J.S. Moser*<sup>29</sup> and *Sytraval*,<sup>30</sup> two cases in which the European Court of Justice found that the views put forward by private (third) parties should have prompted the Commission to take those considerations into account in its decision-making. Another case where the principle of due diligence was applied in this connection, is *TU-München*,<sup>31</sup> as

26. See C-248/99 P *France v Monsanto Company and Commission* ECR 2002 p. I-1, paras. 92–93.

27. See case T-44/90 *La Cinq v Commission* ECR 1992, p. II-1, para. 94, where the Court of First Instance stated that the Commission failure to fulfil its obligation to take account of all the relevant facts in the case amounted to a manifest error of appraisal and not a procedural error, which would have been more logical. See further case T-7/92 *Asia Motor France v Commission* ECR 1993, p. II-669, para. 37.

28. See opinion of Mr Advocate General Poiares Maduro in case C-141/02 P *max.mobil (T-Mobile Austria)* ECR 2005, p. I-1283, para. 81.

29. See case C-170/02 P *Schlüsselverlag J.S. Moser v Commission* ECR 2003, p. I-9889.

30. See case C-367/95 P *Commission v Sytraval* ECR 1998, p. I-1719.

31. See case C-269/90 *TU München*.



mentioned above. The common ground in these cases is the interpretation of the private parties' legitimate interest in having a decisive influence over the institutions decision-making, especially in cases where the Community institution has a wide power of appraisal or where complex economic or technical issues are at stake.

### 3.2.2.1.2 The Principle of a Right to be Heard

The right to be heard in administrative proceedings was developed by the European Court of Justice in its very early case law as an independent general principle. In a staff case in 1962, *Alvis*, the European Court of Justice held that according to a generally accepted principle of administrative law in force in the Member States, the administrations of these states must allow their servants the opportunity of replying to allegations before any disciplinary decision is taken concerning them. This rule, which the European Court of Justice found to a part of 'sound justice and good administration', was to be followed by the Community institutions. In *Transocean Marine Paint* from 1974, the right to be heard was introduced as a general principle of administrative procedure.<sup>32</sup>

The right to be heard in Community law is ensured to private parties that in some way are affected by a measure taken by a Community institution, and first and foremost to those who are adversely affected. The typical situation is where an institution initiates proceedings of some kind against a private party, involving sanctions, fines and or penalty payments. The decision does not necessarily have to be addressed to a party for that party to be considered targeted. Third parties that might lose a benefit through the Community measure may also be 'targeted'.<sup>33</sup> It is more questionable whether there is a right to be heard in a situation where a private party turns to the institution in order to apply for a benefit. In *Windpark Grothusen*, a company had applied for financial support for an energy project administered by the Commission, together with 700 other applicants. When the application was denied, the company maintained that they had not been given a right to be heard. Both the Court of First Instance and the European Court of Justice found that the company did not have such right, as the company had not been adversely affected in the way understood by case law.<sup>34</sup> On the other hand, in *TU München* mentioned above in the context of the principle of due diligence, the party in the case, a university, was considered to have a right to be heard in regards to an application of exemption of import duties.<sup>35</sup> In *TU München*, the ground for promoting administrative procedural guarantees for the private party was the fact that the Commission had a wide power of appraisal in deciding the matter and that the importing university could be an important source of information, since they were

32. See case 17/74 *Transocean Marine Paint Association v Commission* ECR 1974, p. 1063, para. 15.

33. See case T-260/94 *Air Inter v Commission* ECR 1997, p. II-997, para. 62.

34. See case T-109/94 *Windpark Groothusen v Commission* ECR 1995, p. II-3007 and C-48/96 *P Windpark Groothusen v Commission* ECR 1998, p. I-2873.

35. See case C-269/90 *TU München*, para. 25.



JUDGMENT OF THE COURT

10 July 2003 \*

In Case C-472/00 P,

Commission of the European Communities, represented by V. Kreuzschitz and S. Meany, acting as Agents, and N. Khan, Barrister, with an address for service in Luxembourg,

appellant,

APPEAL against the judgment of the Court of First Instance of the European Communities (Third Chamber, Extended Composition) of 24 October 2000 in Case T-178/98 *Fresh Marine v Commission* [2000] ECR II-3331, seeking to have that judgment set aside,

\* Language of the case: English.

the other party to the proceedings being:

Fresh Marine Company A/S, established in Trondheim (Norway), represented by J.-F. Bellis and B. Servais, avocats, with an address for service in Luxembourg,

applicant at first instance,

THE COURT,

composed of: G.C. Rodríguez Iglesias, President, J.-P. Puissechet, R. Schintgen and C.W.A. Timmermans (Presidents of Chambers), C. Gulmann, D.A.O. Edward, A. La Pergola, V. Skouris, S. von Bahr, J.N. Cunha Rodrigues (Rapporteur) and A. Rosas, Judges,

Advocate General: C. Stix-Hackl,  
Registrar: L. Hewlett, Principal Administrator,

having regard to the Report for the Hearing,

after hearing oral argument from the parties at the hearing on 17 September 2002,

after hearing the Opinion of the Advocate General at the sitting on 28 November 2002,

gives the following

## Judgment

1 By application lodged at the Court Registry on 29 December 2000, the Commission of the European Communities brought an appeal under Article 49 of the EC Statute of the Court of Justice against the judgment of the Court of First Instance of 24 October 2000 in Case T-178/98 *Fresh Marine v Commission* [2000] ECR II-3331 ('the contested judgment'), by which the Commission was ordered to pay Fresh Marine Company A/S ('Fresh Marine'), established in Trondheim (Norway), the sum of NOK 431 000 in damages.

## Legal background

2 As stated in Article 8(10) of Council Regulation (EC) No 384/96 of 22 December 1995 on protection against dumped imports from countries not members of the European Community (OJ 1996 L 56, p. 1):

'A provisional duty may, after consultation, be imposed in accordance with Article 7 on the basis of the best information available, where there is reason to believe that an undertaking is being breached, or in case of breach or withdrawal of an undertaking where the investigation which led to the undertaking has not been concluded.'

- 3 Article 13(10) of Council Regulation (EC) No 2026/97 of 6 October 1997 on protection against subsidised imports from countries not members of the European Community (OJ 1997 L 288, p. 1) provides:

‘A provisional duty may, after consultation, be imposed in accordance with Article 12 on the basis of the best information available, where there is reason to believe that an undertaking is being breached, or in case of breach or withdrawal of an undertaking where the investigation which led to the undertaking has not been concluded.’

## Facts

- 4 The factual background to the dispute is set out at paragraphs 1 to 21 of the contested judgment as follows:

‘1 [Fresh Marine] is a company established in 1992 and incorporated under Norwegian law, which specialises in the sale of farmed Atlantic salmon.

- 2 Following complaints lodged in July 1996 by the Scottish Salmon Growers’ Association Ltd and the Shetland Salmon Farmers’ Association on behalf of their members, the Commission announced on 31 August 1996, by two

separate notices published in the *Official Journal of the European Communities*, the initiation of an anti-dumping and an anti-subsidy proceeding concerning imports of farmed Atlantic salmon originating in Norway (OJ 1996 C 53, pp. 18 and 20).

- 3 The Commission... found that it was necessary to impose definitive anti-dumping and countervailing measures...
  
- 4 On 17 June 1997, [Fresh Marine], having been informed of the Commission's findings, offered an undertaking pursuant to Article 8 of [Regulation No 384/96] and Article 10 of Council Regulation (EC) No 3284/94 of 22 December 1994 on protection against subsidised imports from countries not members of the European Community (OJ 1994 L 349, p. 22)....
  
- 5 By Decision 97/634/EC of 26 September 1997 accepting undertakings offered in connection with the anti-dumping and anti-subsidy proceedings concerning imports of farmed Atlantic salmon originating in Norway (OJ 1997 L 267, p. 81), the Commission accepted the undertakings offered by a number of Norwegian exporters of farmed Atlantic salmon, including that of [Fresh Marine].... [Fresh Marine]'s undertaking entered into force on 1 July 1997.
  
- 6 On the same day, the Council adopted Regulation (EC) No 1890/97 of 26 September 1997 imposing a definitive anti-dumping duty on imports of farmed Atlantic salmon originating in Norway (OJ 1997 L 267, p. 1) and Council Regulation (EC) No 1891/97 of 26 September 1997 imposing a definitive countervailing duty on imports of farmed Atlantic salmon originating in Norway (OJ 1997 L 267, p. 19). Pursuant to Article 1(2) of

each of those two regulations, imports into the Community of farmed Atlantic salmon originating in Norway produced by [Fresh Marine] were exempt from those duties on account of the acceptance of its undertaking by the Commission.

- 7 On 22 October 1997, [Fresh Marine] sent the Commission a report on all its exports of farmed Atlantic salmon to the Community during the third quarter of 1997 (“the October 1997 report”).
  
- 8 On 16 December 1997, the Commission adopted, on the basis of Council Regulation No 384/96 and [Regulation No 2026/97], Regulation (EC) No 2529/97 of 16 December 1997 imposing provisional anti-dumping and countervailing duties on certain imports of farmed Atlantic salmon originating in Norway (OJ 1997 L 346, p. 63). That regulation imposed a provisional anti-dumping duty... and a provisional countervailing duty... on imports, into the Community, of farmed Atlantic salmon originating in Norway produced by [Fresh Marine]... The regulation entered into force on 18 December 1997....
  
- 9 By letter of 19 December 1997, the Commission informed [Fresh Marine] of the... facts... It stated that examination of the data disclosed in the October 1997 report had shown that [Fresh Marine] had exported farmed Atlantic salmon, gutted head-on, at an average price... lower than the minimum average price set in its undertaking of 17 June 1997, which led it to believe that it had not observed that undertaking....
  
- 10 By fax of 22 December 1997, [Fresh Marine] complained that the Commission had manipulated the October 1997 report by deleting a number of lines which were intended to cancel lines containing errors. Pointing out that it had ceased all exports to the Community since the entry into force of Regulation No 2529/97, and as a result was suffering considerable harm, it asked for the immediate lifting of the sanctions taken against it.

11 In its letter of 5 January 1998, the Commission explained to [Fresh Marine] the reasons why it had decided to delete a number of lines from the October 1997 report containing quantities and values preceded by a minus sign, which, in the absence of explanations in the report, could not be offset against the corresponding invoices. It added that, if [Fresh Marine] sent it in good time a proper report showing that all sales transactions, net of credit notes, during the third quarter of 1997 were, on average, above the minimum price, the Commission would be prepared to reconsider its position. It again emphasised the provisional nature of the duties imposed by Regulation No 2529/97 and pointed out to [Fresh Marine] that it could have chosen to continue to export to the Community by providing the relevant customs authorities of the Member States concerned with an appropriate guarantee in regard to its “DDP” (“delivered duty paid”) sales.

12 On 6 January 1998, [Fresh Marine] sent to the Commission an amended version of the October 1997 report.

...

19 By letter of 30 January 1998, the Commission informed [Fresh Marine] that it now took the view that [Fresh Marine] had, during the third quarter of 1997, complied with the minimum export price fixed in its undertaking in respect of salmon, gutted head-on, and that, accordingly, there was no longer any reason to believe that the undertaking had been broken.

20 By letter of 2 February 1998 the Commission informed [Fresh Marine] that it intended to propose to the Council that it should not impose definitive duties and that, accordingly, the provisional duties imposed by Regulation

No 2529/97 ought not to be confirmed. It added that, under Article 10(2) of Regulation No 384/96, the amounts lodged as provisional duties were to be released in so far as there was no decision by the Council to collect all or part of them definitively.

21 On 23 March 1998, the Commission adopted Regulation (EC) No 651/98 amending Regulations Nos 1890/97, 1891/97 and 2529/97 and Decision 97/634 (OJ 1998 L 88, p. 31). Under Regulation No 651/98, the provisional anti-dumping and countervailing duties imposed by Regulation No 2529/97 were repealed so far as concerned imports of [Fresh Marine]'s products... Its undertaking was moreover reinstated with effect from 25 March 1998...'

#### The proceedings before the Court of First Instance and the contested judgment

- 5 On 27 October 1998, Fresh Marine brought an action before the Court of First Instance seeking an order requiring the Commission to make good the damage it had suffered following the adoption of the provisional measures prescribed by Regulation No 2529/97, totalling NOK 2 115 000.
- 6 The Commission claimed that the action should be dismissed as inadmissible or, in the alternative, as unfounded.
- 7 Having declared the action to be admissible, the Court of First Instance pointed out, at paragraph 54 of the contested judgment, that, in order for the Community to incur non-contractual liability, the applicant must prove the unlawfulness of the alleged conduct of the institution concerned, actual damage and the existence of a causal link between that conduct and the alleged damage.



8 In that connection, the Court of First Instance found as follows:

*‘Unlawfulness of the conduct alleged against the Commission*

...

57 Although the measures of the Council and Commission in connection with a proceeding relating to the possible adoption of anti-dumping measures must in principle be regarded as constituting legislative action involving choices of economic policy, so that the Community can incur liability by virtue of such measures only if there has been a sufficiently serious breach of a superior rule of law for the protection of individuals ([Case T-167/94] *Nölle v Council and Commission* [[1995] ECR II-2589], paragraph 51), the special features of the present case must be pointed out. In the present case, the damage at issue arose from the allegedly unlawful conduct of the Commission when it examined the October 1997 report with the intention of checking whether [Fresh Marine] had complied during the third quarter of 1997 with the undertaking, the acceptance of which had brought to an end the anti-dumping and anti-subsidy investigation in regard to it. That allegedly unlawful conduct led the Commission to believe that [Fresh Marine] had broken its undertaking. It took place in the course of an administrative operation which specifically and exclusively concerned [Fresh Marine]. That operation did not involve any choices of economic policy and conferred on the Commission only very little or no discretion.

58 It is true that the alleged unlawfulness of the Commission’s conduct caused the alleged damage only when, and because, it was confirmed by the adoption of provisional measures against imports of [Fresh Marine]’s

products within the framework of Regulation No 2529/97. However, the Commission, in that regulation, did no more with regard to [Fresh Marine] than draw the appropriate provisional conclusions from its analysis of the abovementioned report, in particular from the level of the average price of exports charged by [Fresh Marine] during the period covered by that report (see the ninth recital in the preamble to Regulation No 2529/97).

59 Furthermore, the background to the cases giving rise to the judgments relied on by the Commission in its written submissions..., in which the Community judicature characterised the measures of the Council and the Commission in an anti-dumping proceeding as legislative acts involving choices of economic policy, was radically different from that of the present dispute. In those cases, unlike the present case, the applicants sought compensation for damage, the operative event for which was a choice of economic policy made by the Community authorities in the context of their legislative power.

60 Thus, in [Case C-122/86] *Epicheiriseon Metalleftikon Viomichanikon kai Naftiliakon and Others v Commission and Council* [[1989] ECR 3959], the applicants sought compensation for the damage which they claimed to have suffered as a result of the Council's decision to close an anti-dumping proceeding without adopting the regulation proposed by the Commission for the imposition of a definitive anti-dumping duty on the relevant imports. In *Nölle v Council and Commission*, cited... above, a Community importer sought compensation for damage allegedly suffered as a result of the adoption by the Council of a regulation introducing a definitive anti-dumping duty and definitively collecting the provisional anti-dumping duty, a regulation which had been declared invalid by the Court of Justice on grounds relating to the conditions under which the Community authorities had chosen the reference country when determining the normal value of the products at issue.

- 61 In conclusion, mere infringement of Community law will be sufficient, in the present case, to lead to the non-contractual liability of the Community (see [Case C-352/98 P] *Bergaderm and Goupil v Commission* [[2000] ECR I-5291], paragraph 44). In particular, a finding of an error which, in analogous circumstances, an administrative authority exercising ordinary care and diligence would not have committed will support the conclusion that the conduct of the Community institution was unlawful in such a way as to render the Community liable under Article 215 of the [EC] Treaty [now Article 288 EC].
- 62 It is therefore necessary to examine whether the Commission, when monitoring compliance by [Fresh Marine] with its undertaking on the basis of the October 1997 report, committed an error which an administrative authority exercising ordinary care and diligence would not have committed in the same circumstances.
- ...
- 75 At first sight, on reading [the] final entries in the October 1997 report, it was possible to adopt the view that [Fresh Marine] had observed its undertaking during the period covered by that report....
- 76 Even if it is accepted that the terms of [Fresh Marine]'s undertaking did not provide for the possibility of including negative values in the quarterly sales reports, the Commission could not, when faced with a report which, at first glance, suggested that [Fresh Marine] had complied with its undertaking, take it upon itself, as it did in the present case..., unilaterally to change the content of that report by deleting lines containing negative values and replacing the final entries... with its own calculations, carried out on the basis of the report thus amended, of the average export price charged by [Fresh

Marine] during the period in question, without explaining to it the reasons prompting it to ignore those final entries and without checking with it whether the changes so made affected the reliability of the information provided in order to monitor compliance with the undertaking. Having decided not to accept the first impression given by the October 1997 report, which was favourable to [Fresh Marine], the Commission was bound to exercise due care in interpreting correctly the data provided in that report, on which it intended to base its finding as to whether or not [Fresh Marine]'s conduct amounted to compliance with the undertaking during the period in question.

77 It cannot, in that connection, rely on the provisions of Article 8(10) of Regulation No 384/96 or Article 13(10) of Regulation No 2026/97.

78 Those provisions aim to enable the Commission, where there are grounds for believing on the basis of the best information available to it that an undertaking which it has initially accepted in the context of an anti-dumping or anti-subsidy proceeding has been breached, to take in good time any necessary provisional measures in order to protect the interests of the Community industry, without prejudice to a subsequent examination of the merits in order to check whether the undertaking in question has in fact been breached.

79 However, in the present case, the Court holds that the October 1997 report, in particular its final entries, suggested that [Fresh Marine] had complied with its undertaking...

80 It was after it had amended that report on its own initiative, without taking the precaution of asking [Fresh Marine] what possible impact its unilateral

action might have on the reliability of the information which [Fresh Marine] had provided, that the Commission concluded that there had been an apparent breach of the undertaking by [Fresh Marine]. The data contained in the October 1997 report, amended in that way, evidently cannot therefore be considered the best information, within the meaning of the provisions referred to in paragraph 77 above, available to the Commission at the time on which to base its conclusion as to whether [Fresh Marine] had complied with its undertaking.

...

82 It must therefore be held that, when analysing the October 1997 report, the Commission committed an error which would not have been committed in similar circumstances by an administrative authority exercising ordinary care and diligence.

...

84 However, it must be pointed out that [Fresh Marine]'s conduct is not blameless either....

...

89 In view of the complexity of its October 1997 report, the lack of obvious links between the erroneous lines and those containing negative values and the ambiguity of those values, [Fresh Marine], without being prompted,

should have sent to the Commission, with the report, the explanations necessary in order to understand that report. By sending the October 1997 report without any comment to that effect, [Fresh Marine] was guilty of negligence which, as the letter which the Commission sent it on 5 January 1998 shows..., confused the Commission's officials....

...

91 ... the Court holds that [Fresh Marine] and the Commission were equally at fault during the investigation as to whether [Fresh Marine] had complied with its undertaking during the third quarter of 1997 and at the end of which the Commission found that there had been an apparent breach of the undertaking making it necessary to take provisional measures against imports of [Fresh Marine]'s products in the framework of Regulation No 2529/97. For its part, [Fresh Marine], by failing of its own accord to append to its October 1997 report the explanations required for the correct understanding of the negative values appearing in it, showed such negligence as would never have been committed by a trader exercising ordinary care and diligence. Even taking into consideration such irregular conduct on the part of [Fresh Marine] and the confusion which such conduct may have caused when the report was read, the Court holds that the Commission's reaction, in unilaterally amending that report even though it suggested, *prima facie*, that [Fresh Marine] had complied with its undertaking during the period in question, was disproportionate and therefore unlawful, and could not be excused in any circumstances.

92 If the damage alleged by [Fresh Marine] is proved, even in part, and if it is apparent that a causal link exists between that damage and the events leading to the imposition of provisional measures on imports of its products, the question which must now be considered, it will be appropriate, when determining the Commission's obligation to make reparation, to take

account of the fact that each party bears half of the responsibility for those events.

*The alleged damage and the causal link between it and the wrongful conduct of the Commission*

...

106 So far as concerns, first, loss of profit between 18 December 1997 and 25 March 1998, it must be observed that the figures given by the Commission for exports of farmed Atlantic salmon by [Fresh Marine] to the Community between July 1997 and September 1998 show that [Fresh Marine] wholly suspended its exports during the period from approximately mid-December 1997 to the end of March 1998....

...

109 In light of those circumstances, it is necessary to assess the amount of the loss of profit suffered by [Fresh Marine] as a result of the suspension of its exports to the Community between 18 December 1997 and 25 March 1998. That loss of profit must be considered to equate to the profit which it would have made if it had continued to export to the Community during that period.

...

115 The loss of profit suffered by [Fresh Marine] will therefore be fixed at NOK 292 000 in respect of the period between 18 December 1997 and 31 January 1998, NOK 135 000 in respect of February 1998 and NOK 150 000 in respect of the period from 1 to 25 March 1998.

...

117 It is necessary now to determine whether there is a causal link between the loss or damage to [Fresh Marine]'s business... and the wrongful conduct of the Commission, confirmed by Regulation No 2529/97...

118 There is a causal link for the purposes of the second paragraph of Article 215 of the Treaty where there is a direct causal nexus between the fault committed by the institution concerned and the injury pleaded, the burden of proof of which rests on the applicant (Case T-149/96 *Coldiretti and Others v Council and Commission* [1998] ECR II-3841, paragraph 101, and the cited case-law). The Community cannot be held liable for any damage other than that which is a sufficiently direct consequence of the misconduct of the institution concerned (see, in particular, Joined Cases 64/76 and 113/76, 167/78 and 239/78, 27/79, 28/79 and 45/79 *Dumortier and Others v Council* [1979] ECR 3091, paragraph 21; Case T-168/94 *Blackspur and Others v Council and Commission* [1995] ECR II-2627, paragraph 52, and [Case T-13/96] *TEAM v Commission* [[1998] ECR II-4073], paragraph 68).

119 In the present case,... the period during which [Fresh Marine] suspended its exports to the Community coincides with that during which the provisional measures imposed by Regulation No 2529/97 applied to imports of its



products. That must be interpreted as evidence of the existence of a causal link between the irregularities, in particular those committed by the Commission, giving rise to the imposition of provisional measures, on the one hand, and the loss of profit, on the other.

120 It is, indeed, undeniable that, were it not for such irregularities and the provisional measures which followed them, [Fresh Marine] would have continued its exports to the Community in compliance with its undertaking. It would thus have suffered no loss of profit on the Community market. The misconduct of the Commission, when analysing the October 1997 report, and which was confirmed by Regulation No 2529/97, is therefore causally linked, within the meaning of the case-law referred to in paragraph 118 above, with the loss or damage to [Fresh Marine]'s business.

121 ... In that regard, it is necessary to ascertain whether, as the case-law requires, [Fresh Marine] showed reasonable diligence in limiting the extent of the damage which it claims to have suffered, a matter which the Commission disputes (see, Joined Cases C-104/89 and C-37/90 *Mulder and Others v Council and Commission* [1992] ECR I-3061, paragraph 33; Joined Cases C-46/93 and C-48/93 *Brasserie du Pêcheur and Factortame* [1996] ECR I-1029, paragraph 85; and Case C-284/98 P *Parliament v Bieber* [2000] ECR I-1527, paragraph 57).

122 The Commission's argument is that, in view of the fact that the duties imposed by Regulation No 2529/97 were provisional, [Fresh Marine] could, by providing a modest amount for the setting-up of a bank guarantee, have continued to export to the Community at unchanged prices.

...

124 However, even supposing that [Fresh Marine], which has not disputed the Commission's statements regarding the cost of such a bank guarantee, had obtained one, the Court holds that it would have run an unusual commercial risk, beyond the level of risk inherent in any commercial enterprise, by exporting to the Community during the period when Regulation No 2529/97 was applicable to imports of its products. If, once that bank guarantee had been issued, it had, as the Commission suggests, decided to export to the Community at unchanged prices without passing on to its Community customers the amount of the provisional duties through the prices it charged, it would have run the risk of having to bear on its own the burden of those duties should they ever have been collected definitively. Since it was not able to tell at that time whether that would eventually be the case, it therefore had no option but to increase its export prices by the amount of those provisional duties. Having regard in particular to competition from Community companies selling salmon and from the numerous Norwegian exporters which had been able to continue to sell on the Community market within the terms of their undertakings during the period in question, [Fresh Marine] could reasonably have taken the view that there was no chance of finding an outlet for its products on that market during that period.

125 In view of those circumstances, the absence of any attempt by [Fresh Marine] to export its products to the Community during the period in question cannot be regarded as a failure to fulfil the obligation, laid down in the case-law referred to in paragraph 121 above, to show reasonable diligence in mitigating the extent of the damage which it claims to have suffered.

...

131 ... the Court holds, on reading the letters of 30 January and 2 February 1998..., that the Commission did not take the necessary and appropriate measures which the party causing the damage must take where damage, such

as that at issue here, is ongoing (see, to that effect, *Parliament v Bieber*, cited in paragraph 121 above, paragraph 57) in order to limit the extent of the damage to which its misconduct, when it was verifying compliance by [Fresh Marine] with its undertaking, had contributed.

132 It is clear from the case-file that, following the explanations provided by [Fresh Marine] at the beginning of January 1998... and the investigation carried out at its premises at the end of that month..., the Commission had become convinced, at least as from 30 January 1998, as attested by its letter of that date, that [Fresh Marine] had complied with its undertaking in the course of the third quarter of 1997. However, the Commission, which, in its own words... and as is shown moreover by the fact that it adopted Regulation No 651/98, was alone entitled in the present case to lift the provisional measures imposed on imports of [Fresh Marine]'s products by Regulation No 2529/97, for no obvious reason delayed until 25 March 1998 before giving [Fresh Marine], by means of Regulation No 651/98, the formal legal reassurance which it could have given at the end of January 1998. Although it could have realised during the abovementioned investigation at the [Fresh Marine]'s premises that [Fresh Marine] was suffering considerable commercial loss as a result of the application of those provisional measures..., by its letter of 2 February 1998 it unjustifiably perpetuated the doubts as to the final outcome regarding the provisional duties imposed by Regulation No 2529/97. It thus dissuaded [Fresh Marine] from resuming commercial activities on the Community market.

...

134 For having thus failed to take the necessary measures as soon as the irregularities giving rise to the imposition of provisional measures on imports of [Fresh Marine]'s products were definitively rectified, the Commission must

be held solely responsible for [Fresh Marine]'s loss of profit, at least as from the end of January 1998.

135 It must therefore be held that, although, as is apparent from the grounds set out in paragraphs 73 to 92 above, [Fresh Marine] contributed to the same extent as the Commission in causing loss or damage to its business, continuation of that loss after the end of January 1998 is, on the other hand, exclusively due to a failure by the Commission to exercise due care; even though the explanations which it had obtained from [Fresh Marine] had definitely made it possible to correct their respective prior errors and removed any reason to continue to believe that the undertaking had been breached, the Commission delayed, for no apparent reason, in regularising [Fresh Marine]'s situation by withdrawing the provisional measures originally imposed against it.

136 It follows that the Commission must be held to be liable for one half of the loss of profit suffered by [Fresh Marine] between 18 December 1997 and 31 January 1998 and for all the loss caused to [Fresh Marine] from 1 February to 25 March 1998...

137 In conclusion, the Commission will be ordered to pay to [Fresh Marine], first, one half of NOK 292 000 in respect of [Fresh Marine]'s loss of profit between 18 December 1997 and 31 January 1998 and, second, NOK 285 000 (NOK 135 000 + NOK 150 000) as compensation for the damage caused to [Fresh Marine] from 1 February to 25 March 1998, that is a total amount of NOK 431 000. The remainder of the application will be dismissed.'

## Forms of order sought before the Court of Justice

9 The Commission claims that the Court should:

- set aside the contested judgment;
  
- in giving final judgment itself, dismiss Fresh Marine's application at first instance and order it to pay the costs;
  
- in the alternative, refer the case back to the Court of First Instance.

10 Fresh Marine contends that the Court should:

- dismiss the Commission's appeal in its entirety;
  
- set aside the contested judgment in that it held that Fresh Marine bore half of the responsibility for the events that caused the damage;

- accordingly, order the Commission to pay Fresh Marine damages of NOK 577 000;
  
- order the Commission to bear the costs incurred by Fresh Marine both at first instance and on appeal;
  
- order the Commission to pay interest at the annual rate of 8% from the date of the contested judgment on the sum of NOK 577 000 and on the costs of Fresh Marine to be paid by the Commission.

## The main appeal

*The first and second grounds of appeal, relating to the cause of the damage and to the seriousness of the breach of Community law*

### Arguments of the parties

- <sup>11</sup> By its first two grounds of appeal, which it is appropriate to examine together, the Commission submits that the Court of First Instance erred in law by holding, first, at paragraph 57 of the contested judgment, that the damage pleaded by Fresh Marine arose from the allegedly unlawful conduct of the Commission when examining the October 1997 report and, second, at paragraphs 59 and 60 of the contested judgment, that the judgments of the Community judicature cited by the

Commission in the proceedings at first instance, in which anti-dumping measures are characterised as legislative acts involving choices of economic policy, concerned cases with a 'radically different' background and by concluding therefore, at paragraph 61 of the contested judgment, that mere infringement of Community law was sufficient, in the present case, to lead to liability of the Community under Article 215 of the Treaty.

- 12 According to the Commission, the administrative act of analysing the October 1997 report could not, in itself, have been the cause of any damage suffered by Fresh Marine since it was only on the entry into force of Regulation No 2529/97 that the undertaking from which its exports had benefited was withdrawn and that anti-dumping and countervailing duties were imposed. It is well established that an action for damages can be brought under Article 215 of the Treaty only where the loss is 'actual and certain' (see Joined Cases 67/75 to 85/75 *Lesieur Cotelle and Others v Commission* [1976] ECR 391). The Commission submits that any loss suffered by Fresh Marine could have become actual and certain only on adoption of Regulation No 2529/97.
  
- 13 Moreover, it is clear from the wording of Article 8(10) of Regulation No 384/96 that, with respect to the imposition of provisional duties, the Commission has a wide discretion in determining the circumstances in which it has reason to believe that an undertaking has been breached. That point was not addressed by the Court of First Instance since it found, at paragraph 57 of the contested judgment, that the analysis of the October 1997 report 'did not involve any choices of economic policy and conferred on the Commission only very little or no discretion'. The contested judgment is therefore inconsistent with the Court of First Instance's own case-law (see Case T-489/93 *Unifruit Hellas v Commission* [1994] ECR II-1201 and Case T-51/96 *Miwon v Council* [2000] ECR II-1841).
  
- 14 According to the Commission, the decisive question is whether the act adopted by it was the result of an exercise of discretion since, under Community law, a loss flowing from such an act leads to liability only if the act satisfies the criterion laid

down in Case 5/71 *Zuckerfabrik Schöppenstedt v Council* [1971] ECR 975, namely a sufficiently serious breach of a superior rule of law for the protection of individuals.

- 15 Fresh Marine contends that the damage was clearly caused by the unlawful conduct of the Commission when examining the October 1997 report. The adoption of Regulation No 2529/97 merely triggered the damage. Its adoption was the logical and inevitable consequence of the act of maladministration committed by the Commission when it unilaterally altered the October 1997 report without taking the precaution of asking Fresh Marine what impact that alteration might have on the reliability of the information provided by it. The fact that the loss became actual following the adoption of Regulation No 2529/97 does not imply *per se* that the adoption caused the damage to Fresh Marine.
- 16 Fresh Marine also submits that, from the point of view of exporters, a regulation imposing anti-dumping measures has all the characteristics of a decision affecting them individually. Regulation No 2529/97 is therefore not a legislative act but, on the contrary, an administrative act adopted in the course of an administrative procedure which specifically and exclusively concerned particular exporters. The fact that the Commission imposed a provisional duty on Fresh Marine is merely the logical consequence of the erroneous finding that it had failed to comply with its undertaking. As the Court of First Instance found at paragraph 58 of the contested judgment, the Commission, in adopting Regulation No 2529/97, did no more than draw provisional conclusions from its analysis of the October 1997 report.

### Findings of the Court

- 17 In order for the Community to incur liability under the second paragraph of Article 215 of the Treaty, a number of conditions, including the existence of a



causal link between the conduct alleged against the institution concerned and the damage complained of, must be satisfied (see, *inter alia*, Case 4/69 *Lütticke v Commission* [1971] ECR 325, paragraph 10).

18 The Court of First Instance observed, at paragraph 119 of the contested judgment, that the period during which Fresh Marine suspended its exports to the Community coincided with that during which the provisional measures imposed by Regulation No 2529/97 applied to imports of its products. It also found, at paragraph 120 of the contested judgment, that it was undeniable that, were it not for the irregularities committed by the Commission and the provisional measures which followed them, Fresh Marine would have continued to export to the Community in compliance with its undertaking.

19 Moreover, at paragraph 58 of the contested judgment, the Court of First Instance, after having found that the alleged unlawfulness of the Commission's conduct caused the damage alleged only when, and because, it was confirmed by the adoption of provisional measures against imports of Fresh Marine's products within the framework of Regulation No 2529/97, ruled that, in that regulation, the Commission had done no more with regard to Fresh Marine than draw the appropriate provisional conclusions from its analysis of the October 1997 report, in particular from the level of the average export price charged by Fresh Marine during the period covered by the report.

20 Even if the latter finding is correct, the fact remains that it is only because Regulation No 2529/97 was adopted by the college of Commissioners that provisional duties were imposed and that Fresh Marine found it necessary to cease its exports to the Community.

21 It is therefore undisputed that it was only after the entry into force of Regulation No 2529/97 that the loss suffered by Fresh Marine became actual and certain.

- 22 At paragraph 57 of the contested judgment, the Court of First Instance held, however, that the damage at issue arose from the allegedly unlawful conduct of the Commission when it examined the October 1997 report.
- 23 Even if that finding is vitiated by an error of law, such an error will remain irrelevant provided the Court of First Instance correctly assessed the conditions under which the Community may incur non-contractual liability.
- 24 In that regard, the system of rules which the Court of Justice has worked out in relation to the non-contractual liability of the Community takes into account, *inter alia*, the complexity of the situations to be regulated, difficulties in the application or interpretation of the legislation and, more particularly, the margin of discretion available to the author of the act in question (see *Brasserie du Pêcheur and Factortame*, cited above, paragraph 43; *Bergaderm and Goupil*, cited above, paragraph 40; and Case C-312/00 P *Commission v Camar and Tico* [2002] ECR I-11355, paragraph 52).
- 25 According to settled case-law, Community law confers a right to reparation where three conditions are met: the rule of law infringed must be intended to confer rights on individuals; the breach must be sufficiently serious; and there must be a direct causal link between the breach of the obligation resting on the author of the act and the damage sustained by the injured parties (see *Brasserie du Pêcheur and Factortame*, paragraph 51, *Bergaderm and Goupil*, paragraphs 41 and 42, and *Commission v Camar and Tico*, paragraph 53).
- 26 As regards the second condition, the decisive test for finding that a breach of Community law is sufficiently serious is whether the Community institution concerned manifestly and gravely disregarded the limits on its discretion. Where

that institution has only considerably reduced, or even no, discretion, the mere infringement of Community law may be sufficient to establish the existence of a sufficiently serious breach (see, *inter alia*, *Bergaderm and Goupil*, paragraphs 43 and 44, and *Commission v Camar and Tico*, paragraph 54).

- 27 Therefore, the determining factor in deciding whether there has been such an infringement is not the general or individual nature of the act in question but the discretion available to the institution concerned (see, to that effect, *Bergaderm and Goupil*, paragraph 46, and *Commission v Camar and Tico*, paragraph 55).
- 28 Since the provisional anti-dumping and countervailing duties were imposed on the basis of Article 8(10) of Regulation No 384/96 and Article 13(10) of Regulation No 2026/97 respectively, the limits to which the Commission's discretion was subject in this case must be determined.
- 29 The provisions referred to in the preceding paragraph, while granting the Commission the power to impose provisional anti-dumping and countervailing duties, require at the same time that there be reason to believe that the undertaking has been breached and that the decision imposing such duties be taken on the basis of the best information available.
- 30 In the present case, the Commission, when adopting Regulation No 2529/97, which imposed provisional duties on Fresh Marine's imports, relied solely on the analysis of a report which, as the Court of First Instance found at paragraphs 79 and 80 of the contested judgment, gave reason to believe that that company had complied with its undertaking not to make sales on the Community market below

a minimum average price, but which the Commission had amended on its own initiative, without taking the precaution of asking Fresh Marine what impact its unilateral action might have on the reliability of the information which Fresh Marine had provided to it.

- 31 It follows that the Commission clearly did not comply with its obligation to impose provisional duties only where there is reason to believe that the undertaking has been breached. In the circumstances of the present case, such conduct must be regarded as a sufficiently serious breach of a rule of Community law satisfying one of the conditions for the incurring of non-contractual liability by the Community (see, *inter alia*, *Bergaderm and Goupil*, paragraphs 42 to 44, and *Commission v Camar and Tico*, paragraphs 53 and 54).
- 32 Accordingly, the first two grounds of appeal must be rejected.

*The third ground of appeal, relating to the Commission's actions in assessing the October 1997 report*

Arguments of the parties

- 33 The Commission complains that the Court of First Instance erred in law in finding that the October 1997 report suggested that Fresh Marine had complied with its undertaking and in holding, therefore, that the Commission's reaction in amending that report had been disproportionate and that it had committed an error which it would have avoided if it had exercised ordinary care and diligence.

34 The Commission submits, first, that if the Court of First Instance had properly understood the nature of the final entries in the October 1997 report, it would not have described it, at paragraph 79 of the contested judgment, as a document suggesting that Fresh Marine had complied with its undertaking.

35 Second, according to the Commission, the Court of First Instance did not evaluate its conduct within the context of Article 8(10) of Regulation No 384/96. Since that provision lays down a test to be applied by the Commission in these circumstances, it is submitted that, by failing to have regard to that test, the Court of First Instance erred in law. In the Commission's view, it was essential that the Court of First Instance determine which party was to bear the burden of proof as to Fresh Marine's compliance with its undertaking before deciding whether or not the October 1997 report contained the best information available.

36 Fresh Marine contends that the Commission's argument concerning the Court of First Instance's alleged misunderstanding of the final entries in the October 1997 report is inadmissible since appeals are limited to points of law and thus exclude points of fact.

37 Finally, Fresh Marine submits that the discretion conferred on the Commission by Article 8(3) of Regulation No 384/96 with respect to the decision whether or not to accept an undertaking cannot be stretched to allow it to manipulate unilaterally a monitoring report and to conclude, on that basis, that an exporter has apparently breached its undertaking.

### Findings of the Court

38 It need only be stated that, even if the third ground of appeal is admissible, it is of no consequence.

39 The Court has held, at paragraph 31 of the present judgment, that, in imposing provisional anti-dumping and countervailing duties, the Commission committed a sufficiently serious breach of Community law for non-contractual liability to be incurred by the Community.

40 Accordingly, it is irrelevant whether or not the Court of First Instance's assessment of the Commission's actions when analysing the October 1997 report is vitiated by an error.

41 Consequently, the third ground of appeal must be rejected.

*The fourth ground of appeal, relating to the diligence shown by Fresh Marine in mitigating the loss*

#### Arguments of the parties

42 The Commission submits that the Court of First Instance erred in law in finding that, despite its not providing a bank guarantee to cover the payment of the provisional duties imposed by Regulation No 2529/97 and to continue to export to the Community, Fresh Marine was not in breach of its duty to mitigate the loss suffered.

43 The Commission observes that the Court of First Instance justified that finding by stating, at paragraph 124 of the contested judgment, that, if Fresh Marine had

continued to export, it would have run the risk of having to bear on its own the burden of those duties should they ever have been collected definitively. In the Commission's view, that reasoning is contradicted by the other findings made by the Court of First Instance. If, as the Court of First Instance held, the conduct giving rise to the Commission's liability was the unilateral amendment of the October 1997 report even though the report suggested that Fresh Marine had complied with its undertaking, the contested judgment does not explain how the Court of First Instance was therefore able to find that there was a risk of the provisional duty being collected definitively in such circumstances.

- 44 Fresh Marine contends that this ground of appeal is inadmissible on the ground that it relates solely to a point of fact. In any event, if it were so obvious, in the present case, that the provisional duties imposed by Regulation No 2529/97 would not be collected definitively, the Commission should explain why it considered it necessary to impose them in the first place. The Commission's reasoning is likewise flawed in that it fails to take into account the fact that it is for the Council and not the Commission to decide to collect provisional duties definitively.

### Findings of the Court

- 45 Under Article 225 EC and Article 58 of the Statute of the Court of Justice, an appeal lies on a point of law only. It follows that, save where the clear sense of the evidence has been distorted, the Court has no jurisdiction to review the assessment of the facts made by the Court of First Instance (see, *inter alia*, Joined Cases C-280/99 P, C-281/99 P and C-282/99 P *Moccia Irme and Others v Commission* [2001] ECR I-4717, paragraph 78, and Case C-104/00 P *DKV v OHIM* [2002] ECR I-7561, paragraph 22).

- 46 The Commission's arguments seek to call into question the Court of First Instance's assessment of the facts in the light of which it held that Fresh Marine had not breached its duty to show the necessary diligence in mitigating the extent of its loss.
- 47 In the present case, the Court of First Instance made a number of findings of fact at paragraph 124 of the contested judgment. It pointed out, in the first place, that if, having provided a bank guarantee, Fresh Marine had decided to export to the Community at unchanged prices without passing on to its Community customers the amount of the provisional duties through the prices it charged, it would have run the risk of having to bear on its own the burden of those duties should they ever have been collected definitively. Since it was not able to tell at that time whether that would eventually be the case, Fresh Marine would have had no option, according to the Court of First Instance, but to increase its export prices by the amount of those provisional duties. However, the Court of First Instance further held that having regard, in particular, to competition from Community companies selling salmon and from the numerous Norwegian exporters which had been able to continue to sell on the Community market within the terms of their undertakings during the period in question, it was reasonable for Fresh Marine to take the view that there was no chance of finding an outlet for its products on that market during that period. The Court of First Instance concluded accordingly that Fresh Marine would have run an unusual commercial risk going beyond the level of risk inherent in the pursuit of any economic activity if it had continued to export to the Community over the period during which Regulation No 2529/97 applied to imports of its products.
- 48 It is clear that the Commission has failed to demonstrate how those findings constitute a distortion of the sense of the evidence submitted to the Court of First Instance.
- 49 Consequently, the fourth ground of appeal must be rejected as inadmissible.



*The fifth ground of appeal, relating to infringement of the rights of the defence*

## Arguments of the parties

- 50 At paragraph 132 of the contested judgment, the Court of First Instance, after having found that the Commission had become convinced, at least from 30 January 1998, that Fresh Marine had complied with its undertaking, held that the Commission had, for no obvious reason, delayed until 25 March 1998 before giving Fresh Marine, by means of Regulation No 651/98, the formal legal reassurance which it could have given it at the end of January 1998.
- 51 By its fifth ground of appeal, the Commission submits that the Court of First Instance infringed its rights of defence by failing to give it an opportunity to explain the alleged delay in adopting Regulation No 651/98.
- 52 Fresh Marine submits that the Commission has misinterpreted the contested judgment. Contrary to what it claims, the Court of First Instance did not hold, at paragraphs 132 and 134 of the contested judgment, that the Commission should have adopted and published Regulation No 651/98 after it had decided that the undertaking should be reinstated, but reproached it for not having provided Fresh Marine at the end of January 1998 with a formal legal reassurance that its undertaking would be reinstated. Such a reassurance did not have to take the form of a Commission regulation, and a letter stating clearly that the provisional duties would not be collected would have been sufficient. Instead of doing so, the Commission, by its letter of 2 February 1998, unjustifiably perpetuated the doubts as to the collection of the provisional duties.

## Findings of the Court

- 53 As is clear from paragraph 132 of the contested judgment, the Court of First Instance found that, although the Commission alone was competent to lift the provisional measures imposed on imports of Fresh Marine's products by Regulation No 2529/97 and although it had become convinced, at least from 30 January 1998, that that company had complied with its undertaking, it unjustifiably perpetuated, by its letter of 2 February 1998, the doubts as to the final outcome of the provisional duties imposed by that regulation, thus dissuading Fresh Marine from resuming its commercial activity on the Community market.
- 54 The Commission has made no submissions in these appeal proceedings which might call into question either the Court of First Instance's findings or the validity of its reasoning.
- 55 Both during the written procedure and at the hearing before the Court, the Commission submitted merely that, if the Court of First Instance had given it an opportunity to explain the procedural requirements for adopting Regulation No 651/98, it would not have found, as it did, that there had been an unjustifiable delay on the basis of the unfounded principle that, once it had been decided at a purely administrative stage to reinstate Fresh Marine's undertaking, the Commission should have adopted Regulation No 651/98 on the same day.
- 56 The fifth ground of appeal must therefore be rejected as unfounded.

57 It follows from all the above findings that the main appeal must be dismissed.

## The cross-appeal

### Arguments of the parties

58 Fresh Marine submits that the Court of First Instance erred in law in holding, at paragraphs 91 and 92 of the contested judgment, that it bore half of the responsibility for the damage suffered by it between 18 December 1997 and 31 January 1998 because it failed to append to the October 1997 report explanations of the negative entries appearing in that report.

59 The absence of such explanations did not, in Fresh Marine's submission, cause the damage which it suffered as a result of the Commission's conduct. Fresh Marine takes the view that the Commission was obliged under Article 18(4) of Regulation No 384/96 to inform it of its intention to delete the negative entries from the October 1997 report before imposing provisional duties. Had the Commission complied with that provision, no damage would have been suffered by Fresh Marine as it would have immediately explained the meaning of the negative entries to the Commission. The Court of First Instance thus erred in law in failing to draw the appropriate conclusions from the Commission's failure to comply with its obligation under Article 18(4) of Regulation No 384/96 to inform Fresh Marine of the amendments which it intended to make to the report.

60 Fresh Marine also claims that the Court should order the Commission to pay it interest, from the date of the contested judgment, on the sums which are to be paid to it.

- 61 The Commission contends that Fresh Marine has misinterpreted the contested judgment in claiming that, according to that judgment, Article 18(4) of Regulation No 384/96 is applicable to the present case. Given that no reference is made to that provision either in the pleadings submitted to the Court of First Instance or in the contested judgment, the cross-appeal must be declared inadmissible because it is based on a plea not raised before the Court of First Instance.
- 62 Alternatively, the Commission submits that Article 18(4) of Regulation No 384/96 is inapplicable to the circumstances of the present case. It is intended to govern situations where a party provides an unsatisfactory response to a questionnaire during an investigation and the Commission intends to reject the evidence supplied and rely on the best evidence available. In the present case, the Commission did not reject the October 1997 report.
- 63 Furthermore, the Court of First Instance's finding that Fresh Marine contributed to the damage through its own negligence is not contradictory. The Court of First Instance having, at paragraphs 84 to 89 of the contested judgment, contradicted Fresh Marine's contention that the October 1997 report was clear, it is established that Fresh Marine was negligent in failing to attach any explanation to that report.
- 64 Finally, the Commission contends that the claim for interest is inadmissible because Fresh Marine does not rely on any error in law on the part of the Court of First Instance. Alternatively, the Commission submits that such a claim is admissible only in relation to an award of damages which the Court might uphold, to the exclusion of any award of costs.

## Findings of the Court

- 65 Since Fresh Marine complains that the Court of First Instance erred in law in its assessment that Fresh Marine was partly responsible for its loss, the cross-appeal is admissible.
- 66 As regards the substance, the Court of First Instance's reasoning, at paragraphs 91 and 92 of the contested judgment, is not contradictory. Having found that the Commission's reaction in unilaterally amending the October 1997 report was unlawful and that Fresh Marine's submission to the Commission of a report which did not contain the explanations necessary to understand it correctly was negligent, the Court of First Instance rightly held that, when determining the Commission's obligation to make reparation, account should be taken of the fact that each party bears half of the responsibility for the events.
- 67 With respect to infringement by the Commission of Article 18(4) of Regulation No 384/96 and any error in law which the Court of First Instance may have committed in failing to draw the appropriate conclusions from such an infringement, it should be pointed out that Article 18(4) deals with failure to cooperate where evidence or information provided by traders is rejected by the Commission. Consequently, since Article 18(4) of Regulation No 384/96 concerns other aspects of the anti-dumping procedure, it is inapplicable to the facts of the present case.

68 The claim for payment of interest is inadmissible on two grounds. First, it does not satisfy the requirements of Article 112(1)(c) of the Rules of Procedure of the Court of Justice because it does not refer to the provisions or principles of Community law alleged to have been infringed by the Court of First Instance. Second, it must be regarded as a new claim which cannot be presented for the first time in an appeal (see, to that effect, Case C-282/98 P *Enso Española v Commission* [2000] ECR I-9817, paragraph 62). Before the Court of First Instance, Fresh Marine claimed only that the Commission should be ordered to make good the damage it suffered and to pay the costs.

69 It follows from the above that the cross-appeal must be dismissed in its entirety.

## Costs

70 Under the first paragraph of Article 122 of the Rules of Procedure, where the appeal is unfounded or where the appeal is well founded and the Court of Justice itself gives final judgment in the case, the Court is to make a decision as to costs. Under Article 69(2) of those Rules, which apply to appeal proceedings by virtue of Article 118, the unsuccessful party is to be ordered to pay the costs if they have been applied for in the successful party's pleadings. Since Fresh Marine has asked for the Commission to be ordered to pay the costs and the latter has been unsuccessful in its grounds of appeal, the Commission must be ordered to pay the costs relating to the main appeal. On the other hand, since the Commission has asked for Fresh Marine to be ordered to pay the costs of the cross-appeal and the latter has been unsuccessful in its grounds of appeal, Fresh Marine must be ordered to pay the costs relating to the cross-appeal.

On those grounds,

THE COURT

hereby:

1. Dismisses the main appeal and the cross-appeal;
2. Orders the Commission of the European Communities to pay the costs relating to the main appeal;
3. Orders Fresh Marine Company A/S to pay the costs relating to the cross-appeal.

Rodríguez Iglesias	Puissochet	Schintgen	
Timmermans	Gulmann	Edward	La Pergola
Skouris	von Bahr	Cunha Rodrigues	Rosas

Delivered in open court in Luxembourg on 10 July 2003.

R. Grass  
Registrar

G.C. Rodríguez Iglesias  
President

**INTERNATIONAL CENTRE FOR SETTLEMENT  
OF INVESTMENT DISPUTES**

Washington, D.C.

Case No. ARB/01/7

**MTD Equity Sdn. Bhd. and MTD Chile S.A.**

**(Claimants)**

v.

**Republic of Chile**

**(Respondent)**

**AWARD**

**Before the Arbitral Tribunal  
comprised of:**

Mr. Andrés Rigo Sureda, President

Mr. Marc Lalonde

Mr. Rodrigo Oreamuno Blanco

**Secretary of the Tribunal**

Mr. Ucheora Onwuamaegbu

Date of dispatch to the parties: May 25, 2004



*Representing the Claimants:*

Messrs. Oscar M. Garibaldi,  
Eugene D. Gulland,  
Fernando Campoamor Sánchez,  
Eric J. Pan and  
Ms. Karin L. Kizer  
Covington & Burlington  
Washington, D.C.

*Of Counsel*

Messrs. Micahel Grasty Cousiño,  
Jorge Bofill Genzsch and  
Pablo Mir Balmaceda  
Grasty Quintana Majlis & Cía.  
Santiago, Chile

*Representing the Respondent:*

Ms. Karen Poniachik,  
Messrs. Claudio Castillo Castillo,  
Andrés Culagovski Rubio,  
Mmes. Liliana Macchiavello Martín,  
Carola Trucco Horwitz and  
Mr. Francisco Javier Díaz Verdugo  
Foreign Investment Committee  
Republic of Chile

Mr. Ronald E. M. Goodman and  
Ms. Abby Cohen Smutny  
White & Case, LLP  
Washington, D.C.

*Of Counsel*

Mr. Francisco J. Illanes  
Cariola, Diez, Pérez-Cotapos & Cía. Ltda.  
Santiago, Chile

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## **I. PROCEDURE**

### **1. Registration of the Request for Arbitration**

1. By letter of June 26, 2001, MTD Equity Sdn (“MTD Equity”), a Malaysian company, and MTD Chile S.A (“MTD Chile”), a Chilean company, (collectively “the Claimants” or “MTD”) filed a request for arbitration with the International Centre for Settlement of Investment Disputes (“ICSID” or “the Centre”) against the Republic of Chile (“the Respondent” or “Chile”). The request, invoked the ICSID Arbitration provisions of the 1992 Agreement between the Government of Malaysia and the Government of the Republic of Chile for the Promotion and Protection of Investments (“the BIT”).

2. The Centre, on June 27, 2001, in accordance with Rule 5 of the ICSID Rules of Procedure for the Institution of Conciliation and Arbitration Proceedings (“Institution Rules”) acknowledged receipt of the request and on the same day transmitted a copy to the Republic of Chile and to the Chilean Embassy in Washington, D.C.

3. On July 17, 2001, the Centre requested further information from the Claimants, with regard to the fulfillment by both Claimants of the requirement set forth in Articles 6(3)(i) and (ii) of the BIT concerning an attempt to resolve the dispute amicably through consultation and negotiation at least three months before the request for arbitration. The Centre also sought confirmation from the Claimants that neither of them had submitted the dispute to courts or administrative tribunals of Chile, as precluded by Article 6(3)(ii) and (iii) of the BIT; and that the majority of the shares in the second Claimant, MTD Chile were, for purposes of Article 6(2) of the BIT, owned by investors

of Malaysia before the dispute arose. The Claimants responded by a letter of July 30, 2001.

4. The request was registered by the Centre on August 6, 2001, pursuant to Article 36(3) of the ICSID Convention, and on the same day the Acting Secretary-General, in accordance with Institution Rule 7, notified the parties of the registration and invited them to proceed to constitute an Arbitral Tribunal as soon as possible.

## **2. Constitution of the Arbitral Tribunal and Commencement of the Proceeding**

5. There were two successive arbitral tribunals in this case, the present Tribunal having been appointed upon the joint resignation of the first set of arbitrators.

6. Following the registration of the request for arbitration by the Centre, the parties agreed on a three-member Tribunal. The parties had agreed that each would appoint an arbitrator and that the third arbitrator, who would be the president of the Tribunal, would be appointed by agreement of the parties.

7. The Claimants appointed Mr. James H. Carter Jr., a national of the United States of America, and the Respondent appointed Professor W. Michael Reisman, also a national of the United States of America. By agreement, the parties appointed Mr. Guillermo Aguilar Alvarez, a national of Mexico, as the presiding arbitrator.

8. All three arbitrators having accepted their appointments, the Centre by a letter of March 5, 2002, informed the parties of the constitution of the Tribunal, consisting of Mr. James H. Carter Jr., Professor W. Michael Reisman, and Mr. Guillermo Aguilar

Alvarez (“the first Tribunal”), and that the proceeding was deemed to have commenced on that day, pursuant to ICSID Arbitration Rule 6(1).

9. As agreed between the first Tribunal and the parties, in consultation with the Centre, the first Tribunal held its first session in New York on May 29, 2002, with the parties attending.

10. In advance of that session, the parties, by a joint letter dated May 24, 2002, communicated to the Tribunal their agreement on several items on the agenda proposed for the session. Those agreements by the parties were affirmed at the meeting and incorporated in the minutes.

11. Arbitrators had requested a rate of remuneration higher than the Centre’s current rate. The Respondent and the Claimants, by letters dated September 17, 2002 and September 24, 2002, respectively, advised the Tribunal that they were unable to offer the rate of remuneration proposed by the Tribunal members.

12. By a letter dated October 2, 2002, the Tribunal notified the parties that it would not be able to serve on the basis of the fees agreed by the parties and that each of its members would be resigning his appointment. By a joint letter of October 17, 2002, members of the first Tribunal tendered their resignation to the Secretary-General of the Centre.

13. On October 18, 2002, the Centre notified the parties of the resignations of Mr. Aguilar Alvarez, Mr. Carter and Professor Reisman and informed them that the

proceeding was suspended pursuant to ICSID Arbitration Rule 10(2). In accordance with Arbitration Rule 11, the parties were by that letter invited to appoint new arbitrators by the same method by which the initial arbitrators were appointed.

### **3. Appointment of the present Tribunal**

14. By a letter of November 26, 2002, the Claimants informed the Centre of their appointment of Mr. Marc Lalonde, a Canadian national, to fill the vacancy created by the resignation of Mr. James H. Carter, and invited the Respondent to appoint a replacement for Professor W. Michael Reisman and to engage in consultations aimed at reaching an agreement on the person to replace Mr. Guillermo Aguilar Alvarez as the presiding arbitrator.

15. By a letter of December 16, 2002, the Respondent notified the Centre that it had appointed Mr. Rodrigo Oreamuno Blanco, a national of Costa Rica, to fill the vacancy created by the resignation of Professor W. Michael Reisman.

16. The parties, by separate letters of January 23, 2003, notified the Centre of their appointment, by agreement, of Mr. Andrés Rigo Sureda, a national of Spain, to fill the vacancy created by the resignation of Mr. Guillermo Aguilar Alvarez as the presiding arbitrator.

17. All three arbitrators accepted their appointments and, on January 29, 2003, the Centre notified the parties that the Tribunal had been reconstituted and the proceeding recommenced on that day, in accordance with ICSID Arbitration Rule 12.

#### **4. Written and Oral Procedure**

18. At the first session of the first Tribunal on May 29, 2002, it was agreed that the proceeding would be in English and Spanish. Documents filed in one language would be followed within five business days by a translation in the other language. The procedural arrangements agreed by the first Tribunal have been adhered to by the Tribunal.

19. The following schedule was also agreed for the exchange of written submissions: the Claimants to file their Memorial by October 1, 2002; the Respondent to file its Counter-Memorial by February 1, 2003; the Claimants to file their Reply by April 15, 2003; and the Respondent to file its Rejoinder by July 1, 2003.

20. It was also agreed that a hearing would be held from Monday August 4 to Thursday, August 14, 2003, including Saturday, August 9, 2003.

21. The Claimants filed their Memorial on October 1, 2002, followed on October 8, 2002 by a Spanish language translation. These submissions were not transmitted to the first Tribunal but were sent to the present Tribunal after it was constituted.

22. Upon the resignation of the members of the first Tribunal, the proceeding was suspended on October 18, 2002, pursuant to ICSID Arbitration Rule 10(2) which provides:

“Upon the notification by the Secretary-General of a vacancy on the Tribunal, the proceeding shall be or remain suspended until the vacancy has been filled.”

23. Arbitration Rule 12 further provides:

“As soon as a vacancy on the Tribunal has been filled, the proceeding shall continue from the point it had reached at the time the vacancy occurred. ...”

24. On December 26, 2002, the Respondent wrote to the Centre suggesting that the effect of ICSID Arbitration Rules 10(2) and 12 was that suspension of the proceeding upon the resignation of the first Tribunal meant a suspension of the schedule established for the filing of submissions, and requested an extension for the filing of its Counter-Memorial. The Claimants in a letter of January 10, 2003 rejected the Respondent’s interpretation of Arbitration Rule 10(2), but agreed with the Respondent that the matter should be determined by the new Tribunal upon its constitution.

25. After the present Tribunal was constituted, by Procedural Order No. 1 of February 3, 2003, issued in English and Spanish, the Tribunal requested the parties to present, no later than by February 14, 2003, any observations that they may have on the effect of the suspension of the proceeding on time limits for filing pleadings. On that day, the parties simultaneously filed submissions.

26. On February 18, 2003, the Claimants requested the Tribunal “to address one new argument” asserted in the Respondent’s submission of February 14, 2003.

27. By Procedural Order No. 2, dated February 20, 2003, the Tribunal decided:

“that the meaning of the term ‘suspension’ in Rules 10 and 12 of the [ICSID] Arbitration Rules applies to all matters related to the proceeding, including time limits, and not only to matters related to action required from the Tribunal,



that the time limit to present the counter-memorial originally fixed [for] February 1, 2003 [be] extended by 103 days [the duration of the suspension] to May 15, 2003.”

28. The Tribunal in that Order then directed the parties:

“(a) to consult each other on the subsequent schedule of the proceeding and other pending matters, including the matter related to business records, and

(b) advise the Tribunal of the result of their consultations not later than March 14, 2003.”

29. By a letter of March 14, 2003, the Claimants notified the Tribunal that the parties were still in discussions on the modified schedule.

30. By a letter of March 17, 2003, the Claimants advised the Tribunal of their agreed schedule for the submission of the remaining pleadings and notified the Tribunal that the parties had resolved the matter related to the business records referred to in Procedural Order No. 2. The Respondent in a letter of March 18, 2003, confirmed the agreement of the parties as communicated in the Claimants’ letter of the previous day.

31. Following a request by the Tribunal that the hearing commence a day later than that proposed by the parties, and correspondence with the parties in that regard, the Tribunal, by a letter dated April 21, 2003, formally took note of the agreed schedule for the submission of the remaining pleadings and proposed dates of the hearing from December 9, 2003 to December 19, 2003, including Saturday, December 13.

32. On June 9, 2003, the Respondent filed its Counter-Memorial in English and the Spanish version on June 16, 2003.

33. By letters of July 11, 2003 and July 14, 2003, respectively, the Claimants and the Respondent notified the Tribunal of each other's witnesses and experts that should be made available for cross examination at the oral hearing.

34. On September 15, 2003, the Claimants filed their Reply in English language, followed on September 23, 2003 by Spanish translations.

35. On October 14, 2003, counsel for the Respondent wrote to the Tribunal concerning their participation in the proceeding stating that:

“due solely to budgetary constraints faced by the Republic of Chile, White & Case LLP must withdraw as counsel of record for the Respondent in respect of [this] case. For the avoidance of doubt we wish to emphasize that our withdrawal does not relate in any way to the merits of the issues raised in the case. We shall assume limited role as advisor to the Republic of Chile with regard to this matter.

All communications and service of documents henceforth may continue to be addressed to us, as well as the other advisors of the Republic in regard to this matter”.

36. On November 21, 2003, the Respondent filed its Rejoinder in Spanish language, followed by the English language version on December 1, 2003.

37. As previously agreed, the hearing on merits was held from December 9 to 19, 2003, in Washington, D.C., at the seat of the Centre. The hearing was conducted in English and Spanish and full verbatim transcripts in both languages were made and distributed to the parties.

38. Pursuant to Rule 38(1) of the Arbitration Rules, on March 26, 2004, the Tribunal declared the proceeding closed, having deliberated by various means.

## II. THE FACTS

39. The facts described below follow the narrative of the Claimants and, unless noted, have not been contested by the Respondent.

40. In 1994 Dato'<sup>1</sup> Nik of MTD visited Chile as a member of a trade delegation organized by the Malaysian Ministry of Public Works. During this visit, he met with government officials and business leaders who emphasized Chile's encouragement of foreign investment. Dato' Nik so reported to the Management Committee of MTD. He also met with Mr. Musa Muhamad, the Malaysian External Trade Commissioner in the Malaysian embassy in Santiago, who encouraged MTD to invest in Chile.<sup>2</sup>

41. In April 1996, Dato' Nik heard from Mr. Muhamad about "an opportunity to build a large planned community near Santiago." Dato' Nik informed Dato' Azmil Khalid who at the time was traveling in the United States. Dato' Azmil Khalid traveled directly from the United States to Chile to investigate this opportunity. There he met with Messrs. Muhamad and Antonio Arenas, a local businessman. They informed Dato' Khalid that they had found "the perfect location for a planned community."<sup>3</sup>

42. Dato' Khalid visited the site in the small town of Pirque and met with the owner of the land, Mr. Jorge Fontaine Aldunate. Mr. Fontaine is reported to have said that "he would like to work with MTD to build a mixed-use planned community on the Malaysian model". Although the site was zoned for agricultural use, Mr. Fontaine is

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<sup>1</sup> "Dato'" is a Malaysian title of honor.

<sup>2</sup> Memorial, para. 13.

<sup>3</sup> Ibid., paras. 14-15.

alleged to have said that the land was unproductive and “could readily be rezoned, particularly if it would attract foreign investment.”<sup>4</sup>

43. Dato’ Khalid returned to Malaysia and reported to MTD’s Management Committee about this opportunity in Chile. The Management Committee decided to investigate it further. For this purpose, Messrs. Lee Leong Yow (Vincent Lee), MTD’s Group General Manager and Head of Operations, and Nazri Shafiee, expert in land valuation, traveled to Chile from May 14 to May 18, 1996. Dato’ Nik was also in Chile on May 16-17, 1996. He visited the project site and met with Mr. Fontaine and his family.<sup>5</sup>

44. Messrs. Lee and Shafiee visited the Foreign Investment Commission (FIC) on May 16, 1996. There they met with Mr. Joaquín Morales Godoy, Senior Legal Counsel.<sup>6</sup> The next day, Mr. Shafiee met with Mr. Fernando Guerra Francovich, the head of Servicio de Vivienda y Urbanización (“SERVIU”).<sup>7</sup> After these meetings, Messrs. Lee and Shafiee concluded that MTD should pursue the investment opportunity and so reported to MTD’s Management Committee.<sup>8</sup> Based on their report, the Management Committee decided “to pursue negotiations with Mr. Fontaine while continuing to study the feasibility of a joint venture to develop the Project.”<sup>9</sup>

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<sup>4</sup> Ibid., para. 16.

<sup>5</sup> Ibid., para. 13.

<sup>6</sup> Ibid., paras. 20-22.

<sup>7</sup> Ibid., para. 23.

<sup>8</sup> Ibid., paras. 25-26.

<sup>9</sup> Ibid., para. 27.

45. MTD engaged Banco Sud Americano in Santiago to appraise the land. In September 1996, the appraisers submitted their report valuing the land of Mr. Fontaine, 3000 hectares, at \$34,385,487. The appraisal assumed that the land could be developed as an upscale community after changing the existing zoning for agricultural use.<sup>10</sup>

46. In September 1996, the negotiations of MTD with Mr. Fontaine appeared to have reached a dead end because of disagreement on which hectares to develop and the control of the joint venture: Mr. Fontaine wanted: (i) to develop all 3000 hectares while MTD wished to develop first the 600 located at the lowest elevations; and (ii) a 50/50 split of the equity while for MTD it was essential to have control.<sup>11</sup>

47. Negotiations resumed in November 1996. The law firm Vial & Palma represented MTD, specifically attorneys Alberto Labbé Valverde and José Miguel Olivares. The parties prepared a “Promissory Contract” dated as of November 21, 1996.<sup>12</sup>

48. On November 6, 1996, according to the Respondent, a meeting took place between Mr. Edmundo Hermosilla, Minister of MINVU, Mr. Sergio González Tapia, *Secretario Regional Ministerial* (“SEREMI”), and representatives of MTD.<sup>13</sup> That this meeting took place, who attended and what was said at the meeting is a matter of controversy between the parties.

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<sup>10</sup> Ibid., para. 28.

<sup>11</sup> Ibid., para. 29.

<sup>12</sup> Ibid., para. 30.

<sup>13</sup> Counter-Memorial, para. 24.

49. In December 1996, Messrs. Dato' Azmil Khalid and Lee negotiated the documents implementing the Promissory Contract and signed them on December 13, 1996.<sup>14</sup> The Promissory Contract would take effect only after FIC's approval of the MTD's investment and provided for: (i) development of the land at first in two tranches of 600 and 630 hectares, the second tranche at the option of MTD; and (ii) the creation of a Chilean corporation, "El Principal Inversiones S.A." ("EPSA"), to be owned 51 per cent by MTD Chile S.A. and 49 per cent by Mr. Fontaine.<sup>15</sup>

50. On December 13, 1996, after signature of the Promissory Contract, Dato' Khalid and Mr. Labbé met with Mr. Eduardo Moyano, Executive Vice President of the FIC.<sup>16</sup>

51. On January 14, 1997, MTD filed an application with the FIC for approval of an initial investment of US\$ 17.136 million. The application described the project as follows:

“[D]evelop a township of 600 hectares of Fundo El Principal de Pirque, which will be a self-sufficient satellite city, with houses, apartments for diverse socioeconomic strata, schools, hospitals, universities, supermarkets, commerce of all sorts, services, and all other components necessary for self-sufficiency” (Exhibit 12 at 3. Translation of the Claimants).”

52. The application specified the location as “Pirque, Metropolitan Region” and that “the investment would provide initial capital to a newly formed corporation named

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<sup>14</sup> Memorial, para. 30.

<sup>15</sup> Ibid., para. 31.

<sup>16</sup> Ibid., para. 32.

MTD Chile S.A., which would use the capital to acquire a 51 percent stake in El Principal S.A., which would own the land and develop the Project.”<sup>17</sup>

53. The application was approved by the FIC at its session of March 3, 1997. The following members of FIC attended: the President of FIC (the Minister of Economy, Development and Reconstruction), the President of the Central Bank, the Undersecretary of Finance, the Undersecretary of Mining, and the Undersecretary of Planning and Cooperation. The FIC informed MTD of the approval by letter dated March 6, 1997 and enclosed the standard contract used by Chile for these purposes.<sup>18</sup>

54. The Foreign Investment Contract was signed on March 18, 1997 by the President of FIC on behalf of Chile and Mr. Labbé on behalf of MTD. The Foreign Investment Contract provides that MTD will develop “a real estate project on 600 hectares of Fundo El Principal de Pirque. The aforementioned project consists of the construction of a self-sufficient satellite city, with houses, apartments, schools, hospitals, commerce, services, etc.” (“the Project”).<sup>19</sup>

55. After signature of the Foreign Investment Contract, MTD injected US\$ 8.4 million into EPSA as a capital contribution and with US\$ 8.736 million MTD purchased 51% of the EPSA shares from Mr. Fontaine “who was receiving them in return for his contribution to EPSA of 600 hectares of land.”<sup>20</sup> The funds contributed by MTD came

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<sup>17</sup> Ibid., para. 33.

<sup>18</sup> Ibid., paras. 35 and 36.

<sup>19</sup> Exhibit 14 to the Memorial at 2.

<sup>20</sup> Ibid., para. 43.

from the resources of the MTD group and US\$ 12 million from a loan made to MTD by the Arab-Malaysian Bank in Kuala Lumpur.<sup>21</sup>

56. In March 1997, MTD representatives met three architectural firms of Santiago “to assist in the design work, performing engineering studies and obtaining regulatory approvals”<sup>22</sup>: Darraidou, Larrain & Uranga (DLU), San Martín & Pascal and URBE. In April 1997, MTD selected DLU “to assist in obtaining zoning changes, subdividing the land, and designing prototype models of the houses and other structures.”<sup>23</sup> According to the Claimant, all three firms confirmed that the process to change the zoning would need to be initiated by the Municipality of Pirque and the change would need to be endorsed by the Ministry of Housing and Urban Development (“MINVU”).<sup>24</sup>

57. MTD submitted a second application to FIC on April 8, 1997 for approval to invest additional working capital of US\$ 364,000. The second application was approved by FIC and MTD informed by letter dated April 22, 1997. The letter of approval enclosed the form of the standard foreign investment contract. The contract for this additional investment was signed on May 13, 1997. Its second clause provides that the investment will be used “[t]o make capital contributions and/or increases to the Chilean receiving company called MTD Chile S.A., which is developing a real estate project on 600 hectares of the Fundo El Principal de Pirque.”<sup>25</sup>

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<sup>21</sup> Ibid., para. 43.

<sup>22</sup> Ibid., para. 44.

<sup>23</sup> Ibid.

<sup>24</sup> Ibid.

<sup>25</sup> Memorial, para. 39.



58. On April 22, 1997, representatives of MTD and Mr. Labbé met with Messrs. Alberto Carbacho Duarte, the MINVU architect with overall responsibility for the Southern region of Santiago, which includes Pirque, and Mr. Sergio Lepe Corvalán, an official in the same office. According to the Claimants, Messrs. Carbacho and Lepe explained that “because Pirque was covered by the *Plano Regulador Metropolitano de Santiago* (PMRS) [...] the MINVU would need to coordinate and approve the necessary zoning changes for the Project...the review process would be handled at the MINVU by the *Secretario Regional Ministerial* (SEREMI).”<sup>26</sup>

59. On May 16, 1997, representatives of MTD met with the Mayor of Pirque, Mr. Manuel José Ossandón.<sup>27</sup>

60. On May 20, 1997, Dato’ Azmil Khalid met with Minister Edmundo Hermosilla. The same day, the MTD team met with Mr. Ricardo Lagos Escobar, then Minister of Public Works.

61. The Mayor of Pirque formally endorsed the Project by a letter dated August 14, 1997 and offered his assistance in obtaining approvals.<sup>28</sup>

62. During this period, Minister Hermosilla was replaced by Mr. Sergio Henríquez Díaz.

63. On September 29, 1997, at an official state dinner on the occasion of the visit of the Prime Minister of Malaysia to Chile, President Eduardo Frei Ruiz-Tagle of Chile

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<sup>26</sup> Ibid., para. 45.

<sup>27</sup> Ibid., para. 46.

<sup>28</sup> Ibid., para. 50.

delivered a toast making reference, *inter alia*, to “*the innovative real estate project in Pirque*” Memorial, para. 51.<sup>29</sup> The next day appearance of the President at the inauguration of the Project was cancelled because of an alleged meeting with the President of Brazil. According to the Respondent, the speech to be read by the President, that was already in the hands of the Claimants, was withdrawn. This fact is contested by the Claimants.

64. Around November, 1997, “MTD heard from its consultants that SEREMI González of the MINVU was showing reluctance about modifying the PMRS for Pirque.”<sup>30</sup>

65. On December 12, 1997, the *Diario Oficial* published the approval of the modification of the PMRS to include the Chacabuco area, North of Santiago, in order to permit its development under the system of *Zonas de Desarrollo Urbano Condicionado* (“ZDUCs”).<sup>31</sup>

66. In early 1998, MTD engaged the services of Mr. Pablo Heilenkötter, an attorney with expertise in land use regulation and real estate development. Since SEREMI González was unwilling to initiate the process to change the zoning, Mr. Heilenkötter and other consultants considered other alternatives under the *Ley General de Urbanismo y Construcción* (“LGUC”): “(i) the preparation of a sectional plan limited to a modification for the zoning in the area of the Project; (ii) the preparation of a communal

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<sup>29</sup> Ibid., para. 51.

<sup>30</sup> Ibid., para. 54.

<sup>31</sup> Ibid., para. 54.

plan for the Municipality of Pirque that would also include a zoning change for the area of the Project; and (iii) an application under article 55 for the construction of housing to complement a pre-existing activity.”<sup>32</sup>

67. Mr. Heilenkötter met with Mr. Lepe on March 6, 1998, and two weeks later with Mr. González together with other consultants of MTD. According to the Claimants, Mr. González informed them that he did not wish to undertake another modification to the PMRS “because it had just been changed in December 1997 to incorporate the Chacabuco area.”<sup>33</sup>

68. As MTD understood the LGUC, it was possible to pursue a change by way of a sectional plan and the *Consejo Regional de la Región Metropolitana* (“CORE”) would “ultimately decide whether to approve the sectional plan, and it could do so over the MINVU’s objection.”<sup>34</sup>

69. At this point, the Mayor of Pirque proposed to the Municipal Council to prepare a sectional plan to obtain a change in zoning. The Council approved such approach and the Mayor informed EPSA on March 31, 1998.

70. On April 13, 1998, MTD representatives and consultants met with Mr. Quintana, the CORE President. He suggested that, since Pirque did not have a Communal

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<sup>32</sup> Ibid., para. 55.

<sup>33</sup> Ibid., paras. 56-57.

<sup>34</sup> Ibid., para. 58.

Regulatory Plan, the Municipality should submit with its sectional plan a strategic plan outlining Pirque's anticipated growth.<sup>35</sup>

71. Sometime in April 1998, Dato' Azmil Khalid met with FIC Executive Vice-President Moyano "to discuss the slow progress of the zoning change request". Mr. Moyano reportedly said that he would make inquiries.<sup>36</sup>

72. On April 16, 1998, the Mayor of Pirque, and MTD representatives and consultants met with Mr. Sergio González who informed them that the Project was inconsistent with MINVU's urban development policy<sup>37</sup>. After the meeting, the Mayor wrote to SEREMI González asking for "guidance about presenting a sectional plan to the MINVU for the development of the Project."<sup>38</sup>

73. On April 20 1998, Mayor Ossandón requested a meeting with the new MINVU Minister, Mr. Henríquez. The meeting took place on May 6, 1998 and it was also attended by representatives and consultants of MTD.<sup>39</sup>

74. The SEREMI's office responded to the letter of April 16 on June 3, 1998 and explained: that "it would be inconvenient to initiate any changes to the PMRS pending completion of studies aimed at revising the *Plan Regional de Desarrollo Urbano* (PRDU)"; that "a sectional plan could not be used to obtain a change in zoning for the Project because only the SEREMI could initiate changes to the PMRS"; and that "before

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<sup>35</sup> Ibid., para. 60.

<sup>36</sup> Ibid., para. 66.

<sup>37</sup> Ibid., para. 61.

<sup>38</sup> Ibid., para. 63.

<sup>39</sup> Ibid., para. 62.

the investment contracts were signed, Minister Hermosilla had informed Mr. Fontaine and the Malaysian businessmen that it would not be possible to develop the Project in Pirque.”<sup>40</sup>

75. At the request of MTD and as a consequence of the letter of June 3, another meeting with Minister Henríquez took place on June 12, 1998. The Minister endorsed the letter of SEREMI González and confirmed that the MINVU would “neither initiate nor support any modification to the PMRS that would allow the Project to proceed.”<sup>41</sup>

76. The same day, Mr. Heilenkötter met with Mr. Banderas of the FIC who informed him that “the FIC could not assist MTD and that its role is strictly limited to approving the inflow of foreign investment funds into Chile”.<sup>42</sup> At the request of Mr. Labbé, another meeting took place with Messrs. Moyano and Banderas. Mr. Moyano confirmed at the meeting that the approval of the FIC was without prejudice to other necessary approvals and that the FIC’s authority was limited to the approval of the flow of funds into the country.<sup>43</sup>

77. The Council of the Municipality of Pirque approved the Sectional Plan on July 3, 1998 and the Mayor submitted it to the SEREMI of MINVU on August 11, 1998. On September 8, 1998, the Mayor also submitted an Environmental Impact Study (“EIS”) to the *Comisión Regional del Medio Ambiente, Región Metropolitana* (“COREMA”). On

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<sup>40</sup> Ibid., para. 63.

<sup>41</sup> Ibid., para. 64.

<sup>42</sup> Ibid., para. 66.

<sup>43</sup> Ibid., para. 67.

September 15, 1998, the COREMA informed the Municipality that it would review the EIS and announced the review in a public statement.<sup>44</sup>

78. MTD's representatives held meetings with Mr. José Miguel Insulza, Minister of Foreign Affairs, who suggested that the Malaysian Government write him and President Frei requesting assistance to address MTD's situation. The Minister of Foreign Affairs of Malaysia wrote to Mr. Insulza and the Malaysian Prime Minister to President Frei on September 11 and September 15, 1998, respectively.<sup>45</sup>

79. On September 25, 1998, the SEREMI of the MINVU returned the sectional plan to the Mayor of Pirque without evaluating the plan on its merits. The letter of SEREMI González indicated that "only the SEREMI could change the PRMS, that doing so would be 'inconvenient', and that a sectional plan could not be used to modify the PMRS."<sup>46</sup>

80. On October 19, 1998, MTD's representatives and their advisors met with the MINVU Minister, Mr. Henríquez, and SEREMI González. Mr. Henríquez re-affirmed that the policy of the Government was to encourage development of Santiago towards the North and not the South where Pirque is located. Hence, he would not support the required zoning change, and the Project should be built elsewhere in Chile. On October 27, 1998, Mr. Shafiee sent Mr. Henríquez a letter thanking him for the meeting and including draft minutes of the meeting. The Minister responded on November 4, 1998

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<sup>44</sup> Ibid., paras. 70-71.

<sup>45</sup> Ibid., para. 69.

<sup>46</sup> Ibid., para. 72.

formally rejecting the Project. He stated that the SEREMI of the MINVU “will not initiate a change to the Regulating Plan for the Santiago Metropolitan Region to make this project possible”. In a press release of the same day, MINVU indicated that it had rejected the Project because it conflicted with existing urban development policy and that the Mayor of Pirque no longer supported the Project.<sup>47</sup>

81. On November 26, 1998, the COREMA rejected the EIS because the sectional plan was incompatible with the existing zoning for the land.<sup>48</sup>

82. On December 15, 1998, the MINVU issued a more detailed press release about the rejection of the Project.<sup>49</sup>

83. On June 2, 1999, MTD notified the Respondent that an investment dispute existed under the Malaysia-Chile Bilateral Investment Treaty (the BIT). At the end of the three-month negotiation period required by the BIT before the dispute may be brought to arbitration, no solution to the dispute had been found.<sup>50</sup> At the request of the Respondent, the parties agreed to a 30-day extension of the negotiation period. Negotiations continued without an agreement being reached at the expiry of the extension.<sup>51</sup>

84. On September 9, 1999, a third Foreign Investment Contract was signed between Chile and MTD for the purpose of providing an additional US\$ 25,000 of working capital to MTD Chile. As stated in the Memorial, “The third Contract was

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<sup>47</sup> Ibid., paras. 74-75.

<sup>48</sup> Ibid., para. 77.

<sup>49</sup> Ibid., para. 75.

<sup>50</sup> Ibid., para. 80.

<sup>51</sup> Ibid., para. 81.

executed after the State of Chile had announced that the Project was incompatible with its urban-development policy and does not reference the Project in Pirque.”<sup>52</sup>

85. On October 8, 1999, MTD informed representatives of the Respondent that it would pursue this matter in formal dispute settlement proceedings under the auspices of ICSID. MTD continued to meet with representatives of the Respondent until it filed the request for arbitration in June 2001.<sup>53</sup>

### **III. PRELIMINARY CONSIDERATIONS**

#### **1. Applicable Law**

86. Article 42(1) of the Convention is the relevant provision for determining the law applicable to the merits of the dispute between the parties. This article requires the Tribunal to “decide a dispute in accordance with such rules of law as may be agreed by the parties”. This being a dispute under the BIT, the parties have agreed that the merits of the dispute be decided in accordance with international law. Applicable law has not been a matter of controversy between the parties except as it pertains to the issue of whether the Respondent has failed to meet its obligations, under the Foreign Investment Contracts, to grant the necessary permits for the Claimants to carry out their investment in Chile. The Claimants argue that the alleged failure of the Respondent has to be considered under international law because Article 3(1) of the Bilateral Investment Treaty between Chile and Denmark (the “Denmark BIT”) has the effect of internationalizing the obligations of the Respondent under the Foreign Investment

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<sup>52</sup> Ibid., para. 40.

<sup>53</sup> Ibid., paras. 82 and 84.



Contracts. The Respondent denies that Article 3(1) of the Denmark BIT had such effect and maintains that Chilean law applies on the basis of Article 42(1) of the Convention. The Respondent affirms that, in the absence of agreement between the parties, “The applicable law in regard to the foreign investment contracts is Chilean domestic legislation, according to the provisions of the Washington Convention.”<sup>54</sup>

87. At this point, the Tribunal will limit itself to note that, for purposes of Article 42(1) of the Convention, the parties have agreed to this arbitration under the BIT. This instrument being a treaty, the agreement to arbitrate under the BIT requires the Tribunal to apply international law. The Tribunal will analyze further this issue when considering the effect of Article 3(1) of the Denmark BIT.

## **2. Significance of an Investment Dispute**

88. At the beginning of its Counter-Memorial, Chile has made statements and provided statistics in support of Chile as “a place to invest”. Indeed, between 1974 and 2001, US\$ 82.9 billion in foreign investment were authorized, and more than four thousand companies invested in Chile. Chile has also pointed out that the case before the Tribunal is the first time that foreign investors appear before ICSID claiming that Chile violated DL 600<sup>55</sup> and engaged in discriminatory practices.<sup>56</sup>

89. The Tribunal, in noting the success of the Respondent in attracting foreign investment, wishes to record its understanding that a dispute before an ICSID Tribunal is not necessarily a black mark on the record of a country or an investor. Bilateral

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<sup>54</sup> Rejoinder, para. 126 and footnote 61.

<sup>55</sup> Decree Law 600, the Foreign Investment Law of the Republic of Chile.

<sup>56</sup> Counter-Memorial, paras. 1 and 2.

investment treaties are relatively new and it is not unreasonable that their application or the many factors that affect foreign investment be a source of disagreement. The fact that disagreements are brought to the decision of a third party, such as an ICSID arbitral tribunal, and that a country has offered to do so in a treaty strengthens rather than detracts from a country's endeavor to attract foreign investment and treat investors fairly and equitably.

### **3. Jurisdiction**

90. As regards the jurisdiction of the Centre and the competence of this Tribunal, the Claimants maintain that their dispute with the Respondent is a legal dispute that arises out of an investment made in Chile by a national of another Contracting State, Malaysia. The Respondent has not raised any objections about this matter.

91. The Respondent consented to ICSID arbitration under the BIT and the Claimants consented when they filed their request for arbitration.

92. Article 6(1) of the BIT provides:

“Each Contracting Party consents to submit to the International Centre for the Settlement of Investment Disputes [...] any dispute arising between that Contracting Party and an investor of the other Contracting Party which involves: (i) an obligation entered into by that Contracting Party with the investor of the other Contracting Party regarding an investment by such investor, or (ii) an alleged breach of any right conferred or created by this Agreement with respect to an investment by such investor.”

93. MTD Equity is a “national of another Contracting State”: it is a corporation organized under the laws of Malaysia and has its seat and operations in Malaysia. It is also an “investor” under the terms of Article 1(c)(ii) of the BIT, which defines investor as

including: “any corporation, partnership, trust, joint venture, organization, association or enterprise incorporated or duly constituted in accordance with applicable laws of that Contracting Party and have their seat and operations in the territory of that same Contracting Party.”

94. MTD Chile is wholly owned by MTD Equity and is a corporation organized under the laws of Chile. Under Article 25(2)(b) of the ICSID Convention and Article 6(2) of the BIT, such a corporation is to be deemed as a Malaysian national for purposes of arbitration proceedings under the ICSID Convention.

95. The dispute between the parties qualifies as a dispute under each of the categories of Article 6(1) of the BIT. It involves an obligation entered into by the Respondent with the Claimants regarding their investment in Chile and an alleged breach of their rights under the BIT in respect of such investment.

96. The requirement of Article 6(3)(i) of the BIT that the parties try to solve the dispute “amicably through consultation and negotiation” for at least three months before resorting to arbitration has also been satisfied. Negotiations took place for a period exceeding three months and through a one-month extension after the Claimants notified, on June 2, 1999, the President of Chile and the Minister of Economy that a dispute had arisen and invoked Article 6 of the BIT.

97. The Tribunal is satisfied that the dispute between the parties arises out of an investment made by MTD Equity, a national of Malaysia, in Chile and that the investment so made qualifies as such under the Convention and the BIT.

#### 4. The Right of States to adopt Policy and enact Legislation

98. The Tribunal concurs with statements made by the Respondent to the effect that it has a right to decide its urban policies and legislation. Indeed, the States parties to the BIT have agreed that their commitment to encourage and create favorable conditions for investors and admit their investments is “subject to [each party’s] rights to exercise powers conferred by its laws, regulations and national policies.”<sup>57</sup> Furthermore, in the definition of investment, the term “investment” is understood to refer to “all investments approved by the appropriate Ministries or authorities of the Contracting Parties in accordance with its legislation and national policies.”<sup>58</sup>

99. Thus, by entering into the BIT, the Contracting Parties did not limit the exercise of their authority under their national laws or policies except to the extent that this exercise would contravene obligations undertaken in the BIT itself. An arbitral tribunal in the specific case of ICSID would not consider the policies or legislation of a country and changes thereto unless a connection can be established with the investment concerned. This connection may be “established if those general measures are adopted in violation of specific commitments given to the investor in treaties, legislation or contracts. What is brought under the jurisdiction of the Centre is not the general measures in themselves but the extent to which they may violate those specific commitments.”<sup>59</sup>

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<sup>57</sup> Article 2(1).

<sup>58</sup> Article 1(b).

<sup>59</sup> *CMS Gas Transmission Company v. The Republic of Argentina*. Case No. ARB/01/8. Decision on Jurisdiction, para. 27.

## **5. The Most-Favored-Nation (MFN) Clause**

100. The Claimants have based in part their claims on provisions of other bilateral investment treaties and have alleged that these provisions apply by operation of the MFN clause of the BIT. The Respondent has not argued against the application of these provisions but, in the case of Article 3(1) of the Denmark BIT and Article 3(3) and (4) of the bilateral investment treaty between Chile and Croatia (“the Croatia BIT”), the Respondent has qualified its arguments by stating that, even in the event that the clause concerned would apply, the facts of the case are such that it would not have been breached. Because of this qualification in the Counter-Memorial and the Rejoinder, the Tribunal considers it appropriate to examine the MFN clause in the BIT and satisfy itself that its terms permit the use of the provisions of the Denmark BIT and Croatia BIT as a legal basis for the claims submitted to its decision.

101. The first paragraph of the MFN clause of the BIT - (Article 3(1)) - reads as follows:

“1. Investments made by investors of either Contracting Party in the territory of the other Contracting Party shall receive treatment which is fair and equitable, and not less favourable than that accorded to investments made by investors of any third State.”

102. The other provisions of this Article extend the clause to compensation related to losses suffered because of wars or like events or limit its application by excluding benefits provided in regional cooperation and taxation related agreements.

103. The question for the Tribunal is whether the provisions of the Croatia BIT and the Denmark BIT which deal with the obligation to award permits subsequent to

approval of an investment and to fulfillment of contractual obligations, respectively, can be considered to be part of fair and equitable treatment.

104. The Tribunal considers the meaning of fair and equitable treatment below and refers to that discussion. The Tribunal has concluded that, under the BIT, the fair and equitable standard of treatment has to be interpreted in the manner most conducive to fulfill the objective of the BIT to protect investments and create conditions favorable to investments. The Tribunal considers that to include as part of the protections of the BIT those included in Article 3(1) of the Denmark BIT and Article 3(3) and (4) of the Croatia BIT is in consonance with this purpose. The Tribunal is further convinced of this conclusion by the fact that the exclusions in the MFN clause relate to tax treatment and regional cooperation, matters alien to the BIT but that, because of the general nature of the MFN clause, the Contracting Parties considered it prudent to exclude. *A contrario sensu*, other matters that can be construed to be part of the fair and equitable treatment of investors would be covered by the clause.

#### **IV. CONSIDERATIONS ON THE MERITS**

105. The Claimants allege that the Respondent has breached:

- (i) Articles 2(2) and 3(1) of the BIT and Article 4(1) of the Croatia BIT by treating their investment unfairly and inequitably;
- (ii) Article 3(1) of the Denmark BIT by breaching the Respondent's obligations under the Foreign Investment Contracts;
- (iii) Article 3(2) and (4) of the Croatia BIT by impairing through unreasonable and discriminatory measures the use and enjoyment of the Claimants' investment and by failing to grant the necessary permits to carry out an investment already authorized; and

(iv) Article 4 of the BIT by expropriating their investment.

106. The alleged breaches of the Denmark and Croatia BITs are based on the MFN clause of the BIT. The Tribunal will now consider each of these claims and the allegation made by the Respondent that the Claimants acted irresponsibly and contrary to the prudent and diligent standard of behavior expected from an experienced investor.

### **1. Fair and equitable treatment**

107. Article 2(2) of the BIT requires that “Investments of investors of either Contracting Party shall at all time be accorded fair and equitable treatment [...]” The Croatia BIT provides that the right to fair and equitable treatment shall “not be hindered in practice” (Article 4(1)). There is no dispute between the parties about the applicability of these provisions, but they disagree on key facts to determine whether the standard of fair and equitable treatment has been breached. They also disagree on the significance of actions taken by the Respondent in relation to the approval of the investment and the execution of the Foreign Investment Contracts, and the significance of the conduct of the Claimants in reaching and executing their decision to invest in Chile.

108. The parties appear to agree on the meaning of fair and equitable treatment, but in view of comments made by them in the memorials, the Tribunal will address this matter first and then will consider the facts underlying the Claimants’ submission for purposes of applying this standard of treatment.

#### ***(i) Meaning of “fair and equitable treatment”***

109. The parties agree that there is an obligation to treat investments fairly and equitably. The parties also agree with the statement of Judge Schwebel that “the meaning

of what is fair and equitable is defined when that standard is applied to a set of specific facts”<sup>60</sup> As defined by Judge Schwebel, “fair and equitable treatment” is “a broad and widely-accepted standard encompassing such fundamental standards as good faith, due process, nondiscrimination, and proportionality”<sup>61</sup>.

110. The parties have commented on whether the fair and equitable standard is part of customary international law or additional to customary international law in reference to recent awards of arbitral tribunals established under NAFTA before and after the interpretation of Article 1105(1) by the NAFTA Free Trade Commission. The Free Trade Commission has interpreted “fair and equitable treatment” as not requiring treatment in addition to or beyond that which is required by the international law minimum standard.

111. The Tribunal notes that Chile has not argued that this is how “fair and equitable treatment” should be understood under the BIT. Chile has simply drawn attention to this interpretation and the consequences it had on the application of the standard of fair and equitable treatment by NAFTA arbitral tribunals. The Tribunal further notes that there is no reference to customary international law in the BIT in relation to fair and equitable treatment.

112. This being a Tribunal established under the BIT, it is obliged to apply the provisions of the BIT and interpret them in accordance with the norms of interpretation established by the Vienna Convention on the Law of the Treaties, which is binding on the

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<sup>60</sup> Opinion of Judge Steven Schwebel, para. 23. Witness Statement submitted with the Memorial.

<sup>61</sup> Ibid.



State parties to the BIT. Article 31(1) of the Vienna Convention requires that a treaty be “interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.”

113. In their ordinary meaning, the terms “fair” and “equitable” used in Article 3(1)<sup>62</sup> of the BIT mean “just”, “even-handed”, “unbiased”, “legitimate”.<sup>63</sup> These terms are also used in Article 2(2) of the BIT entitled “Promotion and Protection of Investments”<sup>64</sup>. As regards the object and purpose of the BIT, the Tribunal refers to its Preamble where the parties state their desire “to create favourable conditions for investments by investors of one Contracting Party in the territory of the other Contracting Party”, and the recognition of “the need to protect investments by investors of both Contracting Parties and to stimulate the flow of investments and individual business initiative with a view to the economic prosperity of both Contracting Parties”. Hence, in terms of the BIT, fair and equitable treatment should be understood to be treatment in an even-handed and just manner, conducive to fostering the promotion of foreign investment. Its terms are framed as a pro-active statement –“to promote”, “to create”, “to stimulate”- rather than prescriptions for a passive behavior of the State or avoidance of prejudicial conduct to the investors.

114. Faced with a similar task, the tribunal in *TECMED* described the concept of fair and equitable treatment as follows:

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<sup>62</sup> Article 3(1): “Investments made by investors of either Contracting Party in the territory of the other Contracting Party shall receive treatment which is fair and equitable, and not less favourable than that accorded to investments made by investors of any third State.”

<sup>63</sup> The Concise Oxford Dictionary of Current English, fifth edition.

<sup>64</sup> Article 2(2): “Investments of investors of either Contracting Party shall at all time be accorded fair and equitable treatment and shall enjoy full protection and security in the territory of the other Contracting Party.”

“[...] to provide to international investments treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment. The foreign investor expects the host State to act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor, so that it may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investment and comply with such regulations. Any and all State actions conforming to such criteria should relate not only to the guidelines, directives or requirements issued, or the resolutions approved thereunder, but also to the goals underlying such regulations. The foreign investor also expects the host State to act consistently, i.e. without arbitrarily revoking any preexisting decisions or permits issued by the state that were relied upon by the investor to assume its commitments as well as to plan and launch its commercial and business activities. The investor also expects the state to use the legal instruments that govern the actions of the investor or the investment in conformity with the function usually assigned to such instruments, and not to deprive the investor of its investment without the required compensation.”<sup>65</sup>

115. This is the standard that the Tribunal will apply to the facts of this case.

The facts or their significance are controversial and the Tribunal will first describe the allegations of the parties as they relate to them.

***(ii) Allegations of the Parties***

116. According to the Claimants, the Respondent breached the fair and equitable treatment provisions of the BIT and the Croatia BIT when it “created and encouraged strong expectations that the Project, which was the object of the investment, could be built in the specific proposed location and entered into a contract confirming that location, but then disapproved that location as a matter of policy after MTD irrevocably committed its investment to build the Project in that location.”<sup>66</sup>

Furthermore, to the extent that, as alleged by MINVU, the Respondent was always

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<sup>65</sup> *Técnicas Medioambientales TECMED S.A. v. The United Mexican States*, ICSID Case No. ARB(AF)00/2, award dated May 29, 2003, para. 154. See also *Waste Management, Inc. v. United Mexican States*, ICSID Case No. ARB(AF)00/3, para. 98.

<sup>66</sup> Memorial, para. 102.

opposed to the Project even before the signing of the Foreign Investment Contracts, then the Respondent acted “dupliciously and in bad faith, for at that time - according to the MINVU’s argument - the State of Chile had already made a decision to block the Project.”<sup>67</sup> The Respondent disputes such allegations by referring to meetings the Claimants had with Government officials and by questioning the significance attributed by the Claimants to the approval of their investment by the FIC.

117. The Respondent places great significance on the November 6, 1996 meeting with Minister Hermosilla and SEREMI González. The Claimants deny that such meeting ever took place. According to the Respondent, in this meeting, the Chilean officials warned Claimants’ representatives that “the PMRS, which categorically forbade urban development in Pirque, posed a serious impediment to the Project”, and that “because the Project was inconsistent with the goals of the PMRS, one of which was to promote urban densification, the office of the SEREMI would not be able to sponsor the project before the CORE.”<sup>68</sup> The Respondent concludes the narrative of the November 6 meeting by saying that that meeting “should have left MTD with grave doubts about the viability of a real estate project in Pirque. At this point, a reasonable investor would have undertaken rigorous due diligence as to whether, among other things, any further developmental costs were warranted. Instead, despite having been put on clear notice that its proposed Project faced serious risks, MTD proceeded to enter into a joint venture agreement, further solidifying its commitment to the El Principal Project.”<sup>69</sup>

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<sup>67</sup>Ibid., para. 103.

<sup>68</sup> Counter-Memorial, paras. 25-27.

<sup>69</sup> Ibid., para. 27.

118. The Respondent maintains that, through the many meetings that representatives of the Claimants had with officials of the Chilean Government, the Claimants were informed about the difficulty of achieving a change in the PMRS, that the SEREMI of MINVU had the initiative to propose such change, and that a sectional plan was not the proper vehicle to change the PMRS because it is an instrument hierarchically lower from a normative point of view. The meetings that the Claimants had with various urban planning firms in March 1997 and related correspondence show that already at that time they were aware of the need to re-zone El Principal.<sup>70</sup>

119. The Respondent further alleges that the role of the FIC is only to approve the capital transfer and not the details of the project itself, hence the limited nature of the description of the purpose of the investment. The Foreign Investment Contracts guarantee the foreign investor the same treatment as a national investor and provide that the authorization to import capital into Chile is “without prejudice to any others which, pursuant to such laws and regulations must be granted by the competent authorities.” Therefore, the Foreign Investment Contracts required “MTD to obtain zoning permits, environmental approvals and other applicable authorizations relating to the Project.”<sup>71</sup>

120. As regards claims of Chile’s extra-contractual liability, the Respondent alleges that they “betray a fundamental misunderstanding of the FIC approval process and other provisions of Chilean law”, and contests even the existence of a possibility of extra-contractual liability: if a contract exists, “a claim may only be brought alleging the

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<sup>70</sup> Ibid., paras. 48-96.

<sup>71</sup> Ibid., paras. 31-32.

contractual breach; an additional claim alleging quasi-contractual liability is inadmissible.”<sup>72</sup>

121. According to the Respondent, the FIC is not obliged under article 15(c) of DL 600, as the Claimants maintain, to obtain reports prior to deciding on foreign investment applications except in limited circumstances required by legislation other than DL 600 itself. There is no legal norm or regulation that imposes upon the FIC the obligation to obtain from any other authority a report or pre-approval of a real estate project such as the proposed investment of the Claimants.<sup>73</sup> The FIC is not required either to seek a change in the PMRS after the approval of the foreign investment application. If this were the case, then Article 9 of DL 600 and Clause Four of the foreign investment contracts would be rendered meaningless and the FIC would operate outside the scope of its authority.<sup>74</sup>

122. The Respondent explains that the FIC’s jurisdiction does not “extend to determining the legal, administrative, technical or economic feasibility of those investments, nor does it restrict or limit the authority or jurisdiction of any government agency. The jurisprudence of domestic courts has uniformly recognized the limited jurisdiction of the Committee and the limited scope of the Investment Contract.”<sup>75</sup> According to the Respondent, the Claimants have completely misrepresented the functions of the FIC by assigning to it the character of a “one-stop window”. As

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<sup>72</sup> Ibid., para. 129 quoting expert Feliú’s opinion.

<sup>73</sup> Ibid., para. 131.

<sup>74</sup> Ibid., para. 133.

<sup>75</sup> Rejoinder, para. 37.

explained by expert Feliú, in public law the “*principle of lawfulness*” requires that, in order for a public body to act as a “one-stop window”, it needs to be so authorized.<sup>76</sup> It was not the FIC’s “duty to reject MTD’s Foreign Investment Application due to restrictions of land use, because the Committee did not have the legal authority to carry out such an evaluation. MTD chose to take the risk associated with its investment, which involved executing an urban development project in a restricted area, while speculating that the policies regarding land use in Chile would be modified in its favor.”<sup>77</sup> The Respondent maintains that the reference to the Municipality of Pirque in the Application does not modify “the authority of the Committee, nor does it make the Committee the underwriter of the viability of the project.”<sup>78</sup>

123. The Respondent also dismisses the argument that it is extra-contractually liable because the Minister of MINVU, as “relevant Minister” under article 13(d) of the DL 600, did not attend the meeting which approved the Claimants’ request. The Respondent maintains that this argument has no basis because under Article 14 the only requirement for a meeting is that a certain quorum be achieved with or without the “relevant Minister”. In any case, it is the SEREMI of MINVU who is responsible for recommending the modification of the PMRS and the SEREMI acts independently of the MINVU Minister. The Respondent affirms further that, if the Minister of MINVU had attended the meeting, the outcome would have remained the same. He would presumably have commented that the project was risky but that in itself would not have been grounds

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<sup>76</sup> Ibid., paras. 40-41.

<sup>77</sup> Ibid., para. 47.

<sup>78</sup> Ibid., para. 50.

for rejecting the application since the investor had the right to seek a modification of the PMRS: “It is not within the FIC’s authority or mandate to perform a risk assessment with respect to the investments that are the subject of the capital inflows it approves. The resolution of questions involving risk is wholly within the investor’s sphere, and such issues have no bearing on the FIC’s approval or disapproval of foreign investment applications.”<sup>79</sup>

124. The Claimants deny that the November 6, 1996 meeting ever took place and consider that the meeting is “crucial to the Respondent’s case: this is the sole warning that MTD is alleged to have received before committing its investment”. The documents presented as evidence of what was said at the meeting were written in 1998, not in 1996.<sup>80</sup> There are no contemporaneous records of the meeting except for the word “Malaysia” in the appointment book of Minister Hermosilla. The Claimants note that “It is striking that the Respondent’s witnesses – without contemporaneous documentary record of the meeting – now remember details of the discussion so well seven years later, but are unable to recall who attended.”<sup>81</sup>

125. The Claimants point out that the warnings that MTD allegedly received from architects, urban planners and government officials after signing the first Foreign Investment Contract would have come too late.<sup>82</sup> The Claimants also note that, in its Reply, the Respondent does not acknowledge that the President of Chile praised the

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<sup>79</sup> Counter-Memorial, paras. 134-137. See also Rejoinder para. 68.

<sup>80</sup> Reply, para. 4.

<sup>81</sup> Ibid., para. 18.

<sup>82</sup> Ibid., para. 7.

Project as innovative in September 1997 and the Claimants were never informed that the cancellation of the President's appearance the next day related to the withdrawing of support for the Project.<sup>83</sup> In fact, the reason given was that the President could not attend because of a conflicting meeting with the President of Brazil.

126. According to the Claimants, it was only in 1998 that they were informed about the meeting of November 6, 1996, and that the approval of the investment application only meant that MTD could import funds and that Chilean officials first began to raise environmental concerns: "The Respondent does not explain why these supposedly long-standing and important governmental positions and policies were not communicated to MTD before 1998."<sup>84</sup>

127. The Claimants address the Respondent's assertion that, if they had acted diligently, they "would quickly have discovered that its [their] Project was unfeasible" by pointing out the following flaws: "*First*, if it was indeed so clear that the Project was not feasible, why did none of the many officials with whom MTD representatives met inform MTD of this impossibility until 1998? *Second*, the Respondent's 'due diligence' argument is premised on the warnings supposedly given to MTD at the phantom meeting of 6 November 1996."<sup>85</sup> In any case, "If the Project was in fact 'unfeasible' from the beginning, the State of Chile should not have misled MTD by approving MTD's investment application and entering into Foreign Investment Contracts with MTD based on the illusory promise of a housing project in Pirque. If, on the other hand, the Project

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<sup>83</sup> Ibid., para. 8.

<sup>84</sup> Ibid., para. 9.

<sup>85</sup> Ibid., para. 28.



was not an impossibility, the Respondent should not have rejected MTD's requests for necessary approvals on the pretext that the applicable norms necessarily preclude any urban development in Pirque."<sup>86</sup>

128. The Claimants also note that the Counter-Memorial overlooks the description of the Project in the application to the FIC, and, instead, focuses on the capital contribution section. It is clear from the project description section and the Second Clause of the Foreign Investment Contract, which are essentially the same, that the project and its location are clearly identified and the contract states that the purpose of the investment is exclusive and it could only be modified with the prior authorization of FIC.<sup>87</sup>

129. The Claimants address the Respondent's explanation that the specific identification of the project in a foreign investment contract lacks significance and state that: "No Governmental official told MTD of any such limitation before signing the Foreign Investment Contracts." The opinions of the experts submitted with the Counter-Memorial and the testimony of Mr. Moyano focus on the fact that a foreign investment contract does not automatically provide all governmental approvals necessary to realize a project, but "they do not address the different question presented by this case: Whether the state of Chile may properly enter into a binding foreign investment contract that specifies the purposes and location of a particular investment project while, at the same

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<sup>86</sup> Ibid., para. 12.

<sup>87</sup> Ibid., paras. 31-34.

time, knowing (and not telling the investor) that the Government will never allow the investor to carry out the project that is the premise of the contract.”<sup>88</sup>

130. The Claimants point out that although the Respondent refused to provide copies of the minutes of the FIC meetings, it did provide records of attendance that show that Ministers who were not permanent members of the FIC attended some meetings, “presumably to discuss and vote upon foreign investment applications that were relevant to their areas of responsibility, as required by Article 13 of DL 600.”<sup>89</sup> According to the Claimants, if “the role of the FIC were simply to approve the inflow of funds (as opposed to approving an investment for a particular project), then it would have been unnecessary and illogical for DL 600: (i) to provide that a Minister who is not a permanent member of the FIC is nevertheless a member for purposes of considering applications that are relevant to that Ministry’s work; and (ii) to require the Executive Vice President of the FIC to coordinate with other government agencies concerning information and authorizations.”<sup>90</sup> Furthermore, the Respondent is obliged to ensure under article 15(a) of the DL 600 that the FIC coordinates and consults with Ministries concerned. Although requested by the Claimants, the Respondent was not able to find any “responsive” documents.<sup>91</sup>

131. The Claimants argue that the Respondent’s position is inconsistent with the availability of other procedures for bringing foreign capital into Chile without signing

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<sup>88</sup> Ibid., para. 36.

<sup>89</sup> Ibid., para. 41.

<sup>90</sup> Ibid., para. 42.

<sup>91</sup> Ibid., para. 49.

a foreign investment contract and without necessarily identifying the object and purpose of their investment: “If the FIC’s role were limited to approval of the inflow of funds there would be no need for the FIC, because the Central Bank of Chile already has authority to [sic] the inflow of funds without consideration of the underlying project.”<sup>92</sup> The position of the Respondent is also inconsistent with the terms of the Foreign Investment Contract: “If the object of the contract were limited to the inflow of funds, the contract would not need to specify the purpose of the investment, or provide that the purpose of the investment can be changed only with the FIC’s approval.”<sup>93</sup>

132. As regards Clause Four of the Foreign Investment Contract, the Claimants point out that “It is one thing to argue that MTD must still satisfy norms and other requirements in the process of realizing the [P]roject – which MTD always understood. It is quite another matter for the Respondent to argue that Clause Fourth [sic] entitled it to approve and accept MTD’s investment in Chile while knowing that the premise of the contract could never be realized.”<sup>94</sup>

133. The Claimants note that the Respondent has not presented contemporaneous evidence to support the alleged actual reasons for the withdrawal of the speech of the President at the inauguration of the Project: “If the President’s office had “withdrawn” the text of a presidential speech that he sent to be read at the inauguration ceremony, it would be reasonable to expect some record of such withdrawal. And if MTD had used a presidential speech without permission, surely the Chilean Government would

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<sup>92</sup> Ibid., para. 43.

<sup>93</sup> Ibid., para. 44.

<sup>94</sup> Ibid., para. 46.

have taken some action at least to indicate its displeasure. By contrast, the Claimants have submitted to the Tribunal a copy of the fax that they received from the Government with the approved words of President Frei's message."<sup>95</sup>

134. The Claimants take issue with the statement of the Respondent that "the laws and regulations that govern urban planning and development in Chile – and in particular modifications to the PMRS – are simple and transparent."<sup>96</sup> It is the opinion of the Claimants that contrary to what the Respondent maintains, a sectional plan was an appropriate instrument to modify the PMRS. According to them, this instrument proposed by a municipality is not dependent on the MINVU for its initiation or completion: "When a sectional plan is filed with the MINVU, the SEREMI is required to analyze the request and forward it to the CORE with a favorable or unfavorable report."<sup>97</sup>

135. The Claimants point out that uncertainty and confusion in the urban planning and development are also evident in respect of the recently proposed Modification No. 48 to the PMRS.<sup>98</sup> The CORE approved said modification by Resolution No. 14/2003. However, the *Contraloría General* has refused to accept the legality of the resolution "ruling that the CORE exceeded its authority by attempting to regulate rural lands located outside of the established urban limits."<sup>99</sup> The decision has been appealed by CORE..

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<sup>95</sup> Ibid., para. 58.

<sup>96</sup> Ibid., para. 70.

<sup>97</sup> Ibid., para. 71.

<sup>98</sup> This modification of the PMRS permits *Zonas de Desarrollo Urbano Condicionado* in the area South of Santiago that includes Pirque.

<sup>99</sup> Reply, para. 72.

136. In the opinion of the Claimants, Modification No. 48 contradicts the arguments of the Respondent as regards the uniqueness of Pirque from an environmental point of view: “It demonstrates that Pirque is not a unique “key sector” that must be exempted from urban development to protect the so called “environmental filter” of the Santiago metropolitan region.”<sup>100</sup> The Claimants point out that it is striking that “MINVU chose to submit a *Declaración de Impacto Ambiental* (“DIA”), which involves a lower level of environmental analysis than an EIS, even though Modification No. 48 would introduce sweeping changes to the use of land throughout the Santiago Metropolitan Region, affecting over 34,000 hectares in comparison with the 600 hectares covered by the Municipality of Pirque’s sectional plan. Further, the MINVU’s DIA is much more vague and general than the EIS submitted with the sectional plan. Yet, in stark contrast to the way the COREMA treated the EIS submitted by the Municipality of Pirque, the COREMA concluded, after evaluating the DIA submitted by MINVU, that the proposed modification of the PMRS would not generate any relevant adverse environmental impacts.”<sup>101</sup>

137. The Claimants consider “disingenuous” the argument put forward by the Respondent to the effect that the Claimants should have requested an amendment of the PMRS instead of designing a sectional plan “because the Respondent made clear that it would not allow realization of the Project *under any procedure*. MTD and the Municipality of Pirque attempted the procedure of a sectional plan only after the MINVU indicated that it would not initiate such a change itself and the Respondent, through the

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<sup>100</sup> Ibid., para. 84.

<sup>101</sup> Ibid., para. 85.

MINVU, declined repeatedly to provide any guidance regarding the proper procedures to be followed to modify the PMRS.”<sup>102</sup>

138. The Respondent argues that the Claimants cannot excuse their failure to comply with the law by alleging ignorance of the law. The law was clear, the plot of land in the Fundo El Principal was exclusively for *silvoagropecuaria* use and the foreign investment contracts grant investors only the authorizations provided therein.<sup>103</sup> Referring to the cases decided by other arbitral tribunals relied on by the Claimants, the Respondent affirms that “[i]n contrast, MTD *never had any right to carry out its Project*, which was always contingent on the obtaining of the relevant authorizations by means of the procedure established by law. MTD did not understand or did not want to understand the regulations in force, choosing instead to follow procedures clearly contrary to the law.”<sup>104</sup>

139. The Respondent points out that the two communications of 1998 that refer to the November 6, 1996 meeting “were prepared and sent before any controversy existed between MTD and the Government, which thus belying [sic] MTD’s argument that this meeting has been fabricated by the Government.”<sup>105</sup> The Respondent also addresses the Claimants’ assertion that they did not receive any warning regarding the feasibility of their investment project before signing the Foreign Investment Contract and that if “MTD had been told in 1996 that the Project was not feasible, it would never have invested in

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<sup>102</sup> Ibid., para. 118.

<sup>103</sup> Rejoinder, paras. 5-7.

<sup>104</sup> Ibid., para. 9.

<sup>105</sup> Ibid., para. 27.

the Project.” The Respondent comments that “this argument is based on an erroneous assumption that the Government of Chile had the obligation to warn MTD about the feasibility of its project before it invested. In fact, it was MTD that had the obligation to obtain the necessary information regarding the legal and technical feasibility of its project. This is particularly true, given that this information was public, transparent, and readily available.”<sup>106</sup> The Respondent points out the failure of the Claimants to mention that, “under the legislation in force at that time, it was possible, though difficult and not guaranteed, to obtain a modification of the PMRS, and that MTD tried to obtain such a modification by means of an erroneous procedure that necessarily led to its rejection.”<sup>107</sup>

140. The Respondent rebuts the argument that their officials were unresponsive to the Claimants’ requests for assistance. In fact, “Due to the evident lack of competence of MTD’s consultants, Mr. Carvacho and Mr. Leppe offered to assist the company by guiding them through the steps necessary to attempt a modification of the PMRS, but MTD never took them up on this offer.”<sup>108</sup>

141. The Respondent reaffirms that it had no obligation to modify the PMRS and to allow the Project to proceed. Every step taken by the Respondent’s officials was taken in accordance to the law, including the rejection of the Sectional Plan. Sectional plans cannot alter or modify the norm established by instruments of a higher hierarchy and the modification of the PMRS was inconvenient because the MINVU SEREMI was undertaking the study of the Regional Plan of Urban Development (“PRDU”). As

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<sup>106</sup> Ibid., para. 30.

<sup>107</sup> Ibid., para. 36.

<sup>108</sup> Ibid., para. 69.

explained by the Respondent, “The PRDU is the urban planning instrument that establishes the roles of the urban centers, their gravitational areas of reciprocal influence, gravitational relations, and growth targets, among others.”<sup>109</sup> The study of PRDU for the Santiago Metropolitan Region had began in 1994 after the entry into force of the PMRS, and “it was being analyzed in 1998.”<sup>110</sup>

142. The contention that, according to Chilean law, the SEREMI had an obligation to forward the sectional plan to the CORE contradicts the LGUC which establishes the legal procedure for the elaboration of the norms of the PMRS, “what the CORE approved or rejected was a proposal of the SEREMI and not a proposal of any other agency. The CORE did not have the power to consider or approve planning proposals of any other entities, including the sectional plans presented by the municipalities.”<sup>111</sup>

143. The Respondent admits that “Chilean urban planning regulations are complex, given their highly technical nature, but they are comprehensible, a diligent investor would require competent professional assistance, as would a domestic investor.”<sup>112</sup> In any case, the Respondent argues that “complexity neither excuses MTD’s negligence nor justifies MTD’s attempts to circumvent the legally established procedures. MTD never followed these procedures but rather chose to evade them. MTD presented a Sectional Plan, through the Municipality of Pirque, to modify the provisions of the

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<sup>109</sup> Ibid., para. 83.

<sup>110</sup> Ibid.

<sup>111</sup> Rejoinder, para. 75.

<sup>112</sup> Ibid., para. 93.



PMRS, even though it was well informed that [sic] procedure was contrary to the regulations in force.”<sup>113</sup>

144. Respondent defends Modification No. 48 as proof of the evolution of the urban planning framework in Santiago: “Land use regulation and the policies adopted in these matters in the Santiago Metropolitan Area can evolve over time. That evolution is carried out within a transparent administrative system, which mandates consultation with, and approval of, multiple government agencies [...] All the modifications [between 1997 and 2002] were the result of the procedures established under Chilean law and sought the public welfare of all the population.”<sup>114</sup>

145. Chile argues that “The fact that the General Finance office of the Republic<sup>115</sup> has formulated observations to the resolution [sic] approves [sic] that Modification No. 48 does not demonstrate to the ‘uncertainty and confusion related to the rules governing development and urban planning in Chile, [...] it demonstrates the functioning of the administrative regime and the Chilean democracy, and that the mere fact that the authority proposes modifications to the norm is no guarantee they will be implemented. This does not imply arbitrary conduct, but the normal process of creation of standards under a democratic and transparent system.”<sup>116</sup>

146. According to the Respondent, it is wrong to characterize Modification No. 48 as a means to allow large-scale urban development in the area of Pirque. The

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<sup>113</sup> Ibid.

<sup>114</sup> Ibid., para. 95.

<sup>115</sup> *Contraloría General de la República*.

<sup>116</sup> Rejoinder, para. 96.

Respondent maintains that “MTD diminishes the impact of the conditions imposed on the development of new projects. In fact, Modification No. 48 would eventually allow the implementation of Conditional Urban Development Projects, only after the fulfillment of much stricter requirements than those previously imposed on any other housing project in the Santiago Metropolitan Area; the projects would have to be subjected to feasibility studies regarding basic conditions of location, size and profile of the proposal. These studies would be carried out by the municipalities where the project is located, by the SEREMI of Agriculture and the SEREMI of Housing. Subsequently, with the unanimous approval of those three agencies, the project would enter a technical evaluation phase by the SEREMI of Housing, which would have to determine if seven determinant conditions are fulfilled...the mere fulfillment of the requirements established in Modification No. 48 would not authorize the modification of land use.”<sup>117</sup>

147. For the Respondent, it is clear that Modification No. 48 would make it more difficult for large-scale real estate projects to be carried out in areas currently outside urban limits, since, as the Respondent explains, they “would have to go through two different and consecutive stages: *first*, they will have to fulfill the new requirements established in Modification No. 48 and, *second*, they will have to abide by the rules currently in place for PMRS modification. Between 1996 and 1998, however, MTD would only have had to fulfill this second stage.”<sup>118</sup>

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<sup>117</sup> Ibid., paras. 99-100.

<sup>118</sup> Ibid., para. 101.

148. In the Rejoinder, Chile re-affirms its right to require that MTD comply with Chilean environmental and urban planning regulations. The Project “constituted an inappropriate attempt to use a Sectional Plan to modify the land use restrictions established by the PMRS for that Municipality”. This was correctly pointed out by the COREMA and “under article 16 of the General Law on the Environment, *COREMA had the obligation to reject it.*”<sup>119</sup>

149. From these allegations, three key issues emerge: the significance of the November 6, 1996 meeting, the scope of the approval by the FIC, and the conduct of the Claimants as diligent investors. The Tribunal will now consider them in that sequence.

***(iii) The November 6, 1996 meeting***

150. The Respondent has attributed particular importance to the meeting allegedly held with “Malaysian businessmen” on November 6, 1996 in order to show the reckless behavior of the Claimants in proceeding to invest notwithstanding warnings of the obstacles that their investment would face. The Claimants contest that such meeting ever took place. As proof of that meeting, there is the word “Malaysia” in the calendar of Minister Hermosilla and reference made to the meeting in two documents of the Respondent dated two years later. There are no briefings prior to the meeting, nor written record of what was discussed, nor any contemporaneous written record of who attended the meeting. Neither Minister Hermosilla nor SEREMI González could determine whether any of the MTD representatives who attended the hearings in Washington were

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<sup>119</sup> Ibid., para. 105.

one of the “Malaysian businessmen” that allegedly attended the November 6, 1996 meeting.

151. This notwithstanding, the Respondent has described in considerable detail the terms of the exchanges that took place at such meeting in the Counter-Memorial and the Rejoinder and so did Messrs. Hermosilla and González in their testimony. The Malaysian representatives of the Claimants, except for Mr. Lee, have presented their passports as proof that none of them was in Chile at the time. Mr. Lee lost his passport, but he was present at the Washington hearings when Messrs. Hermosilla and González testified.

152. Given the factual controversy surrounding this meeting, the Tribunal will analyze the situation with and without the meeting and to what extent the conduct of the parties is consequent with the statements allegedly made by Chilean officials and the Claimants’ representatives.

153. The alleged meeting of November 6, 1996 is one of many meetings that took place before and after that date between representatives of the Claimants and Chilean Government officials. Representatives of the Claimants met with Mr. Morales of the FIC on May 16 and with Mr. Guerra of SERVIU on May 17, 1996. The timing of the November 6 meeting coincides with the resumption during that month of negotiations of MTD, through the firm Vial & Palma, with Mr. Fontaine, which led to the signature of the Promissory Contract on November 21, 1996. Hence, the importance attributed to the meeting by the Respondent to show that the Claimants had been warned about the

existing difficulties to build the Project by Chilean officials at the highest level and at an early stage of the Claimants' decision-making on the Project.

154. According to the Counter-Memorial, "Upon hearing that MTD had selected Pirque as the location for its Project, SEREMI González informed Minister Herмосilla that the Project was not feasible. Minister Herмосilla conveyed this point to MTD, explaining that the PMRS, which categorically forbade urban development in Pirque, posed a serious impediment to the Project. He added that the PMRS could not be circumvented and that the only way to develop a real estate project in Pirque was by modifying the PMRS."<sup>120</sup> Allegedly, the process for modifying the PMRS was explained to the Claimants at their own request. SEREMI González, "the official with sole authority to initiate the modification process,"<sup>121</sup> explained that "because the Project was inconsistent with the goals of the PMRS, one of which was to promote urban densification, the office of the SEREMI would not be able to sponsor the project before CORE."<sup>122</sup> Mr. Herмосilla also suggested that "MTD find an alternative location for its Project."<sup>123</sup>

155. This record of the meeting provided by the Respondent will be considered by the Tribunal in the context of the subsequent conduct of the parties.

156. The FIC approved the first request of the Claimants for foreign investment related to the Project on March 3, 1997. On March 18, 1997, the corresponding Foreign

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<sup>120</sup> Counter-Memorial, para. 25.

<sup>121</sup> Ibid., para. 27.

<sup>122</sup> Ibid.

<sup>123</sup> Ibid.

Investment Contract was signed. A second request for investment was approved by the FIC on April 8, 1997 and another Foreign Investment Contract signed on May 13, 1997. On September 29, 1997, the President of Chile at a state dinner in honor of the Prime Minister of Malaysia praised the Project as innovative and “a tangible demonstration that people may fully profit from the favorable conditions that the governments are creating”. Then the next day the office of the President of Chile sent a public statement in similar terms to be read at the ceremony to inaugurate the Project in Pirque after canceling his appearance because of a meeting with the President of Brazil.

157. The Respondent alleges that the statement of the President intended to be read at the inauguration had been officially withdrawn. There is no evidence of such withdrawal nor of any disclaimer to this effect after the statement was actually read at the inauguration. It is also claimed now by the Respondent that the President cancelled his attendance at the inauguration at the request of the new Minister of MINVU, Mr. Henríquez, and that the actual reason for the cancellation of the President’s attendance was that: “Having learned of the difficulties that MTD’s project faced and of the warnings that his predecessor had imparted to MTD, Minister Henríquez believed that President Frei’s presence at the ceremony could be misinterpreted, and therefore urged the President not to attend.”<sup>124</sup> It is undisputed that the Claimants were not informed at the time of the real reason for the cancellation of the President’s appearance or the alleged withdrawal of his statement. They have apparently learned about it during the course of these proceedings. Given that President Frei spoke at the state dinner only the

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<sup>124</sup> Counter-Memorial, para. 59.

evening before, there was no reason to suspect that there were other reasons for the cancellation of the President's appearance. The Respondent does not seem to have acted in accordance with the allegedly clear warnings given to representatives of the Claimants on November 6, 1996.

158. The Claimants' own actions contradict also the allegation of what was said at the November 6 meeting assuming that it took place. Irrespective of the inconsequent business decisions taken notwithstanding the alleged clear warnings of the Respondent, a matter to which the Tribunal will turn later, the Claimants, in their dealings with Mr. Fontaine, sought protection in respect of the approval of their investment by the FIC. They conditioned the taking effect of the Promissory Contract to the FIC's approval of the transfer of funds. It would seem reasonable to assume that, if the statements made to them by Minister Hermosilla and SEREMI González had been as clear as alleged, the Claimants would have protected themselves accordingly by looking for another site or canceling the proposed investment altogether. It would have been equally inconsequential for the Claimants to seek the FIC's approval for an investment considered unfeasible by high level officials of the Respondent. The Tribunal will have further to say about the Claimants' diligence.

159. The scope of the approval of the first two investments of the Claimants by the FIC is a key element in the consideration of whether the Respondent fulfilled its obligation to treat the Claimants fairly and equitably and the Tribunal will turn to this question now. At this point, the Tribunal is only concerned with the actual approval of the inflow of funds for the Project and with the fact that Chile entered into the Foreign

Investment Contracts with the Claimants. The Tribunal will discuss later the claim that Chile breached the Foreign Investment Contracts and, by operation of the MFN clause, the BIT.

*(iv) Significance of the Approval of the FIC*

160. The parties disagree on the meaning of the approval of the investment by the FIC under DL 600 and the significance of the absence of the Minister responsible for the sector of the proposed investment from the meeting where the investment was approved. Chile maintains that approval by the FIC does not mean more than an authorization to import funds into the country. The description of the project in the application to the FIC is too brief for it to be significant to the approval of the investment and it would be, in any case, beyond the scope of the FIC's authority to attribute to its approval any other meaning.

161. According to Chile, who attends the meeting of the FIC is not important provided there is a quorum for the meeting and the provisions of DL 600 do not require that the sector Minister concerned be part of the quorum. In fact, according to the Respondent, the practice of the FIC is that the sector Ministers do not attend the FIC meetings except in the case of some sectors, e.g. mining, and that the documents related to an investment are not distributed to the sector Ministers before a FIC meeting nor is notice of the meeting sent to the non-permanent members of the FIC. In any case, argues Chile, even if the Minister of MINVU had attended, the outcome would have been the same given the limited role that the FIC plays. On the other hand, the Claimants consider the approval of the FIC to be the approval of the investment and of the Project at the



described location, and to give them the right to develop the site. They attribute to the absence of the Minister of MINVU from the meeting of the FIC that approved the Project, the subsequent obstacles against which otherwise they would have been alerted.

162. DL 600 confers on the FIC the power to approve on behalf of “the Chilean State the inflow of foreign capital under this Decree-Law and to stipulate the terms and conditions of the corresponding contracts” (Article 12). The FIC members are all at the ministerial level except for the president of the Central Bank (Article 13). Decisions are taken by simple majority and a quorum for a meeting requires only the presence of any three members (Article 14). In order for the FIC to exercise its functions, the Executive Vice-Presidency is responsible, *inter alia*, for the coordination of foreign investments and to carry out and expedite the procedures required by public institutions that must report or grant their authorization prior to the approval of the applications submitted to the FIC (Article 15). The applications require the investor to specify the location of the investment and the requirement is repeated in the non-negotiable standard foreign investment contract. It is this contract that, in terms of DL 600, evidences the authorization of the FIC (Article 3). A change in the location of the investment would require a change in the contract and hence, the approval of the FIC.

163. The Tribunal considers that the ministerial membership of the FIC is by itself proof of the importance that Chile attributes to its function, and it is consequent with the objective to coordinate foreign investment at the highest level of the Ministries concerned. It is also evident from the DL 600 that the FIC is required to carry out a minimum of diligence internally and externally. Approval of a Project in a location

would give *prima facie* to an investor the expectation that the project is feasible in that location from a regulatory point of view. The practice whereby the non-permanent member of the FIC is not notified of the FIC meetings and no information is distributed to the Minister concerned prior to the meetings, when followed consistently, may impair seriously the coordination function of the FIC. This is not to say that approval of a project in a particular location entitles the investor to develop that site without further governmental approval. The Foreign Investment Contracts are clear in that respect and this matter is dealt with separately in this award. What the Tribunal emphasizes here is the inconsistency of action between two arms of the same Government *vis-à-vis* the same investor even when the legal framework of the country provides for a mechanism to coordinate. This is even more so, if, as affirmed by the Respondent, the presence of the MINVU Minister in the FIC meeting where the investment was approved would not have made a difference.

164. Chile has argued that each organ of the Government has certain responsibilities, that it is not its function to carry out due diligence regarding the legal and technical feasibility of a project for investors, and that this is the investors' responsibility. The Tribunal agrees that it is the responsibility of the investor to assure itself that it is properly advised, particularly when investing abroad in an unfamiliar environment. However, in the case before us, Chile is not a passive party and the coherent action of the various officials through which Chile acts is the responsibility of Chile, not of the investor. Whether the Claimants acted responsibly or diligently in reaching a decision to invest in Chile is another question.

165. The Claimants contacted officials of the Respondent from the very beginning in May 1996. It is only in June 1998, almost two years after the supposed November 6, 1996 meeting, that the SEREMI González informed the Claimants in writing about the policy against changing the zoning of El Principal and modifying the PMRS, and Minister Henríquez rejected the Project. Chile claims that it had no obligation to inform the Claimants and that the Claimants should have found out by themselves what the regulations and policies of the country were. The Tribunal agrees with this statement as a matter of principle, but Chile also has an obligation to act coherently and apply its policies consistently, independently of how diligent an investor is. Under international law (the law that this Tribunal has to apply to a dispute under the BIT), the State of Chile needs to be considered by the Tribunal as a unit.

166. The Tribunal is satisfied, based on the evidence presented to it, that approval of an investment by the FIC for a project that is against the urban policy of the Government is a breach of the obligation to treat an investor fairly and equitably. In this respect, whether the meeting of November 6, 1996 took place or not does not affect the outcome of these considerations. In fact, if it did take place, it is even more inexplicable that the FIC would approve the investment and the first two Foreign Investment Contracts would be signed. Minister Hermosilla and the FIC were different channels of communication of the Respondent with outside parties, but, for purposes of the obligations of Chile under the BIT, they represented Chile as a unit, as a monolith, to use the Respondent's term.

167. This conclusion of the Tribunal does not mean that Chile is responsible for the consequences of unwise business decisions or for the lack of diligence of the investor. Its responsibility is limited to the consequences of its own actions to the extent they breached the obligation to treat the Claimants fairly and equitably. The Tribunal will now address the alleged Claimants' lack of diligence and of prudent business judgment raised by the Respondent.

**(v) *The issue of the Claimants' diligence***

168. The lack of diligence of the Claimants alleged by the Respondent rests on the trust placed in Mr. Fontaine, the lack of adequate professional advice in the urban sector and the acceptance of an exorbitant land valuation at the time they made the investment.

169. The Respondent contends that the Claimants decided to invest in Chile without conducting meaningful due diligence. They relied on self-serving statements of Mr. Fontaine that the land was unproductive and could be readily re-zoned, "particularly if it would attract foreign investment."<sup>125</sup> If the Claimants had made "even the most rudimentary of inquiries" they would have learned that Pirque actually possesses high-quality agricultural land and plays an important role in the environmental health of the Metropolitan Region. They would have also learned about the PMRS adopted just two years earlier which "expressly prohibited urban development in Pirque and designated it as an exclusive *silvoagropecuaria* zone."<sup>126</sup> The Respondent finds it striking that the

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<sup>125</sup> Ibid., para. 8.

<sup>126</sup> Ibid., para. 9.

two-man team of the Claimants arrived at its favorable recommendation to invest in Chile after only four days in the country, particularly when it is considered that the investment in El Principal “appears to have been MTD’s first venture outside of Southeast Asia.”<sup>127</sup>

170. The Respondent contrasts the practices of the Claimants with those followed by diligent foreign investors. Normally, “foreign investors routinely seek contractual protections against losses arising from difficulties in obtaining governmental authorizations by incorporating related representations and warranties, covenants, conditions precedent or subsequent, or other protective provisions”.<sup>128</sup> The Claimants proceeded to enter into the Promissory Contract “despite a cursory understanding of Chile’s foreign investment laws, a flawed land appraisal, warnings from government officials regarding land use issues, and apparently no additional professional advice regarding the risks inherent to its proposed development of a satellite city on land restricted to urban development.”<sup>129</sup>

171. The Respondent draws attention to other arbitral awards not mentioned in Judge Schwebel’s opinion. The Respondent refers to the need of an arbitral tribunal to take into account, quoting from the award in *American Manufacturing & Trading v. Republic of Zaire*, the “existing conditions of the [host] country”<sup>130</sup> when applying the standards of a bilateral investment treaty: “In Chile, zoning modifications, such as those required for the PMRS, involve a lengthy administrative process –a process that Chilean

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<sup>127</sup> Ibid., paras. 9 and 11.

<sup>128</sup> Ibid., para. 29.

<sup>129</sup> Ibid.

<sup>130</sup> ICSID Case No. ARB/93/1, 36 I.L.M. 1531, at 1553 (1997).

Government officials explained to MTD at length.”<sup>131</sup> The Respondent also refers to *Azinian*<sup>132</sup> to emphasize that the Claimants, like the claimants in that case, were “alien to the host State’s business environment, had not secured the resources and services needed to implement the Project, and had not commissioned “any feasibility study worth the name.”<sup>133</sup>

172. The Respondent emphasizes that the Claimants accepted as true the representations made by Mr. Fontaine that the land use restrictions on the Fundo El Principal could be modified and did not carry any further investigation to verify their validity.<sup>134</sup> They also accepted the valuation of the land done by Banco Sud Americano on the assumption that the land would be re-zoned for urban use and without specific identification of the 600 hectare plot that the Claimants were interested in buying.<sup>135</sup>

173. The Respondent criticizes the assumptions underlying the valuation of Mr. Fontaine’s land done by Banco Sud Americano. In the first place, the valuation ignored the limitations imposed by the PMRS and “the appraisers assumed, without any analysis or explanation, that the land in El Principal would be re-zoned for urban use.” According to the Respondent, had the Claimants made “even the most primitive attempt to conduct reasonable due diligence and consult with any urban planner, environmental expert, architect, or, at the very least, a lawyer experienced in real estate development issues, the

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<sup>131</sup> Counter-Memorial, para. 109.

<sup>132</sup> *Robert Azinian et al. v. The United Mexican States*, ICSID (AF) Case N. ARB (AF)97/2, ICSID REV. –Foreign INV. L.J. 538 (1999).

<sup>133</sup> Counter-Memorial, para. 111.

<sup>134</sup> Rejoinder, para. 14.

<sup>135</sup> *Ibid.*, paras. 24-25.

erroneous nature of the appraisal's re-zoning assumption would have been imparted to MTD's representatives."<sup>136</sup>

174. The appraisal also assumed that the road known as the Paseo Pie Andino would be built within five years, and "improperly suggested that the mere proposal of the unrealized Project raised the value of the land and erroneously assumed that the land could be divided into "*parcelas de agrado*" of 0.5 hectares." In fact, after the passage of the PMRS, the minimum subdivision possible was four hectares.<sup>137</sup>

175. The Claimants decided on the value of the land only on the basis of that appraisal without considering the specific value of the 600 hectares that would be the basis of the initial investment, or how the value of the land was affected by the existing road system, or applicable zoning restrictions. According to the Respondent, if a more "exacting land appraisal" had been conducted, the Claimants, would have discovered that the value of the 600-hectare area proposed for development under the Project was between US\$ 4.1 and US\$ 4.6 million.<sup>138</sup>

176. It is clear from the record that no specialist in urban development was contacted by the Claimants until the deal had been closed. The firms contacted thereafter, to the extent that there is a contemporary written record, do not seem to have been as clear as they are now in their testimony about the difficulty of changing the zoning. The

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<sup>136</sup> Counter-Memorial, para. 20.

<sup>137</sup> Ibid., para. 22.

<sup>138</sup> Ibid., para. 23.

only thing that emerges with certainty is that the Claimants were in a hurry to start the Project.

177. The Claimants apparently did not appreciate the fact that Mr. Fontaine may have had a conflict of interest with the Claimants for purposes of developing El Principal. He played lightly to them the significance of the zoning changes and they seem to have accepted at first hand Mr. Fontaine's judgment. The price paid for the land was based on the Project going ahead and it was paid up-front without any link to the progress of the Project.

178. The BITs are not an insurance against business risk<sup>139</sup> and the Tribunal considers that the Claimants should bear the consequences of their own actions as experienced businessmen. Their choice of partner, the acceptance of a land valuation based on future assumptions without protecting themselves contractually in case the assumptions would not materialize, including the issuance of the required development permits, are risks that the Claimants took irrespective of Chile's actions.

## **2. Breach of the BIT by Breach of the Foreign Investment Contracts**

179. The Claimants argue that the Respondent's failure to observe its contractual obligations, "constitutes a breach of its treaty obligation to observe the contractual obligations it undertook regarding MTD's investment. Because the breach at issue is a breach of an international obligation, the matter is governed, first and foremost, by international law. To the extent that the issue turns on the scope of the obligations

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<sup>139</sup> "the Tribunal must emphasize that Bilateral Investment Treaties are not insurance policies against bad business judgments." *Emilio Agustín Maffezini v. The Kingdom of Spain*, ICSID Case No. ARB/97/7 para. 69.



arising out of the Foreign Investment Contracts, the Contract must be interpreted in accordance with its plain language and the general principles of contract law, in keeping with the internationalization of contract obligations [...] This conclusion is particularly relevant in this case, because the Foreign Investment Contracts do not contain a choice-of-law clause.”<sup>140</sup>

180. The Claimants emphasize the fact that the Foreign Investment Contracts were contracts of adhesion because their terms were not negotiable.<sup>141</sup> The location of the Project in Pirque was “a fundamental assumption of the bargain between MTD and the State of Chile. MTD had a right to that location, and the State of Chile had a correlative obligation to take such steps as might be necessary to permit the use of that location for the development of the Project. The State of Chile breached that obligation by blocking the development of the Project on the ground that it was to be located in the very place designated in the Contracts.”<sup>142</sup> The refusal of the Respondent to re-zone the area concerned “frustrated the rights and legitimate expectations of MTD under the Foreign Investment Contracts and treated the entire Foreign Investment Application procedure as an empty formality.”<sup>143</sup>

181. The Claimants also argue that the approval of the investment in Pirque has the effect of approving the location of the Project and that the reference in clause Four of the Foreign Investment Contracts to “other” authorizations refers to authorizations other

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<sup>140</sup> Reply, para. 104.

<sup>141</sup> Memorial, para. 109.

<sup>142</sup> Ibid., para. 110.

<sup>143</sup> Ibid.

than those granted in the Foreign Investment Contracts themselves: “it would be the height of bad faith to construe Clause Fourth [sic] as giving the State of Chile the power to destroy the basis of the bargain by erasing, after the fact, the very object of the investment as specified in the Contracts.”<sup>144</sup>

182. As regards the obligation to grant the necessary permits for an authorized investment, the Claimants affirm that “the Respondent is obligated *under the Treaty* to grant the necessary permits to the extent that doing so is *consistent* with its laws and regulations. The Respondent cannot seriously contend that modifying the PMRS to permit large-scale urban development project in Pirque would have been inconsistent with Chilean laws and regulations, for that is precisely what the Respondent is trying to do, on a far larger scale, through Modification No. 48.”<sup>145</sup>

183. Chile argues that, even if Article 3(1) of the BIT between Chile and Denmark were applicable, it has not been proven by the Claimants that Chile has violated its obligations under that provision and “under international law, the violation of a contract does not suppose an *ipso facto* violation of an international treaty.”<sup>146</sup>

184. Chile considers that it has complied with its obligations under the Foreign Investment Contracts and that the mere mention of El Principal in the Foreign Investment Contracts did not grant the Claimants an unfettered right to develop the Project in that location. The authorization granted by the FIC under DL 600 is only an authorization to

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<sup>144</sup> Ibid., para. 111.

<sup>145</sup> Reply, para. 117.

<sup>146</sup> Rejoinder, para. 126.

transfer capital and it is without prejudice and independent from other authorizations that may be required under Chilean law. Foreign investors have no right to a preferential treatment *vis-à-vis* local investors: “Just as a domestic investor cannot obtain a waiver of the PMRS by executive fiat, neither could MTD.”<sup>147</sup>

185. Based on statements made by Chile in the Counter-Memorial, the Claimants point out that the Respondent refused “*for reasons of ‘inconvenience’*” even “to consider taking the administrative actions necessary to permit urban development on the piece of land designated in the Contracts, a result that was entirely in its power and discretion to achieve [...] To this it may now be added that, under the Respondent’s own version of the facts, the State of Chile entered into Foreign Investment Contracts *with the intent that it would not allow the Project to be built in Pirque.*”<sup>148</sup>

186. The Claimants contest that the scope of the Foreign Investment Contracts is governed by Chilean law and that under that law the FIC did not have “the capacity or authority to approve the nature and location of the investment project”.<sup>149</sup> The Claimants state that “Under basic principles of international law, the State of Chile may not evade its international responsibility by invoking any alleged insufficiency in the authority of the organ through which it acted.”<sup>150</sup> The Claimants also contest the argument that DL 600 guarantees treatment as a national investor and that they would have received better treatment if authorization of the investment and the Foreign Investment Contract would

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<sup>147</sup> Counter-Memorial, para. 124.

<sup>148</sup> Reply, para. 105.

<sup>149</sup> Ibid., para. 107.

<sup>150</sup> Ibid., para. 108.

have given them the right to the modification of the PMRS. The Claimants argue that, under the BIT, they are “entitled to certain standards of treatment even if the State of Chile chooses not to extend the same treatment to its own national investors [...] [L]ocal investors are not eligible to enter into foreign investment contracts and hence cannot receive any of the special guarantees or advantages that DL 600 authorizes [...] [T]he principle of non-discrimination under Article 9 of DL 600 protects foreign investors from *worse* treatment than that accorded to national investors; it does not prevent them from receiving the benefits provided in the foreign investment contracts.”<sup>151</sup>

187. The Tribunal considers the legal basis of the claim valid based on the wide scope of the MFN clause in the BIT, as already discussed. The Tribunal notes the statement of the Respondent that under international law the breach of a contractual obligation is not *ipso facto* a breach of a treaty. Under the BIT, by way of the MFN clause, this is what the parties had agreed. The Tribunal has to apply the BIT. The breach of the BIT is governed by international law. However, to establish the facts of the breach, it will be necessary to consider the contractual obligations undertaken by the Respondent and the Claimants and what their scope was under Chilean law.

188. The Tribunal has found that Chile treated unfairly and inequitably the Claimants by authorizing an investment that could not take place for reasons of its urban policy. The Claimants have based their arguments on the fact that “the location of the Project was a fundamental assumption of the bargain between MTD and the State of Chile. MTD had a right to that location, and the State of Chile had a correlative

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<sup>151</sup> Ibid., para. 109.

obligation to take such steps as might be necessary to permit the use of that location for the development of the Project.”<sup>152</sup> The Tribunal accepts that the authorization to invest in Chile is not a blanket authorization but only the initiation of a process to obtain the necessary permits and approvals from the various agencies and departments of the Government. It also accepts that the Government has to proceed in accordance with its own laws and policies in awarding such permits and approvals. Clause Four of the Foreign Investment Contracts would be meaningless if it were otherwise. Therefore, the Tribunal finds that Chile did not breach the BIT on account of breach of the Foreign Investment Contracts.

189. As already discussed under fair and equitable treatment, what is unacceptable for the Tribunal is that an investment would be approved for a particular location specified in the application and the subsequent contract when the objective of the investment is against the policy of the Government. Even accepting the limited significance of the Foreign Investment Contracts for purposes of other permits and approvals that may be required, they should be at least in themselves an indication that, from the Government’s point of view, the Project is not against Government policy.

### **3. Unreasonable and Discriminatory Measures**

190. The argument of the Claimants regarding unreasonable and discriminatory measures is based on Article 3(3) of the Croatia BIT. This Article provides:

“Each Contracting Party shall protect within its territory investments made in accordance with its laws and regulations by investors of the other Contracting

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<sup>152</sup> Memorial, para. 110.

Party and shall not impair by unreasonable or discriminatory measures the management, maintenance, use, enjoyment, extension, sale and liquidation of such investments.”

191. The Claimants allege that the unfair and inequitable measures described earlier are also unreasonable and that the Respondent’s “refusal to re-zone the El Principal Estate in Pirque to permit construction of the Project is discriminatory because the State of Chile has permitted construction of other large-scale real-estate projects in the Chacabuco area, north of Santiago.”<sup>153</sup>

192. Furthermore, the Claimants maintain that the acceptance and approval of an environmental impact declaration (DIA) by COREMA in support of Modification No. 48 “illustrates the State of Chile’s unreasonable and discriminatory treatment of the EIS submitted by the Municipality of Pirque in support of the proposed Sectional Plan.”<sup>154</sup>

193. According to the Respondent, none of the modifications to the PMRS referred to by the Claimants were achieved through sectional plans and followed the standard PMRS modification procedure. Furthermore, Modification No. 48 “will make the completion of large real estate projects more – rather than less – difficult in the Metropolitan Region of Santiago.”<sup>155</sup>

194. The Respondent finds also inadmissible the comparison of the EIS with the DIA prepared for Modification No. 48. An EIS is only required by the existing

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<sup>153</sup> Memorial, para. 115.

<sup>154</sup> Reply, para. 115.

<sup>155</sup> Rejoinder, paras. 5-7.

environmental regulation when projects entail significant environmental impacts.<sup>156</sup> In contrast to the environmental consequences of the Project, “Modification No. 48 would not generate direct impacts on the environment, it would set out conditions for the development of future Urban Conditional Development Projects”. Projects presented under Modification No. 48 will still need an EIS and satisfy “a *more demanding* environmental evaluation than that applied to the Sectional Plan for Pirque.”<sup>157</sup>

195. The Respondent explains the justification given by COREMA to reject the EIS. First of all, the COREMA followed the prescribed procedure. It accepted the EIS for review within five days of receipt because *prima facie* there were no evident administrative errors. The next step was to consult with other Government agencies with jurisdiction over environmental matters. This is what COREMA did in the case of MTD’s EIS. COREMA issued a negative evaluation regarding the substance of the EIS only after “consulting with other agencies about the environmental impacts of MTD’s Project.”<sup>158</sup> The Project was inconsistent with the PMRS, which for purposes of evaluating an environmental impact study is considered an environmental regulation, and, hence, the Project failed to comply with environmental regulations. The EIS also failed to address identified environmental obstacles and was extremely vague.<sup>159</sup>

196. To a certain extent, this claim has been considered by the Tribunal as part of the fair and equitable treatment. The approval of an investment against the

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<sup>156</sup> Ibid., para. 108.

<sup>157</sup> Ibid., paras. 110-111.

<sup>158</sup> Counter-Memorial, para. 153.

<sup>159</sup> Ibid., para. 154.

Government urban policy can be equally considered unreasonable. On the other hand, the changes of the PMRS related to Chacabuco or more recently Modification 48, as explained by the Respondent, do not dispense with specific changes of the PMRS when the land is zoned of “*silvoagropecuario* interest”. Therefore, there is no basis for considering the modifications made to PMRS as discriminatory. The Tribunal is also satisfied by the explanation regarding the rejection of the EIS by COREMA.

#### **4. Failure to Grant Necessary Permits**

197. This claim is based on the Croatia BIT by way of the MFN clause of the BIT. Article 3(2) of the Croatia BIT reads as follows: “When a Contracting Party has admitted an investment in its territory, it shall grant the necessary permits in accordance with its laws and regulations.”

198. The Claimants consider that this “clause obligates the State, once the investment is approved, to grant the necessary permits to the investor, in accordance with the country’s laws and regulations.”<sup>160</sup> And further, “At the very minimum, this provision obligates the [S]tate of Chile to grant to MTD such permits as may be necessary to cover those aspects of the investment that were specifically considered by the [S]tate in admitting the investment. Accordingly, if a formal re-zoning permit is required for the development of the Project and if that permit can only take the form of an amendment of the PMRS, the [S]tate of Chile is required by the quoted provision [Article 3(2)] to grant such permit by adopting such an amendment to the PMRS.”<sup>161</sup>

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<sup>160</sup> Memorial, para. 118.

<sup>161</sup> Ibid., para. 119.



199. While the Claimants realize that permits must be granted in accordance with the laws and regulations of the State and that the PMRS is one such regulation, they consider that, to use such reasoning, misses the point: “It is the modification of the PMRS – which is entirely within the State of Chile’s discretion – that is at issue here. There is nothing in the State of Chile’s laws or regulations that would prevent the [S]tate of Chile from modifying the PMRS to allow the Project to be fulfilled [...] The State of Chile refused to make such modification not because it lacked the power to do so, but because it chose not to do it for reasons of policy. Any interpretation that allowed the State to do just that would turn the treaty obligation to grant necessary permits for an approved investment into a dead letter.”<sup>162</sup> On the other hand, when Chile had the will to modify the PMRS, it found a way to justify it.

200. The Respondent dismisses the Claimants’ statement that no legal norm prevented Chile from modifying the PMRS to allow the carrying out of the Project.<sup>163</sup> If the argument presented by the Claimants were correct, it would “render meaningless that clause of the Chile-Croatia Treaty and the Foreign Investment Contracts – clauses found in countless other bilateral investment treaties and foreign investment contract worldwide – requiring foreign investors to comply with domestic laws and regulations.”<sup>164</sup> Under such theory, “a foreign investor would be able [sic] circumvent the PMRS modification

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<sup>162</sup> Ibid., para. 120.

<sup>163</sup> Counter-Memorial, para. 143.

<sup>164</sup> Ibid., para. 144.

process, while domestic investors could not – a result that would contravene the non-discrimination provision of DL 600.”<sup>165</sup>

201. As to the modifications made to the PMRS, the Respondent affirms that they reflect minor changes that underscore the firm commitment of Chile to respect this instrument. The most significant modification of land use involved re-designating land at La Platina from Ecological Preservation to a Complementary Green Area to allow the construction of a zoological park. The modification introduced by Resolution 39 in 1997 incorporated new lands in the PMRS rather than changed the use of land already in the PMRS, the municipalities of Colina, Lampa and Til-Til in the Province of Chacabuco. Furthermore, “The incorporation of Chacabuco [...] was wholly consistent with the original purpose of the PMRS, which was to allow urban development in Santiago’s north, where Chacabuco is located, rather than in the southeast, where Pirque is located.”<sup>166</sup> Chile does not deny that it can change the PMRS but asserts that it is not obliged to do so, “[t]he simple fact that the PMRS *could* be modified did not mean that MTD was *entitled* to its proposed modification.”<sup>167</sup>

202. Chile points out that it is an unexplained indictment of the Claimants that Chile adhered to its urban planning policy: Chile – like any other sovereign State - has the power to establish its policies. In fact, it is a Government’s *raison d’être* to enact laws that reflect policy choices. MTD was aware of Chile’s policy before it purchased El Principal and has “no credibility to decry that policy now and argue –without support –

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<sup>165</sup> Ibid., para. 145.

<sup>166</sup> Ibid., paras. 147-149.

<sup>167</sup> Ibid., para. 150.

that Chile was somehow automatically obligated as a matter of law to change a policy benefiting the millions of residents of [sic] Metropolitan Region.”<sup>168</sup>

203. The Respondent contests the argument that it failed to give the necessary permits and hence it violated Article 3(2) of the Croatia BIT: “Even assuming that article 3(2) [...] is applicable to the present case, Chile has not violated that obligation. Chile has demonstrated that the actions of its officials were not carried for [sic] for extra-legal reasons such as the particular preferences or whims of government officials.”<sup>169</sup> The permits needed for the Project, as found by the tribunal in *TECMED* in interpreting a similar provision, need to be granted in accordance with the laws of the State concerned,<sup>170</sup> and there is no merit to the contention of the Claimants that, “Because the breach at issue is a breach of an international obligation, the matter is governed, first and foremost, by international law.”<sup>171</sup>

204. The Tribunal considers the legal basis of the claim valid based on the wide scope of the MFN clause in the BIT, as already discussed. The Tribunal disagrees with the Respondent’s statement that there is no merit to the contention of the Claimants that, if there is a breach of an international obligation, “the matter is governed, first and foremost, by international law”. The breach of an international obligation will need, by definition, to be judged in terms of international law. To establish the facts of the breach, it may be necessary to take into account municipal law. In the instant case, the Tribunal

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<sup>168</sup> Ibid., para. 151.

<sup>169</sup> Rejoinder, para. 130.

<sup>170</sup> *Environmental Techniques TECMED S.A. v. the Mexican United States*, ICSID Case No. ARB(AF)/00/2, Decision of May 29, 2003.

<sup>171</sup> Rejoinder, paras. 131-132.

will need to establish first whether the Respondent's failure to modify the PMRS to the benefit of the Claimants was in accordance with its own laws.

205. The Tribunal draws a distinction between permits to be granted in accordance with the laws and regulations of the country concerned and those actions that require a change of said laws and regulations. To the extent that the application for a permit meets the requirements of the law, then, in accordance with the BIT and Article 3(2) of the Croatia BIT, the investor should be granted such permit. On the other hand, said provision does not entitle an investor to a change of the normative framework of the country where it invests. All that an investor may expect is that the law be applied.

206. As explained by the Respondent, the carrying out of the investment would have required a change in the norms that regulate the urban sector in Chile. The PMRS forms part of this normative framework, as repeatedly stated by the Respondent. Laws and regulations may be changed by a country but it is not an entitlement that can be based in Article 3(2) of the Croatia BIT. This clause is an assurance to the investor that the laws will be applied, and to the State a confirmation that its obligation under that article is confined to grant the permits in accordance with its own laws. The Tribunal concludes that the Respondent did not breach the BIT by not changing the PMRS as required for the Project to proceed.

## **5. Expropriation**

207. The Claimants affirm that MTD made its investment "after receiving authorization to do so from the State; was forced to halt the execution of its project

because it was informed that it lacked a necessary permit; attempted to obtain such permit but the attempts were rebuffed; as a result it was unable to continue with the Project and essentially lost the value of its investment. In these circumstances, the treatment suffered by the investor constitutes an indirect expropriation.”<sup>172</sup>

208. The Claimants argue that their investment has been expropriated by the Respondent in breach of Article 4 of the BIT. The Claimants allege indirect expropriation resulting from actions and failure to act by the Respondent, irrespective of whether “the State intended or not to cause an indirect expropriation.”<sup>173</sup> In making this argument, the Claimants rely on definitions of indirect expropriation by arbitral tribunals in the cases of *Metalclad Corp. v. United Mexican States*<sup>174</sup> and *CME Czech Republic B.V. (The Netherlands) v. Czech Republic*<sup>175</sup> and consider that the facts of their case are analogous to *Metalclad* and *Biloune*<sup>176</sup>: in these two cases “arbitral tribunals have found that the failure or refusal of the host State to provide a necessary permit to the investor constituted an indirect expropriation.”<sup>177</sup>

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<sup>172</sup> Memorial, para. 127.

<sup>173</sup> Ibid., para. 124.

<sup>174</sup> “covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host state.” (*Metalclad Corp. v. United Mexican States*, ICSID Case No. ARB(AF)/97/1, Award, 30 August 2000, 103, 16 ICSID Rev.-FILJ 165 (2001)).

<sup>175</sup> “De facto expropriation or indirect expropriation, i.e. measures that do not involve an overt taking but that effectively neutralize the benefit of property of the foreign owner, are subject to expropriation claims. This is undisputed under international law.” (*CME Czech Republic B.V. (The Netherlands) v. Czech Republic*, Partial Award, 13 September 2001, 604 available at <http://www.cnts.cz/doc10/en/pdf/cme-cr-eng.pdf> (citing Sacerdoti, J., *Bilateral Treaties and Multilateral Instruments on Investment Protection*, 1997 Recueil des Cours 382 (1998)).

<sup>176</sup> *Biloune and Marine Drive Complex Ltd v. Ghana Investments Centre and the Government of Ghana*, 95 I.L.R. 183 (1994).

<sup>177</sup> Memorial, para. 126.

209. Chile is “bewildered” by this claim because “MTD continues to enjoy full ownership of its interest in EPSA, and still has the right to seek zoning and other permits and approvals required under Chilean law [...] MTD remains able to explore investment opportunities in Pirque and has the right to seek a modification of the PMRS, and other urban planning regulations.”<sup>178</sup> The Respondent draws attention to the award in *Feldman v. Mexico* which found that “*not all governmental regulatory activity that makes it difficult or impossible for an investor to carry out a particular business, change in the law or change in the application of existing laws that makes it uneconomical to continue a particular business, is an expropriation.*”<sup>179</sup> The instant case does not concern “the **change** of an existing law or the application thereof. To the contrary, this case merely involves the Republic of Chile’s consistent application of its policies, regulations and laws.”<sup>180</sup>

210. In the same vein, the Respondent contests the reliance of the Claimants on *Biloune*. There the arbitral tribunal held that “the combination of measures used against the investor constituted constructive expropriation”. In the case before this Tribunal, the Respondent argues that “*Biloune* simply does not support the theory that the denial of a permit alone or, as in the case of MTD, the absence of a change in zoning, constitutes a constructive expropriation [...] contrary to the facts in *Biloune*, Chilean Government

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<sup>178</sup> Counter-Memorial, para. 114 and Rejoinder, para. 10.

<sup>179</sup> Counter-Memorial, para. 115.

<sup>180</sup> Ibid.

officials never assured MTD that a change in zoning would be *unnecessary* or that MTD could proceed with its Project without modifying the PMRS.”<sup>181</sup>

211. The Claimants respond to Chile’s bewilderment about their expropriation claim by pointing out that, by definition, an indirect expropriation claim “takes place when the State deprives the investor of the use and benefit of the investment without formally depriving the investor of title.”<sup>182</sup>

212. The Claimants also contest the interpretation given by the Respondent to *Metalclad* and *Biloune*: “MTD received authorization from the [S]tate of Chile to make an investment to develop a project in Pirque, but was denied the ability to proceed with the development because the State denied a key permit [...] *Biloune is not a case about the number of acts that a State must undertake against an investment* [...] It is the overall impact of the state action on the investment that determines the existence of indirect expropriation. In this case, the refusal of the State of Chile to provide the key permit to allow the development of the Project in Pirque resulted in a complete frustration of the Project and a complete loss of in [sic] the value of MTD’s investment.”<sup>183</sup>

213. The Respondent contests again in the Rejoinder the arguments presented by the Claimants on expropriation and insists on the irrelevance of the cases relied on by the Claimants (*Middle East Cement*, *TECMED*) because no license was revoked or permit renewal denied: “MTD has not identified any property right that has been seized

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<sup>181</sup> Ibid., para. 118.

<sup>182</sup> Reply, para. 123.

<sup>183</sup> Reply, footnote 35 at pages 54-55.

by Chile. Moreover, MTD has admitted that it has been judicially compelled to accept an offer ‘approximately equivalent to US \$10.069.206’ for its shares in EPSA, which hardly supports their claim that these are essentially without value.’<sup>184</sup>

214. As already stated, the Tribunal agrees with the argument of the Respondent that an investor does not have a right to a modification of the laws of the host country. As argued by the Respondent, “every State has the power to amend any of its laws. The mere fact that Chile *can* change the PMRS does not mean, however, that Chile is *obligated* to do so.”<sup>185</sup> The issue in this case is not of expropriation but unfair treatment by the State when it approved an investment against the policy of the State itself. The investor did not have the right to the amendment of the PMRS. It is not a permit that has been denied, but a change in a regulation. It was the policy of the Respondent and its right not to change it. For the same reason, it was unfair to admit the investment in the country in the first place.

## V. DAMAGES

215. The Claimants seek “full compensation for the damage they have sustained as a consequence of the State of Chile’s treaty violations, so that the Claimants are restored to the position they would be in had those treaty violations not occurred.”<sup>186</sup>. This entails the recovery of : “(i) the full cost of their investment (minus any remaining

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<sup>184</sup> Rejoinder, para. 142.

<sup>185</sup> Counter-Memorial, para. 144.

<sup>186</sup> Memorial, para. 129.



value), (ii) pre-award compound interest at a commercially reasonable rate, and (iii) the costs and expenses associated with this proceeding.”<sup>187</sup>

216. Chile contends that the Claimants have failed to prove the alleged losses and their causal link to the alleged breaches. Chile points out several fundamental flaws in their claim. First, they failed to mitigate their losses by entering into the Promissory Contract notwithstanding Minister Hermosilla’s warning in the November 6, 1996 meeting that their project faced serious regulatory obstacles and without protecting themselves against the risks posed by these obstacles. The failure of the Claimants to mitigate losses is a cause of loss not attributable to the Republic of Chile.<sup>188</sup>

217. Chile affirms that preparatory expenses till March 18, 1997 (date of signature of the first Foreign Investment Contract) should not be recoverable. As regards the other claimed losses, almost 80% occurred by transferring the funds to Chile between March 19, 1997 and the meeting held with Minister Hermosilla on May 20, 1997. During that period, architects, urban planners and governmental officials warned MTD that the Project faced serious difficulties and Mr. Hermosilla repeated his early warning.<sup>189</sup> After May 20, 1997 and until September 25, 1998 when the SEREMI confirmed that the sectional plan could not be used to amend the PMRS, the Claimants spent more than US\$ 1.4 million: “any reasonable investor would have long since developed serious reservations about allocating additional funds to a questionable investment”.<sup>190</sup> Even after

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<sup>187</sup> Ibid., para. 130.

<sup>188</sup> Counter-Memorial, para. 165.

<sup>189</sup> Ibid., para. 167.

<sup>190</sup> Ibid., para. 168.

September 25, 1998, the Claimants continued to spend more than US\$ 3.2 million on the Project and then declined to take advantage of an opportunity to recover about half their losses when they rejected the offer made by Mr. Fontaine to buy their shares of EPSA on November 24, 2001.<sup>191</sup>

218. Chile also questions whether the Claimants themselves actually incurred the losses: “Most of the alleged losses – including equity injections, debt servicing, salary payments and various other expenses – are supported by documents relating to MTD Construction or MTD Capital.”<sup>192</sup> Chile also finds that the Claimants have failed to substantiate the fate of the amount injected in EPSA or “explain whether the use of those funds constitutes recoverable losses.”<sup>193</sup>

219. The Respondent contends that there is no legal basis for the claim of interest or bank guarantee charges related to the loan used to finance the investment. Chile relies on the finding of the tribunal in *Middle East Cement* that “denied costs related to a bank loan taken out by the claimant itself because such costs ‘are normal commercial risks for the Claimant. They could only be claimed if, it were shown that they were caused by conduct of the Respondent which was in breach of the BIT’”<sup>194</sup>. Chile argues that, “[i]n the present case, Claimants not only did not take out the bank loan, but they also failed to demonstrate how a ‘loss’ relating to debt service was a direct

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<sup>191</sup> Ibid., para. 169.

<sup>192</sup> Ibid., para. 172.

<sup>193</sup> Ibid., para. 173 and Rejoinder, para. 153.

<sup>194</sup> *Middle East Cement Shipping and Handling Co. S.A. v. Arab Republic of Egypt*, ICSID CASE No. ARB/99/6, Award, 12 April 2002, paras. 153-154. Quoted in para. 178 of the Counter-Memorial.

result of actions or in actions by the Republic of Chile. Claimants fail to show that they incurred any losses related to debt servicing.”<sup>195</sup>

220. Chile contests the entitlement of Claimants to pre-award interest and maintains that “international law, as a rule, does not allow compound interest”, and that, if the Tribunal should find that compound interest is allowed, then it would be “required to take into account the circumstances of the case and not award compound interest.”<sup>196</sup>

221. As regards the level of the rate of interest, Chile offers the alternative of the average dollar-based “*interés corriente*”<sup>197</sup> used for bank lending in Chile or the annual average of the London Inter-Bank Offering Rate (“LIBOR”) as more reasonable alternatives to the 8% claimed by the Claimants.<sup>198</sup>

222. Chile also argues that it is unclear how expenses under “salaries”, “travel expenses” or “other” relate to the Project, and why they should be its responsibility.<sup>199</sup>

223. The Respondent considers that the Claimants grossly understate the current value of their investment, particularly the value of the land that according to the valuation of the Claimants’ expert is twenty times less than it was at the time they bought it.<sup>200</sup>

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<sup>195</sup> Ibid., para. 178.

<sup>196</sup> Ibid., para. 183.

<sup>197</sup> The statutory interest rate applied by courts in Chile.

<sup>198</sup> Counter-Memorial, para. 184.

<sup>199</sup> Ibid., paras. 179, 180 and 182.

<sup>200</sup> Ibid., paras. 185-189.

224. The Respondent requests that “the Tribunal order Claimants to bear the expenses incurred by the Republic of Chile in connection with these proceedings, the fees and expenses of the members of the Tribunal and the charges for the use of the facilities of the Centre, in their entirety.”<sup>201</sup>

225. The Claimants note that the Respondent does not dispute the standard of compensation advanced in the Memorial.<sup>202</sup> They object to the interpretation given by the Respondent to the *Mihaly* award on the issue of preparatory costs. In that case, the tribunal found that “certain preparatory expenses incurred by the investor did not give rise to an ‘investment’ for purposes of ICSID jurisdiction, in circumstances in which the State had made it clear that it did not intend to admit any investment from the claimant until execution of a binding investment contract.”<sup>203</sup> In the instant case, there is no dispute that the investment was approved and three Foreign Investment Contracts executed.

226. The Claimants also comment on the issue of mitigation of damages that precisely “because the great majority of MTD’s expenses are evidenced by its initial investment in early 1997, it was reasonable and consistent with MTD’s obligation to mitigate damages for MTD to continue seeking Government approvals even after it became apparent that Government officials were opposing the Project.”<sup>204</sup> As for the failure to accept the buy-out offer of Mr. Fontaine, the Claimants maintain that such offer

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<sup>201</sup> Ibid., para. 191.

<sup>202</sup> Reply, para. 127.

<sup>203</sup> Ibid. para. 130.

<sup>204</sup> Ibid., para. 131.

was illusory because of the terms of payment. In neither of the payment alternatives offered by Mr. Fontaine, the Claimants would be able to “cash out” their holdings in EPSA.<sup>205</sup>

227. The Claimants reaffirm that MTD Equity and MTD Chile directly made the initial investment with funds supplied to MTD Equity by MTD Capital: “Contrary to the Respondent’s assertions, MTD Equity directly incurred all other Project-related expenses, either directly through its owned subsidiary MTD Construction or by incurring legally enforceable obligations to its parent, MTD Capital, to repay expenditures that it made on MTD Equity’s behalf.”<sup>206</sup>

228. The Claimants maintain that the debt service and bank guarantee fees claimed as part of the damages are “directly related to the State of Chile’s actions destroying the value of MTD’s investment and denying MTD any opportunity to recoup its costs and earn a return on capital. Because the Respondent’s conduct breached its obligations to MTD under the Treaty, these payments fall squarely into the exception the *Middle East Cement* tribunal carved out for commercial risk costs that are incurred as a direct result of the State’s misconduct.”<sup>207</sup>

229. The Claimants argue that compound interest is not unfair or inappropriate in the circumstances of this case because “the State of Chile cannot escape the fact that it approved MTD’s application to invest in a project in Pirque and then frustrated that

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<sup>205</sup> Ibid., paras. 132-135.

<sup>206</sup> Ibid., para. 139.

<sup>207</sup> Ibid., para. 148.

investment. MTD's possession of the land does not diminish its losses. In contrast to the land owner in the *Santa Elena* case, which was 'able to use and exploit [the property] to some extent,' MTD has not been able to use its investment in the land held by EPSA for *any* kind of profitable activity."<sup>208</sup>

230. As regards the interest rate applicable to pre-award interest, the Claimants recall that the dispute is not governed by Chilean law and therefore the *interés corriente* applied by Chilean courts is not appropriate. Similarly, it is not appropriate to apply LIBOR since they invest their dollars in local Malaysian markets: "At a minimum, MTD should be awarded US\$ 8.782 million in simple interest at its requested rate of 8 percent."<sup>209</sup> The Claimants also find no merit to "Chile's argument that the 'constructive value' of MTD's 51 percent share in EPSA should be US\$ 12.8 million, which is based on a highly inflated estimate of land values and disallowance of most of MTD's investment expenses."<sup>210</sup>

231. The Claimants contest the current valuation of the land in the Sánchez Report commissioned by the Respondent. They allege that the Sánchez Report relies on valuation data for land that is not comparable to the land that EPSA owns. In particular, "Sánchez relies on land values that he acknowledges have been affected by speculation about the pending Modification No. 48, which would permit urban development in Pirque."<sup>211</sup> The Claimants argue that "by relying on prices that may reflect speculation

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<sup>208</sup> Ibid., para. 157.

<sup>209</sup> Ibid., para. 158.

<sup>210</sup> Ibid., para. 159.

<sup>211</sup> Ibid., para. 162.

about potential opportunities for urban development if Modification No. 48 comes into effect, the Respondent is permissibly trying to capitalize on the effects of its own actions upon market values. Having denied MTD the opportunity to develop its Project on the ground that no urban development may be allowed, it cannot now take actions encouraging a speculative increase in price and thereby reduce MTD's compensation."<sup>212</sup> The Claimants allege that the "PIX assessment,<sup>213</sup> which values land at US\$ 1.27 million, is a more reliable measure of the impact of the State of Chile's refusal to allow development on the land."<sup>214</sup>

232. The Claimants consider faulty the argument that MTD overpaid for its shares in EPSA based on 1996 land values: "To begin with, MTD did not simply buy land; it bought stock in a joint venture engaged in development of a business. The 1996 Palma Kitzing<sup>215</sup> value analysis was based on the valuation of the assets to be used in such a venture, not bare land values, and assumed that the Project would be built. Ironically, the Respondent itself submitted (for very different purposes) the 1995 URBE Report, which estimated the value of the land for investment purposes in 1995-1996 at more than US\$ 25 million."<sup>216</sup> In any case, "relying on the Sánchez Report's *post hoc* analysis as a basis to assess the value of the land in 1996 would be inconsistent with the practice of other international tribunals, which have rejected appraisals that were not prepared at the time the investor was injured."<sup>217</sup>

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<sup>212</sup> Ibid., para. 163.

<sup>213</sup> Commissioned by the Claimants.

<sup>214</sup> Reply, para. 163.

<sup>215</sup> Palma Kitzing is the firm contracted by Banco Sud Americano.

<sup>216</sup> Ibid., para. 164.

<sup>217</sup> Ibid., para. 166.

233. As regards Claimants' costs, the Claimants consider that the Respondent should bear all the costs associated with them because MTD's large investment losses were caused by the Respondent's improper actions.<sup>218</sup>

234. In its Rejoinder, the Respondent contests the additional claim of US\$ 3.2 million in interest for "delay resulting from Chile's request for an extension to file its Counter-Memorial."<sup>219</sup> The Respondent argues that "the Tribunal decided [...] that by application of Rules 10 and 12 of the Rules of Arbitration, the 'suspension' included all the issues related to the procedure, including time limits and the actions of the Tribunal. For that reason, the sum of US\$ 3.2 million in interest that the Claimants attribute to the State must be rejected, since the procedure was suspended for all the 'issues related to the procedure.'"<sup>220</sup>

235. The Respondent also points out that: (i) the Claimants are entitled to collect damages from their partner, Mr. Fontaine, in the amount offered by him to buy the Claimants' shares of EPSA; and (ii) the Claimants' concerns about the economic difficulties and solvency issues of their partner are of no relevance. The sum offered by Mr. Fontaine must be deducted from the amount claimed, as well as interest from November 24, 2001, the date of Mr. Fontaine's offer.<sup>221</sup>

236. The Respondent clarifies that, in the URBE report, the land was not appraised and this report only calculated the value of the project minus the costs,

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<sup>218</sup> Ibid., para. 169.

<sup>219</sup> Ibid., para. 147.

<sup>220</sup> Ibid.

<sup>221</sup> Ibid., paras. 150-151.



including the cost of land, a fact omitted by MTD. In contrast, Mr. Sánchez appraised the 600 hectares in El Principal and not the current value of the project, therefore, a comparison between the two is “deceptive and inaccurate.”<sup>222</sup> The Respondent also finds that MTD has not been able to substantiate the fate of the US\$ 8.4 million injected into EPSA.<sup>223</sup>

237. The Tribunal will address the following issues regarding damages that emerge from the parties’ allegations:

- (i) Eligible expenses for purposes of calculating damages;
- (ii) Damages attributable to business risk;
- (iii) Date from which interest should accrue; and
- (iv) Applicable rate of interest.

238. The Tribunal first notes that the BIT provides for the standard of compensation applicable to expropriation, “prompt, adequate and effective” (Article 4(c)). It does not provide what this standard should be in the case of compensation for breaches of the BIT on other grounds. The Claimants have proposed the classic standard enounced by the Permanent Court of Justice in the *Factory at Chorzów*: compensation should “wipe out all the consequences of the illegal act and re-establish the situation which would, in all probability, have existed if that had not been committed.”<sup>224</sup> The Respondent has not objected to the application of this standard and no differentiation has been made about the standard of compensation in relation to the grounds on which it is

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<sup>222</sup> Ibid., paras. 176-177.

<sup>223</sup> Counter-Memorial, para. 173.

<sup>224</sup> Quoted in Reply, para. 127.

justified. Therefore, the Tribunal will apply the standard of compensation proposed by the Claimants to the extent of the damages awarded.

#### **1. Eligible Expenditures**

239. The Tribunal considers that the Claimants have proven that the expenditures related to the Project were made by them or on their behalf and that they were made for purposes of the investment in Chile.

240. The Tribunal considers as eligible for purposes of the calculation of damages the following expenditures:

(i) Expenditures related to the initial investment in the amount of US\$ 17,345,400.00.

(ii) The Tribunal has found that Chile's responsibility is related to the approval of the transfer of funds by the FIC in spite of the policy of the Government not to change the PMRS. Therefore, the Tribunal considers that expenditures for the Project prior to the execution of the first Foreign Exchange Contract on March 18, 1997 are not eligible for purpose of the calculation of damages even if they could be considered part of the investment. For the same reason, expenditures made after November 4, 1998– the date on which Minister Henríquez informed the Claimants in writing that the PMRS would not be changed – are also to be excluded from said calculation. The total of expenditures during this period on account of salaries, travel, legal services and miscellaneous items, as detailed in Exhibit 93A submitted with the Reply, amount to US\$ 235,605.37.

(iii) The Tribunal considers the financial costs related to the investment made to be part of a business decision on how to finance the investment. As stated by the tribunal in *Middle East Cement* and referred to by the parties in their allegations: “They could be claimed, if it were shown that they were caused by conduct of the Respondent which was in breach of the BIT.”<sup>225</sup> Since the Tribunal has found that Chile breached its obligation to treat the Claimants’ investment fairly and equitably and this treatment is related to the decision of the Claimants to invest in Chile, the Tribunal considers that the financial costs related to the investment in the amount of US\$ 3,888,582.95 are part of the eligible expenditures for purposes of the calculation of damages.

241. The aggregate of the above eligible expenditures amounts to US\$ 21,469,588.32. However, the residual value of the investment and the damages that can be attributed to business risk need to be deducted from such amount. The Tribunal will now turn its attention to these matters.

## **2. Damages Attributable to Business Risk. Residual value of the Investment**

242. The Tribunal decided earlier that the Claimants incurred costs that were related to their business judgment irrespective of the breach of fair and equitable treatment under the BIT. As already noted, the Claimants, at the time of their contract with Mr. Fontaine, had made decisions that increased their risks in the transaction and for which they bear responsibility, regardless of the treatment given by Chile to the Claimants. They accepted to pay a price for the land with the Project without appropriate

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<sup>225</sup> *Middle East Cement*, para. 154.

legal protection. A wise investor would not have paid full price up-front for land valued on the assumption of the realization of the Project; he would at least have staged future payments to project progress, including the issuance of the required development permits.

243. The Tribunal considers therefore that the Claimants should bear part of the damages suffered and the Tribunal estimates that share to be 50% after deduction of the residual value of their investment calculated on the basis of the following considerations.

244. Mr. Fontaine has made an offer for MTD's EPSA shares of US\$ 10,069,206. The Claimants are, by the terms of their shareholders' arrangements with Mr. Fontaine and as decided by an arbitral tribunal and confirmed by the Chilean courts, obliged to accept this offer or buy him out. For this reason, the Tribunal considers that the price offered by Mr. Fontaine for the shares of EPSA currently held by the Claimants constitutes the residual value of the investment. Because only part of the offer is in cash, the cash value of the remainder on a present value basis is US\$ 9,726,943.48.<sup>226</sup>

245. The Tribunal notes that the Claimants had not accepted Mr. Fontaine's offer because it is not a full cash offer and are concerned about the uncertain financial situation of Mr. Fontaine. This is of no relevance to this Tribunal, since the risk of having chosen Mr. Fontaine as a partner should be borne by the Claimants. Chile had no participation in his selection nor has it been claimed that the financial difficulties of Mr. Fontaine can be attributed to Chile. The Claimants themselves have manifested that they

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<sup>226</sup> For purposes of this calculation, the Tribunal has used the US dollar two-year swap rate of May 6, 2004 for a two-year swap effective May 21, 2004 published by *Bloomberg*. The two-year swap rate represents an interest rate at which semiannual cash flows may be discounted until the maturity of the swap. There are no LIBOR rates for period of more than one year.

knew all along about his financial difficulties. This is a business risk that the investors shall bear.

246. To conclude, the Claimants should bear the risk inherent in Mr. Fontaine's offer and 50% of the damages after deducting the present value of such offer from the total amount calculated in Section 1 above.

### **3. Date from which pre-award interest should accrue**

247. The Tribunal considers that interest on the amount of damages for which Chile is responsible should accrue from November 5, 1998, the day after Minister Henríquez notified the Claimants that it was against his Government's policy to modify the PMRS.

248. The Claimants in their Reply increased the amount of their claim with the interest accrued during the extension granted by the Tribunal to the Respondent to file the Counter-Memorial. Chile has argued that the additional interest should not be awarded since the suspension was for all the "issues related to the procedure."<sup>227</sup> The Tribunal has awarded interest from November 5, 1998 for the reasons stated above and considers that the extension of the term for the submission of the Counter-Memorial does not have a bearing on this matter.

### **4. Applicable Rate of Interest**

249. The Claimants have requested that the Tribunal apply a compound annual interest rate of 8%. The Respondent has proposed the dollar-based annual rate of interest

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<sup>227</sup> Counter-Memorial, para. 147.

applicable in Chile or the average annual LIBOR. The Respondent has objected to a compound interest rate as not being in accordance with international law.

250. This being an international tribunal assessing damages under a bilateral investment treaty in an internationally traded currency related to an international transaction, it would seem in keeping with the nature of the dispute that the applicable rate of interest be the annual LIBOR on November 5 of each year since November 5, 1998 until payment of the awarded amount of damages. Based on the rates published daily by Bloomberg, the annual LIBOR on November 5 of each year since November 5, 1998 are as follows: (i) 5.03813 % in 1998, (ii) 6.16 % in 1999, (iii) 6.71625 % in 2000, (iv) 2.24625 % in 2001, (v) 1.62 % in 2002, and (vi) 1.4925 % in 2003.

251. The Tribunal considers that compound interest is more in accordance with the reality of financial transactions and a closer approximation to the actual value lost by an investor. As expressed by the tribunal in *Santa Elena*: “Where an owner of property has at some earlier time lost the value of his asset but has not received the monetary equivalent that then became due to him, the amount of compensation should reflect, at least in part, the additional sum that his money would have earned, had it, and the income generated by it, been reinvested each year at generally prevailing rates of interest.”<sup>228</sup>

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<sup>228</sup> *Compañía de Desarrollo de Santa Elena, S.A. v. Republic of Costa Rica*, ICSID Case No. ARB/96/1, Final Award, 17 February 2000, para. 104.

## **VI. COSTS**

252. Taking into account that neither party has succeeded fully in its allegations, the Tribunal decides that each party shall bear its own expenses and fees related to this proceeding and 50 % of the costs of ICSID and the Tribunal.

## **VII. DECISION**

253. For the reasons above stated the Tribunal unanimously decides that:

1. The Respondent has breached its obligations under Article 3(1) of the BIT.

2. The Claimants failed to protect themselves from business risks inherent to their investment in Chile.

3. The Respondent shall pay the Claimants the amount of US\$ 5,871,322.42.

4. The Respondent shall pay compound interest on such amount from November 5, 1998 and determined as set forth in paragraphs 249- 251 above until such amount has been paid in full.

5. The parties shall bear all their respective expenses and fees related to this proceeding.

6. The parties shall share equally the fees and expenses incurred by ICSID and the Tribunal.

7. All other claims filed in this arbitration shall be considered dismissed.

Done in Washington, D.C., in English and Spanish, both versions being equally authoritative.

*signed*

Andrés Rigo Sureda  
President of the Tribunal  
Date: May 21, 2004

*Signed*  
Marc Lalonde  
Arbitrator  
Date: May 13, 2004

*Signed*  
Rodrigo Oreámuno Blanco  
Arbitrator  
Date: May 21, 2004



THE MATTER OF AN  
ARBITRATION UNDER THE  
UNCITRAL ARBITRATION RULES 1976

INVESMART, B.V.

CLAIMANT

v

CZECH REPUBLIC

RESPONDENT

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**AWARD**

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**TRIBUNAL**

Dr Michael Pryles

Mr Christopher Thomas Q.C.

Professor Piero Bernardini

Secretary of the Tribunal

Ms Leah Ratcliff

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## Award of the Tribunal

### The Parties, Representation and Tribunal

1. The Claimant is INVESMART B.V. ("**Invesmart**"), a limited liability company registered with the Amsterdam Chamber of Commerce Company in the Netherlands under the Registration Number 34127007. It was incorporated in August 1999 under the name Robilant International Holding B.V. and was renamed in 2000. Its registered office is situated at:

Via Manzoni 46, 20122  
Milan, Italy

("Claimant")

2. The Respondent is THE CZECH REPUBLIC, represented by Miroslav Kalousek, the Director of the Czech Ministry of Finance ("**MOF**"). Its registered office is situated at:

Leetenská 15  
118 10 Prague 1  
Czech Republic

("Respondent")

3. In this arbitration the Claimant is represented by:

King and Spalding LLP

Mr Reginald R Smith  
1100 Louisiana  
Suite 4000  
Houston, Texas 77002

Mr Kenneth R Fleuriet  
25 Cannon Street  
London EC4M 5SE  
United Kingdom

Mr Craig S. Miles  
1100 Louisiana  
Suite 4000  
Houston, Texas 77002

4. In this arbitration the Respondent was originally represented by:

Linklaters  
Ludek Vrana  
Partner  
Palac Myslbek  
Na Prikope 19  
117 19 Prague 1

5. By facsimile dated 20 November 2007, Linklaters informed the Tribunal that they no longer represented the Respondent and advised the Tribunal that new counsel had been appointed by the Respondent in this arbitration:

Weil, Gotshal & Manges

Ms Karolina Horakova  
Partner  
Krizovnicke nam. 1  
11000 Prague 1

6. The Claimant, by letter dated 12 April 2007, appointed Professor Piero Bernardini as an arbitrator. The Respondent, by letter dated 14 February 2007, appointed Mr Christopher Thomas Q.C. as an arbitrator. Pursuant to Article 7(1) of the UNCITRAL Arbitration Rules, the two party-appointed arbitrators appointed Dr Michael Pryles as the third and presiding member of the Tribunal on 11 May 2007. All members of the Tribunal signed an Arbitrators Engagement Agreement.
7. On 17 July 2008, the members of the Tribunal, at the consent of the parties, appointed Ms Leah Ratcliff as the Tribunal Secretary.

## **Procedural Background**

8. This arbitration arises from alleged violations of the Agreement on Encouragement and Reciprocal Protections of Investments between The Kingdom of the Netherlands ("Netherlands") and the Czech and Slovak Federal Republic dated 29 April 1991 (the "**BIT**" or the "**Treaty**"). On 8 December 1994, the Czech Republic confirmed to the Netherlands that the Treaty remains in force for the Czech Republic as a successor state to the Czech and Slovak Republic. Article 8 of the BIT provides for the settlement of disputes as follows:

### Article 8

1) All disputes between one Contracting Party and an investor of the other Contracting Party concerning an investment of the latter shall if possible, be settled amicably.

2) Each Contracting Party hereby consents to submit a dispute referred to in paragraph (1) of this Article, to an arbitral tribunal, if the dispute has not been settled amicably within a period of six months from the date either party to the dispute requested amicable settlement.

3) The arbitral tribunal referred to in paragraph (2) of this Article will be constituted for each individual case in the following way: each party to the dispute appoints one member of the tribunal and the two members thus appointed shall select a national of a third State as Chairman of the tribunal. Each party to the dispute shall appoint its member of the tribunal within two months, and the Chairman shall be appointed within three months from the date on which the investor has notified the other Contracting Party of his decision to submit the dispute to the arbitral tribunal.

4) If the appointments have not been made in the above mentioned periods, either party to the dispute may invite the President of the Arbitration Institute of the Chamber of Commerce of Stockholm to make the necessary appointments. If the President is a national of either Contracting Party or if he is otherwise prevented from discharging the said function, the Vice-President shall be invited to make the necessary appointments. If the Vice-President is a national of either Contracting Party or if he too is prevented from discharging the said function, the most senior member of the Arbitration Institute who is not a national of either Contracting Party shall be invited to make the necessary appointments.

5) The arbitration tribunal shall determine its own procedure applying the arbitration rules of the United Nations Commission for International Trade Law (UNCITRAL).

6) The arbitral tribunal shall decide on the basis of the law, taking into account in particular though not exclusively:

- the law in force of the Contracting Party concerned;
- the provisions of this Agreement, and other relevant Agreements between the Contracting Parties;
- the provisions of special agreements relating to the investment;
- the general principles of international law.

7) The tribunal takes its decision by majority of votes; such decision shall be final and binding upon the parties to the dispute.

9. Disputes having arisen between the parties, the Claimant filed a Notice of Arbitration dated 14 February 2007.
10. In its Notice of Arbitration the Claimant stated that attempts to settle the dispute amicably began on 29 July 2003, including a meeting held with the representatives of the Czech Republic in Prague on 24 October 2003, and that there appeared to be little prospect for an amicable settlement of the dispute.
11. Following constitution of the Tribunal a preliminary hearing was convened on 24 August 2007. At the hearing the claimant was represented by Mr Kenneth Fleuriet and Mr Craig Miles of King and Spalding LLP. The Respondents were represented by Ludek Vrana and Dr Rupert Bellinghausen of Linklaters.
12. Following the preliminary hearing the Tribunal made *Procedural Order No 1* dated 30 August 2007 which provided, *inter alia*, that the language of the arbitration is English and, whilst the place of the arbitration is Paris, France, the hearing will be held in London, England.
13. Procedural Order No 1 also set out the following procedural timetable:

<b>STEP IN PROCEEDING</b>	<b>DATE</b>
Claimant's statement of claim together with all documents upon which it relies and witness statements (fact and expert)	10 December 2007
Respondent's statement of defence together with all documents upon which it relies and witness statements (fact and expert) by 10 December 2007	25 March 2008
Parties to request the production of individual or defined categories of documents, in each instance explaining the relevance and materiality of the request	4 April 2008
Parties to produce the requested documents or provide reasons for non-production	By 18 April 2008
Parties may seek an order for production of a document or documents not produced by the other parties	On or before 23 April 2008
Tribunal to endeavour to decide applications for the production of documents	2 May 2008
Claimant to provide a Statement of Reply together with additional documents relied upon and responsive witness statements	15 July 2008
Respondent to provide a Statement of Rejoinder together with any additional documents relied upon and responsive witness statements	3 October 2008
Case Management Conference	9 October 2008
Hearing	10–19 November 2008

14. The parties, having each been granted brief extensions of time, provided the following submissions:

Statement of Claim dated 12 December 2007

Statement of Defence dated 27 March 2008

Reply Memorial dated 18 July 2008

Statement of Rejoinder dated 6 October 2008

15. The Claimant provided statements from the following lay witnesses:

Mr Paul de Sury

Mr Radovan Vávra

16. The Statement of Claim was also accompanied by the following expert reports:

Professor Hyun Song Shin



Associate Professor Raj Desai

PricewaterhouseCoopers

17. The Claimant's Reply Memorial was accompanied by Second Witness Statements from each of the Claimant's fact witnesses and supplementary expert reports from each expert.

18. The Respondent provided witness statements from the following:

Mr Pavel Racoča

Mr Pavel Řežábek

Mr Bohuslav Sobotka

Mr Zdeněk Tůma

19. The Respondent provided expert reports from the following:

Dr Milan Hulmák

Dr Petr Kotáb

Professor Claus-Dieter Ehlermann

Professor Anthony Saunders

Mr Pavel Závitkovský (KPMG)

Mr Jean Luc Guitera (KPMG)

20. The Respondent's Reply Memorial was accompanied by Second Witness Statements from each of the Respondent's witnesses of fact and Second Expert Reports from Professor Saunders, Professor Ehlermann and KPMG (prepared by Mr Pavel Závitkovský).

#### **Discovery/document production**

21. On 4 April 2008, both parties requested that the other produce certain categories of documents pursuant to section 6(a) of Procedural Order No 1 dated 30 August 2007.

22. Both parties responded to these requests on 18 April 2008, largely without objection. The Claimant, whilst stating that the "categories of documents requested by the Czech Republic appear overly broad, and the relevance of a number of the categories is neither apparent nor adequately explained", confirmed by letter dated 23 April 2004 that it had produced all of the documents in its possession that were covered by the categories identified by the Respondent. Similarly, by letter dated 18 April 2004 the Respondent produced all documents in its possession that were responsive to the categories, except for documents held by the Czech Office of the Protection of Competition or UOHS to use the Czech acronym ("OPC"), which were subject to formal administrative procedures to facilitate their release. These documents were provided to the Claimant on 16 June 2008.

### **Security for Costs**

23. On 27 March 2008, the Respondent submitted an Application to the Tribunal seeking orders that the Claimant provide security for the Respondent's costs likely to be incurred in this arbitration.
24. On 21 May 2008, the Claimant submitted a Response to this Tribunal objecting to this application.
25. On 3 July 2008, the Tribunal made an Order that it did not have authority to make the order sought in the Respondent's application of 27 March 2008.

### **Procedural steps as requested by the Chairman to the Tribunal**

26. On 3 July 2008, the Chairman of the Tribunal wrote to the Respondent requesting that they provide a table of abbreviations covering all abbreviations used in the Statement of Defence. The Chairman also asked the parties to provide the Tribunal with a list of persons referred to in their respective submissions.
27. On 4 July 2008, the Chairman of the Tribunal requested that the parties provide to the Tribunal, prior to the hearing:
  - (a) an agreed statement of facts;
  - (b) an agreed chronology; and
  - (c) a list of issues to be determined by the Tribunal.
28. On 10 July 2008, the Respondent provided to the Tribunal a list of persons referred to in the Statement of Defence. The Respondent also suggested that the Parties be required to provide the other documents requested by the Tribunal at a date following the second round of Parties' Submissions. The Claimant concurred.
29. By email dated 10 July 2008, the Chairman of the Tribunal deferred consideration of this issue.
30. On 19 September 2008, the Chairman of the Tribunal wrote to the parties requesting that the agreed statement of facts be provided to the Tribunal by 10 October 2008.
31. The Parties were not able to agree upon a statement of facts prior to the Case Management Conference. The provision of this document to the Tribunal was deferred until after the Case Management Conference.

### **Case Management Conference**

32. By the agreement of the parties, the Tribunal postponed the Case Management Conference until 20 October 2008.
33. At this conference, the Tribunal considered a series of procedural matters as listed in the provisional agenda circulated by the Secretary prior to the Conference.
34. Specifically, the matters considered at the conference were the procedure to be followed at the hearing including, *inter alia*, opening statements, order of witnesses, examination of witnesses, sitting times, equal allocation of hearing time between the parties, restrictions on new evidence, interpreters, transcription, document bundles and restrictions on witness attendance.
35. In respect of the agreed statement of facts the Tribunal decided, by agreement of the parties, that negotiations on an agreed statement of facts would resume and that, where the parties' opinions diverged, their separate assessments of a particular fact were to be set out in the Statement.
36. On 24 October 2008, the parties provided to the Tribunal an agreed statement of facts and detailed hearing schedule.

### **Claimant's extraordinary submission dated 4 November 2008**

37. On 4 November 2008, the Claimant made an extraordinary submission to the Tribunal in relation to allegations made by the Respondent in its Statement of Rejoinder that  
Principal of Invesmart B.V. submitted to the Czech National Bank ("CNB") "false minutes" of a meeting of Invesmart's shareholders on 16 October 2002.
38. On 5 November 2008, the Respondent submitted a short statement to the Tribunal in reaction to the Claimant's submission.
39. Consideration of the matters raised by the Claimant were deferred until the hearing.

### **The hearing**

40. A hearing took place at the International Dispute Resolution Centre in Fleet Street, London. It commenced on 10 November 2008 and concluded on 18 November 2008. Verbatim transcripts were produced and made available concurrently with the aid of LiveNote computer software.
41. At the hearing the following persons appeared as legal counsel for the Claimant:

Mr Reginald Smith (King & Spalding)

Mr Ken Fleuriet (King & Spalding)

Mr Tom Childs (King & Spalding)

Mr Craig Miles (King & Spalding)

42. , Principal of Invesmart B.V. also attended the hearing as a representative of the Claimant.

43. The following persons appeared as legal counsel for the Respondent:

Ms Karolina Horakova (Weil, Gotshal & Manges)

Ms Barbora Balaptikova (Weil, Gotshal & Manges)

Professor James Crawford

Mr Zachary Douglas

44. Mr Radek Snabl, Ms Marketa Skypalova and Mr Vaclav Rombald attended the hearing as representatives of the Czech Ministry of Finance.

45. Both sides made an oral presentation at the opening of the hearing. At the close of the hearing, the Tribunal decided, by the agreement of the parties, that neither side would make post hearing submissions, except for those relating exclusively to costs.

46. At the hearing all of the above listed witnesses gave evidence and were cross-examined by opposing counsel, with the exception of Mr Milan Hulmák and Dr Kotáb. The Claimant waived its right to cross-examine these witnesses and as a consequence they did not appear at the hearing.

## **Factual Background**

47. In 1990, as a primary step in Czechoslovakia's transition from a communist to a market economy, the Czechoslovakian banking system was reformed. The "monobank" system, in which the central bank was responsible for both monetary policy and commercial banking, was disestablished and privately owned commercial banks commenced operation in Czechoslovakia. Union Banka, which commenced operations in 1991, was one of a number of small banks that were established at this time.

48. The Czech banking system was plagued by instability and severe liquidity issues throughout the 1990s and a number of banks collapsed. In an attempt to address these crises the Czech government initiated three state aid programs, including two Consolidation Programs between 1991 and 1994, and between 1994 and 1995 and a Stabilisation Program between 1995 and 1998.

49. Under the First Consolidation Program the Czech government (and its successors, the Czech Republic and the Slovak Republic) strengthened the balance sheets of the four largest banks (Komerčno banka, Česká sporitelna, Investicni a Postovno banka (IPB), and Ceskolovenska obchodni banka).
50. On 1 January 1993, Czechoslovakia peacefully dissolved into its constituent states: the Czech Republic and the Slovak Republic. The Second Consolidation Program was thus implemented by the newly formed government of the Czech Republic. It was similarly structured to the First Consolidation Program and directed state aid to mid tier and small Czech Banks. A number of insolvent small banks were acquired by other banks with the assistance of the CNB as part of the program.
51. Under the Stabilisation Program state aid was provided to failing banks through Česká Finanční, s.r.o ("CF"), a wholly owned Czech Government entity. Under the stabilisation program the CF purchased participant banks' poor quality (non-performing) assets at nominal value, – a maximum of 110 per cent of the bank's registered capital. In return the bank would, after seven years, repurchase at nominal value any assets that remained uncollected. This arrangement had the effect of offering participant banks a seven year interest free loan. Further, the banks had an obligation to accept and subsequently observe the terms and conditions of a stabilisation plan.
52. The banks were obliged to allocate the funds received from the CF preferentially to well-performing assets having higher liquidity and bearing fewer risks. The implementation of a cautious investment policy should have improved the banks' liquidity and enabled them, in the course of a seven year period, to create sufficient resources to re-transfer the non-performing assets from the CF. A total of six small Czech banks participated in the Stabilisation Programme.

### **The expansion of Union Banka**

53. Against this back-drop, Union Banka expanded its operations within the Czech Republic. In 1995 it underwent internal restructure through the establishment, by Union Banka's shareholders, of Union Group. This became the holding company of Union Banka.
54. Between 1996 and 1998, Union Banka acquired four distressed banks, Ekoagrobanka, Evrobanka, BDS and Foresbank. The acquisitions of Ekoagrobanka, Evrobanka and BDS took place under the aegis of the Second Consolidation Program. These acquisitions were made pursuant to agreements with the CNB whereby the CNB agreed to compensate Union Banka for the difference between the assets recorded on the banks' accounts and the value of those assets as determined by independent audits. The purpose of this agreement was to mitigate the

losses Union Banka would have otherwise borne as a consequence of absorbing the non-performing loan books of other banks.

55. In 1998, a dispute arose between Union Banka and the CNB about the terms of their agreement in relation to Union Banka's acquisition of BDS. This matter was settled in December 1999 pursuant to the "**BDS Settlement Agreement**". The CNB had agreed to compensate Union Banka for 85 percent of the difference between the book value of BDS' balance sheet liabilities and the value of its assets and goodwill, to be established by an independent audit. Compensation was paid but Union Banka subsequently claimed a further amount. When the CNB refused, the bank commenced and succeeded in an arbitral claim. The CNB complied with the arbitral award but in doing so required Union Banka to sign a settlement agreement recording their agreement that the settlement was final and binding.<sup>1</sup>
56. In September 2002, while the principal events at issue in this arbitration were occurring, Union Banka initiated further arbitral proceedings against the CNB in relation to the terms of the BDS Settlement Agreement. Union Banka valued this claim at CZK 1.762 billion. This was recorded in its books on 23 September 2002 (the "**CNB Receivable**") as is discussed further below at paragraph 110. The CNB won that arbitration in April 2003.
57. Meanwhile, in late 1997, Union Banka entered into an agreement with CF, the state consolidation agency, to acquire Foresbank as part of the broader Stabilisation Program. However, in 1998 Foresbank was taken out of the Stabilisation Program and an alternative set of agreements were concluded between Union Banka and CF.
58. Pursuant to these agreements, Foresbank repurchased its assets from the CF at the nominal value of the uncollected assets, discounted from the original 2004 payment at 11.5 percent per annum (a rate derived from the then prevailing market interest rate). The discounting of the purchase price allowed Union Banka to retain the economic value of the interest free loan. In addition it was agreed that (1) CF would deposit the proceeds from the sale of the loans back to Union Banka, (2) the deposit (known as the "**Fores Deposit**") would mature on the original 2004 payment date and bear the same 11.5 percent per annum interest rate, and (3) the deposit would be fully secured by Government Bonds. Under the terms of these agreements the Fores Deposit, plus interest, would be worth CZL 1.591 billion to CF at maturity in December 2004.
59. By 2002, market interest rates had fallen to below 4 percent in the Czech Republic and Union Banka was incurring significant losses on the Fores Deposit.

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<sup>1</sup> Exhibit R-4, Cooperation Agreement regarding takeover of Bankovní dům SKALA a.s., dated 19 March 1996; Exhibit R-5, arbitration award of the Arbitration Court attached to the Economical Chamber of the Czech Republic and the Agrarian Chamber of the Czech Republic, Ref. No. 55/98, dated 1 April 1999; Exhibit R-6, Settlement Agreement entered into by the CNB and Union Banka on 27 December 1999 ("**BDS Settlement Agreement**").

## **Union Banka's accumulation of related party loans**

60. Throughout this same period Union Banka entered into a number of related party loans ("RPLs") with its shareholders or related parties for the purpose of purchasing shares in Union Banka. The majority of these loans were under-secured and non-performing.
61. In its 1998 Audit Report, Union Banka valued the RPLs at approximately CZK 4.5 billion.<sup>2</sup> The CNB took remedial action against Union Banka. However, Union Banka's practice of granting RPLs continued. By June 2000, the CNB quantified the RPLs at CZK 5.461 billion.<sup>3</sup>
62. In January 2001, the CNB took further remedial action against Union Banka and requested that it confine its investment of the proceeds received from repayment of the RPLs or from the sale of Union Group's shareholdings in other companies to assets with zero-risk weighting.<sup>4</sup> On 31 May 2001, Union Banka was fined CZK 2.5 million by the CNB for providing new RPLs to finance the purchase of Union Group shares.<sup>5</sup>
63. As a result of problems inherited from the acquired problem banks compounded with the RPLs, Union Banka became a problem bank itself. It sought to address these issues through state aid.

## **State aid discussions between Union Banka and CF in 2001**

64. During 2001, Union Banka put forward three separate proposals for state aid. Each involved the assistance of CF in cleansing Union Banka's balance sheets.
65. First, in February 2001, Union Banka proposed that CF buy 100 percent of the shares of Foresbank for its liquidation value thereby terminating the Foresbank Deposit early.<sup>6</sup>
66. Secondly, in October 2001, Union Banka proposed that Foresbank would purchase certain of the assets of Union Banka, including a number that Union Banka acquired through the takeovers of Ekoagrobanka, Evrobanka and Foresbank. CF would then acquire the Foresbank for a purchase price of CZK 1.2 billion.<sup>7</sup>

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<sup>2</sup> Exhibit R-19, 1998 Audit Report of Union Banka prepared by Deloitte & Touche, dated 19 May 1999.

<sup>3</sup> Exhibit R-20, Report from bank inspection performed from 11 September to 13 October 2000 by CNB in framework or exercise of bank supervision, dated 22 December 2000, p. 15.

<sup>4</sup> Exhibit R-21, measure of the CNB against Union Banka, a.s., dated 3 January 2001.

<sup>5</sup> Exhibit R-25, decision of the CNB, dated 31 May 2001.

<sup>6</sup> Exhibit R-33, letter dated 2 February 2001 from Union Banka to CF.

<sup>7</sup> Exhibit C-35, Union Group Proposal for solving relations between Fores, Union Banka and Česká Finanční, dated 24 October 2003.

67. Thirdly, in December 2001, Union Banka proposed the transaction which is referred to as the **CF Transaction** whereby CF would relinquish its deposit arising from Union Banka's acquisition of Foresbank in exchange for a portfolio of under-performing loans.<sup>8</sup> This was effectively a debt for cash swap which was premised on the Government having greater leverage to recover under these loans than Union Banka. The Government could also seek to acquire equity in the debtor companies (which were mostly state owned entities) in service of the loans.

68. In these proceedings the CF Transaction was also referred to as the Foresbank Settlement.

### **Invesmart retained by Union Banka**

69. In late 2001, Union Banka opted for a strategy whereby it would implement a restructuring plan. The primary aim of the plan was to clean up Union Banka's balance sheet, bring its internal governance in line with western banking standards and improve its profitability. In particular, the management of Union Banka aimed to redevelop both its corporate and retail banking enterprises by attracting additional customers and offering a broader range of services including insurance and leasing services.<sup>9</sup>

70. In order to achieve this, Union Banka, with the support of the Czech Government, sought to find an investor that would acquire Union Banka and assist with its restructuring.

71. Invesmart was hired as a consultant to Union Banka on 8 November 2001 to assist with this process. Under the terms of the consultancy agreement between Union Banka and Invesmart, Invesmart was to:

- (i) assist Union Banka in restructuring its debts;
- (ii) conduct due diligence of the bank and its loan portfolio; and
- (iii) prepare the bank for sale to a strategic investor.

72. Invesmart simultaneously entered into a share sale and purchase agreement ("**SPA**") with certain shareholders of Union Group, effectively acquiring an option to buy their 70 percent shareholding.<sup>10</sup> The Claimant made submissions that the purpose of this agreement was to ensure that initiatives proposed by Invesmart could not be frustrated by shareholders of Union Group or Union Banka.

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<sup>8</sup> See Exhibit R-34, minutes of a meeting between the CNB, Union Banka and Union Group held on 5 December 2001, dated 11 December 2001.

<sup>9</sup> First Witness Statement of Radovan Vávra, paragraph 10.

<sup>10</sup> Exhibit C-38, Share Sale and Purchase Agreement between Certain Shareholders of Union Group a.s. and Invesmart B.V. as purchaser, dated 6 November 2001.



73. Shortly after being appointed as Invesmart's CEO, [redacted] met with Union Bank's President, Ms Marie Parmová. At that meeting Ms Parmová informed [redacted] that the Government and Union Banka were:

in the final stages of negotiating a deal with Česká finanční (the Foresbank Settlement) that would address the problem of the underperforming loans that Union Banka has unherited under the Czech Government's Consolidation and Stabilization Programs and which would also rectify the issue of the excess interest that Union Banka was having to pay on the Česká finanční deposit.<sup>11</sup>

74. In December 2001, Invesmart commenced due diligence to determine the value of the bank. Invesmart hired Ernst & Young to undertake due diligence of Union Banka's loan portfolio. Deloitte & Touche, Union Banka's external auditor, was retained to conduct additional reviews of the bank's accounts, including an audit of Union Banka's books ("2001 Audit").

75. By February 2002, Invesmart was aware as a result of this due diligence that Union Banka had neither properly characterised its RPLs as unsecured nor made adequate provision for the unsecured credit it had extended. Ernst & Young also established that a number of commercial loans made by Union Banka required higher provision than Union Banka had recorded in its accounts.<sup>12</sup>

#### **Invesmart's decision to acquire Union Banka**

76. Notwithstanding these disclosures, in March 2002 Invesmart decided to acquire Union Banka in its own right. It planned to restructure the bank itself and then sell it to a strategic investor in the short to medium term.<sup>13</sup>

77. It was from this time onwards that the events that form the basis of Invesmart's complaints in this arbitration transpired. These events include a complex array of communications between Invesmart, Union Banka and various organs of the Czech Government regarding the provision of state aid to Union Banka, as well as regulatory and private contractual steps that were taken by Invesmart to acquire a controlling interest in Union Banka. In order to assess Invesmart's claim it is necessary to consider the various "strands" of events that ultimately led to the revocation of Union Banka's license.

78. These are:

- (a) Invesmart's contractual arrangements with Union Banka and Union Group to acquire a controlling interest in both entities;

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<sup>11</sup> First Witness Statement of [redacted], para 17.

<sup>12</sup> Exhibit C-40, Ernst & Young Phase II Report on the Proposed Acquisition of Union Group Holding, a.s., dated 12 February 2002.

- (b) Invesmart's applications to the CNB for regulatory approval to acquire a controlling interest in Union Banka;
- (c) Union Banka's growing financial problems throughout 2002; and
- (d) MOF's consideration of Invesmart's request to provide state aid to Union Banka.

The material facts are considered in turn below.

### **Invesmart's contractual arrangements to acquire Union Banka**

79. Invesmart contracted to acquire an indirect interest in the bank through two SPAs ("SPA A" and "SPA B").<sup>14</sup> These were concluded with different groups of shareholders of Union Group on 9 and 10 May 2002. The transactions contemplated by both SPA A and SPA B were structured with the specific purpose of cleansing the balance sheet of Union Banka and addressing the RPL problem.
80. What was known as "SPA A" was an agreement with the selling shareholders to, in the future, purchase 36.24 percent of the shares in Union Group.<sup>15</sup> Invesmart was to pay two of the shareholders CZK 600 million for their shares. Both of these shareholders were debtors of Union Banka and Invesmart was to pay this part of the purchase price to Union Banka and the remainder (approximately CZK 1 billion) to a third selling shareholder. This agreement was unconditional. Invesmart was to place the purchase price in escrow by 17 June 2002 and to unconditionally close the transaction on 24 June 2002, subject to the payment by Invesmart of a contractual penalty of CZK 60,000,000 in case of failure to close by such date.
81. Under "SPA B" Invesmart agreed with the selling shareholders to, in the future, acquire 33.82 percent of the shares of Union Group.<sup>16</sup> Four of the shareholders selling shares under SPA B were also debtors of Union Banka. Their share of the purchase price (approximately CZK 660 million) was to be used to repay the RPLs owed to Union Banka. The remainder (i.e., approximately CZK 500 million) was to be released to the selling shareholders. Under the terms of SPA B, Invesmart was to post a letter of credit under which it would pay the selling shareholders by 17 June 2002. The payment itself was to take place by 9 December 2002.

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<sup>13</sup> Statement of Claim, para 72.

<sup>14</sup> Exhibit C-47, Share Sale and Purchase Agreement "A" between Certain Shareholders of Union Group, a.s. as Sellers and Invesmart B.V. as Purchaser, dated 10 May 2002; Exhibit C-46, Share Sale & Purchase Agreement "B" between Certain Shareholders of Union Group, a.s. as Sellers and Invesmart B.V. as Purchaser, dated 9 May 2002.

<sup>15</sup> Exhibit C-47, Share Sale and Purchase Agreement "A" between Certain Shareholders of Union Group, a.s. as Sellers and Invesmart B.V. as Purchaser.

<sup>16</sup> Exhibit C-46, Share Sale and Purchase Agreement "B" between Certain Shareholders of Union Group, a.s. as Sellers and Invesmart B.V. as Purchaser.

Simultaneously with the posting of the letter of credit, the selling shareholders would move the shares into escrow.

82. Completion of the transaction was conditional on the provision of state aid by 2 December 2002.<sup>17</sup> Relevantly, the agreement contained the following provision:

If by December 2, 2002, Purchaser fails to receive:

a) the approval statement of Government of the Czech Republic to the proposal of the Ministry of Finances of the Czech republic of settlement of the relationship between Česká Finanční, s.r.o and Union Banka, a.s. concerning the programme of stability reinforcement and consolidation of Foresbank, a.s. (now Fores a.s.) then this Contract shall expire on the date of December 3, 2002.

b) the approval statement of the Czech National Bank to indirect acquisition of Union Banka, a.s. ...then this Contract shall expire on the date of December 3, 2002.

83. Together SPA A and SPA B constituted an agreement to acquire 70 percent of Union Group for CZK 2.833 billion.

84. In the following months SPA A and SPA B were amended.

85. In particular, on 27 May 2002 the SPAs were amended such that a cash payment, instead of the letter of credit, was to be deposited in escrow under SPA B on 17 June 2002 and the closing date under SPA A was postponed to 30 September 2002.

86. On 14 August 2002, Invesmart and Union Group's selling shareholders entered into Addendum No 4 to the SPAs. Instead of making payment to the shareholders in exchange for their shares, Invesmart would assume the shareholders' debts under the RPLs "as soon as the CNB gives the approval with the taking over of debts by [Invesmart]". The Addendum was to become effective upon approval by the shareholders of Invesmart. Thus, SPA A had also become conditional.<sup>18</sup>

87. On 14 October 2002, Invesmart and the selling shareholders entered into Addendum No 5 to the SPAs. Invesmart was to assume the debts of the selling shareholders to Union Banka without undue delay. Addendum No 5 was to become effective upon (1) the CNB's approval of Invesmart's acquisition of control over Union Banka and assumption for selling shareholders' debts and (2) approval of Invesmart's shareholders.<sup>19</sup>

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<sup>17</sup> *Id.*, Clause 3.3.

<sup>18</sup> Exhibit R-50, Addendum No 4 to the Share Sale and Purchase Agreements "A" and "B" dated 14 August 2002.

<sup>19</sup> Exhibit R-75, Addendum No. 5 to the Share Sale and Purchase Agreements "A" and "B", dated 14 October 2002.

## **Invesmart's applications to the CNB for regulatory approval to acquire Union Banka**

88. On 4 April 2002, Invesmart submitted to the CNB the first of three formal applications to acquire a controlling interest in Union Banka.
89. Much is made in the Claimant's submissions about the CNB's ultimate decision to approve Invesmart's acquisition of Union Banka on 24 October 2002. For this reason, it is worthwhile setting out the surrounding facts to enable the CNB's decision to be viewed in context.
90. Pursuant to Czech Law No 215/89 Col. on Banks, Invesmart was required to obtain the CNB's approval before it could acquire a controlling interest in Union Banka.
91. In 2002, Invesmart made three separate applications to the CNB to acquire Union Banka.
92. The first two applications, dated 4 April 2002 and 4 June 2002 respectively, were both rejected by the CNB on the grounds that Invesmart had failed to furnish essential information relating to the source of the funds with which it proposed to acquire Union Banka. This was a significant omission because under Section 9(3)(c) of Decree of CNB No. 166/2002 Coll., dated 8 April 2002, an applicant seeking to acquire an interest in a Czech Bank was required to submit:
- documents on the origin of the applicant's funds from which the purchase of shares of the bank or purchase of a share in an entity through which is acquired indirect share in the bank...is to be covered.<sup>20</sup>
93. The CNB's decisions to reject Invesmart's first two applications were both subject to 15 day appeal periods. These expired on 3 July 2002 and 22 October 2002 respectively. Despite frequent requests by the CNB, Invesmart was unable to provide evidence of the provenance of its funds. Instead, it sought to secure further government support and alternative forms of finance to strengthen Union Banka's ailing balance sheets and complete the acquisition.
94. The following exchange of correspondence in relation to Invesmart's second application is illustrative of this conduct:
- (a) On 2 September 2002, CNB wrote to Invesmart requesting further information regarding the source of Invesmart's funding for the acquisition of Union Banka.<sup>21</sup>
- (b) On 12 September 2002, Invesmart met with the CNB. At this meeting the CNB warned that if Invesmart could not adduce evidence regarding the provenance of

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<sup>20</sup> Exhibit R-307, Decree of CNB No. 166/2002 Coll., dated 8 April 2002.

<sup>21</sup> Exhibit R-56, letter dated 2 September 2002 from CNB to Dr Gert Rienmüller

its funds its application would be rejected.<sup>22</sup> The minutes of this meeting show that Invesmart informed the CNB that its investors would not commit funds for the transaction until a final decision regarding state aid was taken.

- (c) On this same day Union Banka wrote to CNB proposing that it would fund Invesmart's acquisition of itself by replacing its existing RPLs with a new RPL to Invesmart.<sup>23</sup> This structure was rejected by CNB.<sup>24</sup>
- (d) On 16 September 2002, Invesmart wrote to the CNB requesting additional forms of support from the Czech Government. Specifically, Invesmart requested that the Czech Government "define" the financial commitment it would make to support Union Group's Polish banking subsidiary, Bank Przemyslowy.<sup>25</sup> It also requested a guarantee from the CNB not to withdraw Union Banka's banking licence unless there is a deterioration "of the Bank's financials" related to the activity of the new management. By this letter Invesmart also informed the CNB that:

The Union Group acquisition will therefore be entirely covered by Invesmart with its own asset [sic]. A Board Meeting and a Shareholder Meeting have been called to increase the capital of the company of additional 90 million euro.

- (e) In response to Invesmart's 16 September 2002 letter the CNB informed Invesmart that:

...any [state assistance] is primarily a matter for the Ministry of Finance, requires approval of the Czech Government and must have the support of the Office for Protection of Economic Competition.

95. On 4 October 2002, the CNB denied Invesmart's second application to acquire a controlling interest in Union Banka on the basis that it had not received sufficient information about the source of the funds that Invesmart would use to finance the acquisition. On the advice of Governor Tůma, Invesmart did not appeal this decision. Rather, it waited until the expiration on 21 October 2004 of the 15 day appeal period for appeal of the decision dated 4 October 2002 to submit a new application.<sup>26</sup>

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<sup>22</sup> Exhibit R-61, minutes of meeting held on 12 September 2002.

<sup>23</sup> Exhibit R-64, letter dated 12 September 2002 from Union Banka to the CNB.

<sup>24</sup> Exhibit R-65, letter dated 20 September 2002 from CNB to the Directors of Union Banka.

<sup>25</sup> Exhibit R-66, letter dated 16 September 2002 from Invesmart to the CNB.

<sup>26</sup> Statement of Claim, para 94.

96. On 22 October 2002, Invesmart submitted its third application for approval by CNB for it to acquire a controlling interest in Union Banka.<sup>27</sup> The application included Minutes of an Extraordinary General Meeting of Shareholders that was convened by Invesmart on 16 October 2002.<sup>28</sup> The application stipulated that the meeting was duly held and a resolution was validly approved for a capital increase of "EUR 90 million by way of share premium upon sole request of the Board of Managing Directors of the Company". . . . further signed and contemporaneously submitted to the CNB a declaration by Invesmart that:

The acquisition of 70% of Union Group, a.s. of the value of approximately EUR 90 million will be entirely funded by Invesmart B.V. with its own capital which has been increased by the Shareholders Meeting of the Company on October 16, 2002 and it will be entirely subscribed by shareholders.<sup>29</sup>

97. This was the only information submitted by Invesmart to the CNB as evidence of the provenance of the funds that it would use to acquire a controlling interest in Union Banka.

98. The expiration of the appeal period and the consequential failure of Invesmart's second application received significant public attention in the Czech Republic on 22 October 2002.

99. On that day *Mlada fronta Dnes*, one of the Czech national daily newspapers, reported that Invesmart had confirmed that it did not appeal against the negative decision of the CNB.<sup>30</sup>

. . . was quoted as saying: "It is very complicated. It cannot be definitively said that we do not continue in our negotiations. We are in contact with the CNB".

100. The CNB also publicly commented on the situation at Union Banka. In the afternoon on 22 October 2002 a spokesperson for the CNB, Ms Alice Frišaufová, made the following comment to the Czech media:

In this administrative proceeding the CNB did not grant its approval to Invesmart for the acquisition of qualified interest in Union Banka because the investor failed to provide the source of funding for the acquisition. As far as this proceeding is concerned, the decision is final. This does not, however, preclude Invesmart from filing a new application and commencing new administrative proceedings on granting the approval with the transfer of the shares.<sup>31</sup>

101. The parties agree that depositors of Union Banka commenced a run on Union Banka on 23 October which caused Union Banka to lose approximately CZK 1.7 billion in deposits.

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<sup>27</sup> Exhibit C-41. Application by Invesmart for Approval for Acquisition of a Qualifying Holding in a Bank, submitted to CNB 22 October 2002.

<sup>28</sup> See Exhibit R-434, Resolution of Meeting of Shareholders of Invesmart, dated 16 October 2002; Exhibit R-435, minutes of a meeting of shareholders of Invesmart B.V., dated 16 October 2002. Both documents were attached to Invesmart's Third Application to the CNB for approval of its acquisition of Union Banka.

<sup>29</sup> Exhibit R-436, Declaration of Invesmart B.V., signed by . . . , dated 16 October 2002.

<sup>30</sup> Exhibit R-78, article published by *Mlada fronta Dnes* on 22 October 2002.

<sup>31</sup> Transcript, Day 4, p. 191, lines 6-14.

Invesmart attributes this event to the comments made by Ms Frišaufová. The Czech Republic argues that the run was caused by public uncertainty generated as a result of the expiration of the appeal period of Invesmart's second application.

102. It was in these circumstances that on 24 October 2002 the CNB approved Invesmart's application to acquire a controlling interest in Invesmart.<sup>32</sup>

### **Union Banka's growing financial problems throughout 2002**

103. The October 2002 run occurred at the end of a period of declining financial fortunes for Union Banka. In June 2002 it became apparent, as a result of Invesmart's due diligence, that its financial situation remained impaired by RPLs to the value of CZK 2.5 billion.<sup>33</sup>
104. On 6 June 2002, CNB delivered a report to Union Banka indicating that Union Banka had extended new RPLs to certain of its shareholders and that, as a consequence, significant additional funds (between CZK 160 billion and 1.878 billion) needed to be created by the bank.
105. Invesmart responded by requesting replacement of Union Banka's board of directors. The CNB was informed of this request<sup>34</sup> and by letter dated 4 July 2002 informed Union Banka that it too required that it replace all of the members of its Board of Directors.<sup>35</sup>
106. Union Banka's financial situation continued to deteriorate as Deloitte & Touche sought to finalise its Union Banka's 2001 auditor's report. In the end an acceptable auditor's report for the bank was only secured as a result of two transactions that Invesmart entered to support the balance sheet of Union Banka.
107. First, on 13 August 2002, Invesmart entered into the Receivables Assignment Agreement with Union Banka (the "**Receivables Assignment Agreement**") under which Invesmart unconditionally agreed to purchase the portfolio of loans earmarked for assignment to CF for a cash payment of CZK 1.2 billion, if by 1 December 2002 CF did not take assignment of these loans. As security for its promise to pay, Invesmart agreed to post a CZK 300 million bank guarantee on the date of signing the Receivables Assignment Agreement. Invesmart's commitment under the Receivables Assignment Agreement, combined with the bank guarantee, thus 'replaced' provisions on the loan portfolio earmarked for transfer to CF for the

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<sup>32</sup> Exhibit R-38, CNB Decision, dated 24 October 2002.

<sup>33</sup> Exhibit R-28, Section 4 of the Formal Application for purchasing a controlling interest in Union Banka, a.s. filed by Invesmart on 17 June 2002 (Second Application to the CNB).

<sup>34</sup> Exhibit R-424, letter dated 17 June 2002 from Union Banka to the CNB.

<sup>35</sup> Exhibit R-421, letter dated 4 July 2002 from the CNB to Union Banka.

purposes of the audit. In effect, the Receivables Assignment Agreement removed the CF loans from Union Banka's balance sheet.

108. Secondly, on 14 August 2002, and as is discussed at paragraph 86 above, Invesmart and Union Group's selling shareholders entered into Addendum No 4 of the SPAs. Instead of making payment to the shareholders in exchange for their shares, Invesmart would assume the shareholders' debts under the RPLs "as soon as the Czech National Bank gives the approval with the taking over of debts by [Invesmart]". The effect of this agreement, having been entered into simultaneously with the Receivables Assignment Agreement, was to remove the CF Transaction as a condition precedent to the acquisition of Union Group share by Invesmart.
109. The 2001 audit of Union Banka, dated 16 August 2002, was issued in explicit reliance on the Receivables Assignment Agreement and Addendum No 4.<sup>36</sup> Specifically, the report was qualified by a statement that in Deloitte & Touche's opinion Union Banka might not be able to continue as a going concern absent Invesmart's capital entry into the bank.<sup>37</sup> However, Invesmart did not issue the bank guarantee required under the RAA on 13 August 2002 or at any time thereafter.<sup>38</sup> Moreover, when the 1 December 2002 deadline for the contemplated assignment of the loan portfolio to CF passed and Invesmart became liable under the Receivables Assignment Agreement to pay the CZK 1.2 billion it had agreed to pay, it failed to do so.
110. Union Banka's balance sheets were further supported by the entry of the "CNB Receivable" on its books on 23 September 2002. This "receivable" was based on an amount sought by Union Banka from the CNB which, having been rejected by the latter, resulted in an arbitration claim quantified by Union Banka at CZK 1.762 billion against it.<sup>39</sup> (Union Banka ultimately lost the arbitration in April 2003.) On 22 October 2002, the same day that Invesmart submitted its third application to the CNB and the day before the run on Union Banka took place, the CNB requested that Union Banka de-recognise the CNB receivable in its accounts by 25 October 2002.<sup>40</sup> Union Banka never took this action, even though the recording of a contingent asset such as the CNB receivable was contrary to IFRS Standards.<sup>41</sup>

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<sup>36</sup> Exhibit C-31, Audit Report of Union Banka for 2001 issued by Deloitte & Touche on 16 August 2002, p. 1.

<sup>37</sup> *Id.*

<sup>38</sup> The Audit Report noted that Union Banka might not be able to continue as a going concern absent Invesmart's capital entry into the bank: *Id.*

<sup>39</sup> See Exhibit R-70, letter dated 22 October 2002 from the CNB to Union Banka.

<sup>40</sup> *Id.*

<sup>41</sup> See First KPMG Expert Report, pp. 10-11.



111. Union Banka also failed to respond to the CNB's 4 July 2002 request to replace its Board of Directors. Consequently on 27 September 2002 the CNB requested that Union Banka replace all members of the Supervisory Board.
112. Mr de Sury and Mr Piga were subsequently appointed to Union Banka's board on 27 September 2002. On 8 October 2002 Mr Vávra was appointed CEO of Union Banka and commenced further due diligence of the bank's loan portfolio.<sup>42</sup>

### **Negotiations for state aid between Invesmart and Czech Government agencies**

113. The documentary record clearly shows that throughout 2002 the MOF was favourably disposed to consider making a grant of state aid to Union Banka. In particular, on 12 April 2002, based on assessments of Union Banka's 2001 proposals, the MOF prepared a draft proposal to Cabinet for the solution of the relationship between Union Banka and CF. This proposal was based on the proposed CF Transaction.<sup>43</sup> The MOF decided not to submit this proposal to Cabinet. Union Banka was informed of this decision in May 2002.<sup>44</sup>
114. Parliamentary elections took place in the Czech Republic on 14 and 15 June 2002.
115. Notwithstanding the parliamentary elections, [redacted] wrote to Minister of Finance Rusnok on 28 June 2008. In this letter [redacted] reiterated Invesmart's intention to proceed with its investment in Union Banka and asked Minister Rusnok to reconsider if the relationship between Union Banka and CF relating to the Fores Deposit could be resolved.<sup>45</sup>
116. Following the elections, with effect from 15 July 2002 a new Minister of Finance, Mr Bohuslav Sobotka, took office. After the change in leadership in July 2002, the MOF was favourably disposed to considering a grant of state aid to Union Banka. On 25 July 2008 First Deputy Minister of Finance, Eduard Janota, wrote to Invesmart stating that:

[The Government]...appreciates [Invesmart's] activity and I may confirm we are ready to discuss your proposal in detail. Please do not hesitate and sent [sic] to the Ministry of Finance and authorised a detailed project prepared in collaboration with Union Banka. Ministry is going to submit it to the Czech government and expects it will make final decision.<sup>46</sup>

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<sup>42</sup> Exhibit R-245, letter dated 17 October 2002 from the CNB to Union Banka.

<sup>43</sup> Exhibit R-40, Proposal for the settlement of the relationship between Česká Finanční, s.r.o. and Union Banka a.s. prepared by MOF, dated 12 April 2002.

<sup>44</sup> Exhibit R-41, letter dated 20 May 2002 from Invesmart to the CNB.

<sup>45</sup> Exhibit R-32, letter dated 28 June 2003 from Invesmart to MOF.

<sup>46</sup> Exhibit R-48, letter dated 25 July 2002 from Deputy Minister of Finance Janota to Invesmart.

117. In August 2001, Invesmart initiated more regular contact with Czech Government agencies and negotiations with the newly elected Czech Government for the provision of state aid to Union Banka commenced in earnest.
118. Invesmart submitted a three part proposal to the Czech Government on 20 August 2002 (the "20 August Proposal"). The key parts of this proposal were as follows:
- (i) settle Union Bank's obligations under the Fores Deposit immediately by payment of CZK 1,134 million (as opposed to the CZK 1,591 million which Union Banka was obligated to pay on 31 December 2004 under the existing contract);
  - (ii) sell problem loans taken over from the 4 small banks in aggregate nominal value of CZK 1.6 billion (purchase price was not specified); and
  - (iii) invest the amount freed by the early termination of the Fores Deposit (i.e., CZK 1,134 million) into subordinated debt of Union Banka of unspecified maturity and bearing an 8 percent rate of interest, to be modified on an annual basis.<sup>47</sup>
119. This proposal was rejected by the MOF on 24 September 2002 at a meeting between the MOF, CKA and CNB. At that meeting Minister Sobotka informed the officials of the CKA and CNB that the MOF would not accept the 20 August Proposal, but that it would be willing to submit an alternatively structured state aid proposal to the Czech Cabinet. Specifically:
- ...the lowering of prospective interest to market rate was proposed for discussion. The MOF was also willing to discuss a reduction in the principal amount of the Fores Deposit by some CZK 400 million through a transfer of problem assets of that amount.<sup>48</sup>
120. Minister Sobotka also indicated that any grant of state aid would be subject to OPC approval.<sup>49</sup>
121. Invesmart was informed of the outcome of the 24 September meeting by letter from the CNB dated 25 September 2002.<sup>50</sup>

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<sup>47</sup> Exhibit R-53, letter dated 20 August 2002 from Invesmart to MOF, Deputy Minister Sobotka (the "20 August Proposal").

<sup>48</sup> Statement of Defence, para 88.

<sup>49</sup> Exhibit R-60, minutes of meeting held on 24 September 2002 between representatives of the MOF, CKA, CNB, and Government Office.

<sup>50</sup> Exhibit R-72, letter dated 7 October 2002 from MOF to the CNB.

122. On 25 October 2002, the day after CNB issued its regulatory approval, discussions resumed between the MOF and Invesmart about the provision of state aid to Union Banka. A meeting took place between Euro-Trend, the consulting group hired by Union Banka on 16 October 2002 to conduct the state aid negotiations,<sup>51</sup> and First Deputy Minister of Finance Dr Doruška.<sup>52</sup> At this meeting Dr Doruška suggested possible forms of state aid. Specifically, a combination of:
- (a) lowering the interest rate on the Fores deposit; and
  - (b) the acquisition by CKA of a portfolio of non-performing loans at a value to be determined by an independent expert plus a mark-up of CZK 650 million, less cost of administration of the portfolio.<sup>53</sup>
123. On 1 November 2002, Union Banka submitted a state aid proposal to the MOF which totalled CZK 1.2 billion (the "**First Euro-Trend Proposal**").<sup>54</sup> The proposal envisaged:
- (a) lowering the interest rate on the Fores Deposit of 11.5 percent to a rate between PRIBOR and a standard commercial rate;
  - (b) acquisition by CKA of a portfolio of non-performing assets at a price determined by independent experts plus an additional amount of state aid; and
  - (c) withdrawal of the arbitration claim which Union Banka filed against the CNB on 25 October 2002 in connection with Union Banka's takeover of the BDS ( the "**BDS Arbitration Claim**") discussed above at paragraph 110.<sup>55</sup>
124. On 5 November 2002, a meeting took place between Union Banka, the MOF and the CKA which was attended by Messrs Vávra (CEO of Union Banka), Nekovar (Euro-Trend), Oklestek (Eurotrend), Janota (First Deputy Minister of Finance, Doruška (MOF), Majer (MOF), Řežábek (CKA) and Svoboda (CKA). At this meeting the parties mooted the possibility of a commercial settlement of the BDS Arbitration Claim as an alternative to the First Euro-Trend Proposal.<sup>56</sup> The parties also discussed the regulatory requirement that any grant of state aid

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<sup>51</sup> Exhibit R-515, Agreement on advisory activities between Union Banka and Euro-Trend, dated 16 October 2002.

<sup>52</sup> Statement of Claim, paras 90 and 104; Statement of Defence, para 120.

<sup>53</sup> Exhibit C-60, minutes of a meeting held on 25 October 2002.

<sup>54</sup> Exhibit R-13, First Plan submitted by Euro-Trend.

<sup>55</sup> Exhibit R-80, Claim by Union Banka against the CNB.

<sup>56</sup> Statement of Claim, para 107.

would have to be approved by the OPC. Invesmart claims that this was the first time at which this requirement was specified by the Czech Government.<sup>57</sup>

125. On 8 November 2002, the CNB, which had already informed Union Banka that it refused to pay the "BDS Receivable" and had requested the bank to de-recognise it in its accounts by 22 October 2002, again advised Union Banka that it would not recognise nor settle the BDS Arbitration Claim.<sup>58</sup> Due to the CNB's objections, the BDS claim was subsequently removed from consideration as a means of providing state aid. (It was later resurrected by Union Banka in its Restructuring Plans.)
126. On 13 November 2002, the CEO of Union Banka, Mr Vávra, again met with staff of the CNB. At this meeting, Mr Vávra informed officials of the CNB that the new Euro-Trend proposal that was about to be circulated would not include the settlement of the BDS Arbitration claim and that Union Banka would limit its request for state aid to CZK 650 million. According to the statement of Mr Vávra, Union Banka was prepared to limit its request for state aid to CZK 650 million in order to avoid any further delay to the completion of the Foresbank settlement.
127. On 14 November 2002 Euro-Trend submitted to the MOF an amended proposal (the "**Second Euro-Trend proposal**") for the provision of state aid. This proposal was for the Czech Republic to provide aid in an amount not exceeding CZK 650 million on the following terms:
- (a) the lowering of the interest rate applied to the Fores Deposit to a floating market rate;
  - (b) early termination of the Fores Deposit and its transformation into a five year subordinated debt;
  - (c) the acquisition by the Czech Consolidation Agency ("**CKA**") of a portfolio of non-performing assets at a price determined by independent experts plus an additional amount of state aid; and
  - (d) a state guarantee of a portfolio of loans.<sup>59</sup>

### **Invesmart's takeover of Union Banka and Union Group**

128. On 17 November 2002, Invesmart signed 18 agreements to unconditionally assume certain of the RPLs of Union Group and Union Banka in the aggregate principal amount of CZK 2.67 billion.<sup>60</sup>

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<sup>57</sup> *Id.*, para 110.

<sup>58</sup> First witness statement of Governor Tůma, para 39; first witness statement of Mr. Vávra, para 63.

<sup>59</sup> Exhibit R-14, Second Euro-Trend Proposal.

<sup>60</sup> Exhibits R-83–R-100, 18 agreements on debt assumption entered into on 17 November 2002; Exhibits R-101–R-104, individual debt assumption and share purchase agreements.

129. On 18 November 2002, Invesmart officially acquired approximately 60 percent of the shares of Union Group, which owned approximately 75 percent of Union Banka at that time. Invesmart also directly acquired approximately 22 percent of the shares in Union Banka. At the CNB's request, the purchase price paid by Invesmart for the shares in Union Banka was to be used exclusively to pay back Union Banka's RPLs.<sup>61</sup>
130. Invesmart never paid for the shares it acquired in Union Banka.

### **Continued negotiations regarding State Aid**

131. On 28 November 2002, Mr Vávra met with officials of the CNB. At that meeting the CNB informed Mr Vávra that the OPC would provide its opinion on the feasibility of state aid. The CNB informed Mr Vávra that there were three obstacles to the provisions of state aid:
- (a) the "one time, last time" rule, meaning that prior recipients would be denied future grants of state aid;
  - (b) the prohibition against state aid where losses were the result of intra-group transfers; and
  - (c) the aid provided must be sufficient for the bank to continue as a going concern.<sup>62</sup>
132. On 29 November 2002, another meeting took place between representatives of the Ministry for Finance, the OPC, the CNB, the CKA, Union Banka and Euro-Trend. At that meeting the OPC informed Union Banka that it would assess the Second Euro-Trend Proposal against the *EC Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty*. The OPC also offered rescue aid to Union Banka. Union Banka did not accept this offer but asked for three months to prepare a restructuring plan that would be verified by its auditor.<sup>63</sup>
133. Following the meeting of 29 November 2002, Union Banka began drafting a new restructuring plan that was directly based on the various EU guidelines relating to state aid.<sup>64</sup>
134. Between 7 January 2003 and 12 February 2003, Invesmart submitted three alternative restructuring plans to the MOF and CNB.
135. The first of these was submitted on 8 January 2003 ("**The First Draft Restructuring Plan**") along with a third proposal for the provision of state aid (the "**Third Euro-Trend Proposal**").

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<sup>61</sup> Witness Statement of Radovan Vávra, paras 47–48.

<sup>62</sup> Exhibit R-275, minutes of a meeting held on 29 November 2002 between Invesmart and the CNB.

<sup>63</sup> Exhibit R-115, minutes of a meeting held on 29 November 2002 between the Ministry of Finance, OPC, the CNB, the CKA, Union Banka, Euro-Trend and Invesmart.

<sup>64</sup> Statement of Claim, para 123; Witness Statement of Radovan Vávra, para 70.

The Third Euro-Trend Proposal envisaged that the Czech Government would implement one or more of the following measures:

- (a) a significant decrease of the fixed interest rate on the Fores Deposit or its reduction to zero;
- (b) the early termination of the Fores Deposit and its transformation into five year subordinated debt;
- (c) the acquisition by CKA of a portfolio of non-performing assets at a price determined by independent experts; and
- (d) the purchase of the BDS Arbitration Claim by CF.<sup>65</sup>

136. The First Draft Restructuring Plan identified the settlement of the BDS Arbitration Claim as the proposed mechanism through which the Czech Government would provide state aid to Union Banka.<sup>66</sup>

137. On 23 January 2003, Union Banka delivered a "**Second Draft Restructuring Plan**" which envisaged the provision of state aid to the value of CZK 1.691 billion which was to be provided via:

- (a) settlement of the BDS Arbitration Claim; or
- (b) a guarantee from the Czech Republic covering a portfolio of non-performing loans.<sup>67</sup>

138. The MOF provided comments on both the First and Second Restructuring Plans at a meeting held on 28 January 2003.<sup>68</sup>

139. On 12 February 2003, Union Banka submitted its third and final restructuring plan to the MOF ("**Third Restructuring Plan**") in which Union Banka proposed settlement of the BDS Arbitration Claim or, in the alternative, a state guarantee. The settlement of the BDS arbitration was proposed notwithstanding the CNB's clear statement of 8 November 2002 that

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<sup>65</sup> Exhibit R-15, Third Euro-Trend proposal, page 13, para (e).

<sup>66</sup> Exhibit R-126, Request for grant of Exemption from State Aid Prohibition, dated 7-8 January 2003, Section 6.2, p. 18.

<sup>67</sup> Exhibit R-139, Request for grant of Exemption from State Aid Prohibition, dated 23 January 2003, Section 6.2.2 A).

<sup>68</sup> Exhibit C-68, comments on the restructuring plan expressed by the MOF in a meeting held on 28 January 2003.

it would not recognise or settle the BDS Arbitration Claim on a commercial basis.<sup>69</sup> The amount of state aid requested totalled CZK 1.762 billion.<sup>70</sup>

140. The Third Restructuring Plan demonstrated that Union Banka's new management led by new CEO Mr Vávra had carried out an in depth inspection of the bank and had decided to create extra adjustments to cover bad loans worth CZK 1.8 billion.<sup>71</sup> It specifically noted that:

The proposed figures for adjustments and provisions to be created considerably exceeds the previously anticipated figures, primarily as a result of the more realistic approach towards the quality of the assets and risk of the Bank's portfolio adopted by the new management team for restructuring.<sup>72</sup>

The plan acknowledged that new management were of the opinion that Union Banka's situation was more dire than originally expected.

### **Union Banka's liquidity crisis and the denial of state aid**

141. By 19 February 2003, it was clear that there was a growing liquidity crisis at Union Banka. On that day the assistant to Union Banka's CEO, Mr Vávra, sent a letter on his behalf to the Minister's secretary, requesting a meeting with Minister Sobotka within the next 48 hours "in a very urgent and pressing matter 'Crisis in Union banka'".<sup>73</sup>
142. On the same day that his assistant requested the meeting with the Finance Minister, Mr Vávra met with CNB officials. The meeting's minutes reveal the bank's deteriorating situation:

Mr. Vávra referred to the current development in the area of liquidity as to catastrophic (sic). During the last two weeks (i.e., since the beginning of February), the Bank registers a continuous drain of liquidity. The liquidity cushion of the Bank is currently represented only by ca. CZK 550 mln and if the situation doesn't change fundamentally, it will run down completely next week, according to the judgment of Mr. Vávra. (Note: in mid January, the liquidity cushion of the Bank was around ca. CZK 1.1 mln).

According to the statement of Mr. Vávra, corporate clients are leaving the Bank, whereas deposits in the retail area grow; however, the total amount of deposits drain represents ca. CZK 40 mln per day.

Mr. Vávra resumed the measures taken by the Bank to date:

- holdback of credit transactions since October 2002
- active effort to increase deposits by means of advertisement and interest rates increase. (Note: the current deposits interest rates at the Union Bank are in rank 2x higher than those by other banks with the highest rates on the market!)

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<sup>69</sup> First witness statement of Governor Tůma, para 40; First Witness Statement of Mr Vávra, para 63.

<sup>70</sup> Exhibit R-18, Third Restructuring Plan.

<sup>71</sup> *Id.*, p. 5.

<sup>72</sup> *Id.*, p. 31.

<sup>73</sup> Exhibit R-156, facsimile dated 19 February 2003 from Darina Koišová of Union Banka to Jana Horová, Ministry of Finance.

However, the Bank is not currently able to prevent the deposits drain by the means of the standard market mechanism...<sup>74</sup> [Underlining added; italics and bolding in original]

143. Thus, on the bank's own view, its liquidity situation was "catastrophical". It was plainly facing peril, and if no action was taken to stem the outflow of deposits, it faced the imminent prospect of having to close down.

144. The minutes continue, recording Mr Vávra as advising that:

If reversion in the liquidity situation did not occur and no hope for public support existed, there would be no other choice left than to "return the licence".

In this respect, he [Mr. Vávra] was warned by the CNB that optional termination of banking activities was possible only under the condition of settlement of all obligations. Thus in the current situation would come into question only administrative hearing about the licence withdrawal, because for example legal causes for the introduction of sequestration were not met (the stability of the banking system was not endangered) (sic).<sup>75</sup> [Emphasis added.]

145. Mr Vávra's 19 February 2003 request for liquidity support from the CNB was denied.

146. At 3 pm on the following day, 20 February 2003, Union Banka's Supervisory Board, comprising [redacted] and Mr de Sury, met with Governor Tůma and three colleagues from the CNB.<sup>76</sup> At that meeting, Governor Tůma read them his copy of the Minister's letter denying the aid which he had himself just received. The minutes record that the members of the bank's Supervisory Board were not able to express their opinion regarding the impact of this development on Invesmart's affiliation with Union Banka, "nor the possibility of the bank's shareholders securing its liquidity".<sup>77</sup> They indicated that they would keep the CNB informed of their actions in the next few days.<sup>78</sup>

147. This meeting was followed by a meeting between the CNB and Mr. Vávra at 4 p.m. He too was informed of the Minister's rejection of the restructuring plan. According to the minutes, Mr Vávra informed the CNB of:

...the critical situation of the bank with respect to its liquidity, when deposit withdrawals by particularly corporate clients increased and in average, the value of deposit values is daily decreased by approx. CZK 40 million. By October 2002, the bank had already used all commercial measures, particularly limitation of loan

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<sup>74</sup> Exhibit R-150, minutes of a meeting held on 19 February 2003 between Mr. Vávra for Union Banka, and Mr. Krejča, Mr. Jíříček, Ms. Goldscheiderová, and Mr. Majer of the CNB.

<sup>75</sup> *Id.*, p. 2.

<sup>76</sup> Exhibit R-154, minutes of a meeting held on 20 February 2003 between [redacted] and de Sury and Governor Tůma, Mr. Štěpánek, Mr. Krejča and Mr. Jíříček of the CNB.

<sup>77</sup> *Id.*

<sup>78</sup> *Id.*

<sup>78</sup> *Id.*



transactions in an active attempt to increase deposits through promotions and increase of interest rates and the sale of quickly liquid assets, but it unable to prevent further outflow of deposits. Other measures, particularly in the area of sale of receivables or repo operations with respect to receivables, are not feasible within the near future and do not resolve the situation of the bank.

...With regard to the above-mentioned situation, the bank is unable to fulfil its legal obligation to maintain solvency and further operation of the bank would only harm the position of its depositors.

The above statement is to be treated as notice under Section 26b of the Act No. 21/1992 Coll., as amended.

3. Mr. Vávra promised to discuss further steps by the bank at a meeting of the board of directors immediately following this meeting and to inform shareholders and the CNB.

4. The CNB acknowledged the above-mentioned facts and considers the eventual decision of the bank to close its branches to be rational. If the bank decides to close its branches, the CNB will immediately notify the Deposit Insurance Fund in order to start the pay-outs of compensation to depositors as soon as possible to minimize the impact on the depositors. Maximum information provided to the public is considered important by the CNB and the CNB is ready to cooperate with the bank in this area.

The CNB is interested in the most orderly exit of the bank from the sector with minimum impact on the bank's depositors and the banking sector ...<sup>79</sup> [Emphasis added.]

148. In the evening of 20 February 2003, Union Banka's management met and decided not to open branches the next day. They informed the CNB about this decision by letter prepared later that same evening, with the time of 7 p.m., in which Mr Vávra and two senior bank officers stated:<sup>80</sup>

...In a situation where the liquidity of the bank is continuously declining and this trend has continued culminating for the last two weeks, we were informed today of the decision of the State not to grant the bank the requested state aid. The decision was publicized during the afternoon and makes a real possibility, according to our recent experience, that a run on the bank will start on 21 February 2003. In accordance with Section 26b of the Banking Act, we have, therefore, come to the conclusion that the bank shall, as a result of the above-mentioned circumstances, in all likelihood become insolvent tomorrow and we give you this information pursuant to the above-mentioned Section 26b.

At the same time, in view of the last consultations with the Czech National Bank, we are taking immediate measures pursuant to Section 26 of the Banking Act and shall limit certain permanent activities, especially, with immediate effect, i.e., with effect from the next following business day – 21 February 2003 – we shall close all branches of Union banka, the clearing centre, etc.<sup>81</sup> [Emphasis added.]

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<sup>79</sup> Exhibit R-155, minutes of a meeting held on 20 February 2003 between Mr. Vávra and Governor Tůma, Mr. Krejča and Mr. Jířiček of the CNB.

<sup>80</sup> Exhibit R-158, letter dated 20 February 2003 from Union Banka to the CNB.

<sup>81</sup> *Id.*

149. The following day, Union Banka closed all of its branches and the CNB initiated administrative proceedings to revoke the bank's licence.<sup>82</sup> The Deposit Insurance Fund was notified that it might be required to compensate the bank's depositors and the CNB commenced administrative proceedings to revoke the bank's licence.<sup>83</sup>
150. It is evident that this notification did not find favour with Invesmart. Three days later, two of the three signatories to the letter, Messrs Vávra and Roman Truhlář, were dismissed and replaced by Mr Michal Gaube and Mr Roman Mentlík. It appears that the reason for their dismissal lay in what [redacted] considered to be "the fact that [the] members of the board of directors whose dismissal was proposed, may take irreversible steps, measures or legal acts that would contradict the interests of Union banka, a.s., its shareholders and clients of Union banka, a.s."<sup>84</sup>
151. There is further evidence of a disagreement between Mr Vávra and [redacted] as to the proper way to proceed. An article in the Czech publication, *Týden*, dated 10 March 2003, later quoted Mr Vávra as saying that the depositors in Union Banka:
- ...should hope for a quick revocation of Union banka's licence and quick payout from the deposit insurance funds. ... This was precisely my logic, why I closed the bank's branches, because the head of Invesmart [redacted] and the CNB did not do it. The branches were closed by me in order for as much money as possible to be saved. ... [redacted] wanted to continue to keep the bank open. He did everything to make that happen, gave me various orders from his post as the head of the Supervisory Board. I firmly stood behind my view that under no circumstance would I do that.<sup>85</sup> [Emphasis added.]
152. On 24 February 2003, the first two applications for declaration of bankruptcy of Union Banka were filed by creditors with the Regional Court in Ostrava.<sup>86</sup>

### **Union Banka's attempts to renew its operation**

153. On 27 February 2003, Union Banka presented a salvage plan to the CNB for the renewal of its operations.<sup>87</sup> This plan was supplemented on three occasions during March 2003.

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<sup>82</sup> Exhibit C-81, letter dated 21 February 2003 from Union Banka to the CNB; Exhibit C-79, CNB notification to Union Banka of the commencement of administrative proceedings to withdraw a banking licence.

<sup>83</sup> Exhibits C-79 and C-81, letters dated 21 February 2003 respectively from the CNB to Union Banka.

<sup>84</sup> Exhibit R-160, minutes of the extraordinary meeting held on 24 February 2003 of the Supervisory Board of Union Banka.

<sup>85</sup> Exhibit R-445, *Týden*, dated 10 March 2003.

<sup>86</sup> Exhibit R-161, Petition for declaration of bankruptcy of Union Banka filed by City Realitni Spravni S.R.O. v Likvidaci and Inert Investment Corp in the Regional Court in Ostrava on 24 February 2003.

<sup>87</sup> Exhibit R-162, Report for the meeting of the Board of Directors of Union Banka on the 27 February 2003 proposal for renewal of business operation ("First Proposal").

154. First, on 3 March 2003, Union Banka filed the plan with the CNB and commented on the CNB's notice of the commencement of administrative proceedings to revoke Union Banka's licence.<sup>88</sup> This plan was based on unverified data. It included a statement that the plan was subject to change pending an external audit to verify the correctness of assumptions and information presented therein.
155. Secondly, on 10 March 2003, Union Banka submitted a supplement to its plan to the CNB.<sup>89</sup> This proposal envisaged Union Banka continuing to operate on a limited licence whereby it would be prohibited from taking further deposits. It would pay out 100 percent of claims by depositors itself and would finance payment of claims by depositors in excess of CZK 5 million per client under a five year loan agreement with the Bank Deposit Insurance Fund ("FPV"). The Czech Government was not satisfied that Union Banka had funds to implement this plan. Further, the proposal was inconsistent with provisions of the *Czech Banking Act* and the law establishing the FPV.<sup>90</sup>
156. Thirdly, on 18 March 2003, [redacted] informed the CNB that Invesmart had entered into a memorandum of understanding with MTGLQ investors, L.P., a wholly owned subsidiary of Goldman Sachs, to cooperate on a new plan.<sup>91</sup> The CNB was informed of this plan once it had already made its decision to proceed with the revocation of Union Banka's banking license, which occurred on that same day.
157. On 27 March 2003, the FMV applied for Union Banka's bankruptcy before the Regional Court in Ostrava. On 31 March 2003, Union Banka created provisions for debts assumed by Invesmart as requested by CNB, resulting in negative capital of CZK1.29 billion.<sup>92</sup>

### **The fraudulent bankruptcy proceedings of Union Banka**

158. The orderly bankruptcy of Union Banka was interrupted by proceedings commenced on 31 March 2003 before the Commercial Court in Ústí Nab Labem. On that same day Judge Berka, the presiding Judge, declared Union Banka bankrupt and appointed Daniel Thonat as the bank's bankruptcy trustee. On 1 April 2003, Mr Thonat and a group of armed men forcibly entered Union Banka's main office in Prague.

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<sup>88</sup> Exhibit R-163, Proposal dated 3 March 2003 to resolve the situation of Union Banka; Exhibit R-164, Union Banka statement dated 3 March 2003 to the commencement of administrative proceedings to revoke Union Banka's licence.

<sup>89</sup> Exhibit R-168, Supplement dated 10 March 2003 to the proposal for resolution of the situation of Union Banka.

<sup>90</sup> See Exhibit R-304, Section 1(1) of the Banking Act; Exhibit-304 and expert opinion of Dr. Kotáb, para 33. See also Exhibit R-169, opinion of the Management of FPV on the proposal of Union Banka, dated 11 March 2003.

<sup>91</sup> Exhibit C-88, letter dated 18 March 2003 from [redacted] to the CNB.

<sup>92</sup> Exhibit C-89, Report by the Czech Chamber of Deputy Standing Committee on Banking regarding the situation of Union Banka, a.s. in June 2003, Section 8.

159. It is common ground that these proceedings were fraudulent and were only sustained on the basis of forged documents. For this reason, Judge Berka annulled his bankruptcy decision on 4 April 2004. Further, on 8 April 2003, the President of the Czech Republic and Prime Minister approved the removal of Judge Berka's immunity.<sup>93</sup> Judge Berka was subsequently prosecuted for abuse of power by a public official.
160. On 14 April 2003, Union Banka filed an application for a voluntary composition with its creditors with the Bankruptcy Court in Ostrava and a voluntary bankruptcy petition. The members of Union Banka's Board of Directors who filed the voluntary bankruptcy petition were recalled the same day and the petition for voluntary bankruptcy was withdrawn the same day.<sup>94</sup>
161. On 24 April 2003, Union Banka lost the BDS Arbitration Claim.<sup>95</sup>
162. On 28 April 2003, the Czech Securities Commission ("CSC") requested Invesmart to honour its obligations to purchase shares in Union Banka tendered to it by the minority shareholders who accepted Invesmart's mandatory tender offer.<sup>96</sup>

#### **The revocation of Union Banka's banking licence and the liquidation of Union Banka**

163. On 30 April 2003, the CNB Board rejected Union Banka's appeal of the CNB's decision of 18 March 2003 to revoke its banking licence. The revocation of Union Banka's licence became effective on 2 May 2003.<sup>97</sup>
164. On 9 May 2003, the CNB filed a petition with the Regional Court in Ostrava to dissolve Union Banka and appoint a liquidator.<sup>98</sup> On the same day, the Regional Court in Ostrava declared Union Banka to have entered liquidation and appointed Value Added S.R.O. as liquidator.<sup>99</sup> The decision came into effect on 19 May 2003. Union Banka did not appeal the decision.
165. On 17 May 2003, the FTV began making payments to Union Banka's depositors.<sup>100</sup>

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<sup>93</sup> Statement of Claim, para 188.

<sup>94</sup> Exhibit R-205, Union Banka's application for declaration of bankruptcy filed on 14 April 2003; Exhibit C-135, Union Banka's application for composition filed on 14 April 2003; Exhibit R-208, Revocation of Union Banka's bankruptcy application, dated 14 April 2003.

<sup>95</sup> Exhibit C-137, Arbitration award of the Court of Arbitration at the Chamber of Commerce of the Czech Republic and the Agrarian Chamber of the Czech Republic.

<sup>96</sup> Exhibit R-293, letter dated 28 April 2003 from the Securities Commission to Invesmart.

<sup>97</sup> Exhibit R-215, CNB decision Ref. No. 203/2512/110, dated 30 April 2003. See also the protocol and delivery of the decision, dated 2 May 2003; Exhibit R-214.

<sup>98</sup> Exhibit R-216, CNB application for liquidation of Union Banka, dated 6 May 2003.

<sup>99</sup> Exhibit R-217, letter dated 26 May 2003 from the CNB with decision on liquidation of Union Banka attached.

<sup>100</sup> Exhibit C-142, decision of the Regional Court in Ostrava Ref. No. 33K 10/2003, dated 29 May 2003.

166. On 27 May 2003, the Regional Court in Ostrava dismissed Union Banka's application for composition.<sup>101</sup>
167. On 29 May 2003, the Regional Court in Ostrava declared Union Banka bankrupt and appointed Ms Michaela Huserová as bankruptcy trustee.<sup>102</sup> Ms Huserová immediately commenced liquidation of the banks assets, a process which continued until Ms Huserová was removed as Union Banka's trustee following a decision of the High Court in Olomouc that she had been involved in unlawfully selling the assets of Union Banka.<sup>103</sup>
168. On 13 June 2003, Union Banka appealed the declaration of bankruptcy and the decision rejecting its application for composition.<sup>104</sup> Both appeals were rejected.

### **Invesmart's refusal to pay for shares it acquired in Union Banka**

169. Invesmart's refusal to pay for the shares it acquired in Union Banka has been the subject of litigation both in the Netherlands and in the Czech Republic.
170. On 9 June 2004, a bankruptcy application lodged by Union Banka's then bankruptcy trustee Ms Huserová was rejected based on debts owing to Union Banka which Invesmart had assumed as consideration for the shares in Union Group.<sup>105</sup>
171. On 9 August 2004, Invesmart applied to the Municipal Court in Prague to annul its assumption of debts pertaining to Union Banka, claiming the assumption void on account of breach of the Banking Act by Union Banka. This claim is still pending. Invesmart in the same submission sued the CNB for EUR188 million in damages allegedly caused to Invesmart by wrongful official procedure applied by the CNB.<sup>106</sup>
172. On 23 April 2004, Ms Huserová on Union Banka's behalf filed three claims against Invesmart in court for a total of CZK670 million in connection with Invesmart's debt assumption.<sup>107</sup>

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<sup>101</sup> Exhibit R-218, decision of the Regional Court in Ostrava Ref. No. 13KV 1/2003, dated 27 May 2003.

<sup>102</sup> Exhibit C-142, decision of the Regional Court in Ostrava Ref. No. 33K 10/2003, dated 29 May 2003.

<sup>103</sup> Statement of Claim, para 207.

<sup>104</sup> Exhibit R-223, Union Banka's appeal against the decision of the Regional Court in Ostrava, dated 12 June 2003; Exhibit R-219, Union Banka's appeal against the decision on liquidation of Union Banka, dated 12 June 2003.

<sup>105</sup> Exhibit R-239, petition for involuntary liquidation of Invesmart filed on 9 July 2004 in the District Court of Amsterdam.

<sup>106</sup> Exhibit R-243, petition for determination of invalidity of the relationship of obligation between Invesmart and the trustee in bankruptcy of Union Banka and claim for damages filed on 9 August 2004 in the Municipal Court in Prague.

<sup>107</sup> Exhibits R-240–R-242, decisions ref. nos. 26 Cm119/2004-28, 26Cm117/2004- 30 and 26Cm118/2004-28, dated 23 February 2005.

173. On 23 February 2005, the Regional Court in Ostrava ordered Invesmart to pay CZK670 million in connection with Invesmart's debt assumption following Ms Huserová's claim filed on 23 April 2004. Invesmart did not pay.
174. On 31 May 2005, Ms Huserová filed a further 15 claims against Invesmart totalling CZK 2.67 billion based on debts assumed by Invesmart as consideration for the shares in Union Group. These claims are still pending.

## **Jurisdiction**

### **Introduction**

175. The Respondent has asserted that the Tribunal does not have jurisdiction to decide the case. In its Statement of Defence, Statement of Rejoinder and at the hearing the Respondent put forward several contentions for its assertion of lack of jurisdiction. In essence, three discrete arguments have been raised:

- (i) the Claimant is not a Dutch investor;
- (ii) the Claimant did not make an investment in the Czech Republic; and
- (iii) the Claimant, through its actions in the Czech courts, is precluded from arguing that it validly acquired the shares in Union Banka and its holding company.

176. The Tribunal will deal with each of these arguments in turn.

### **Nationality**

177. Article 1(b) of the BIT defines "investors" as follows:

- (b) the term 'investors' shall comprise:
  - i. natural persons having the nationality of one of the Contracting Parties in accordance with its law;
  - ii. legal persons constituted under the law of one of the Contracting Parties.

178. It is not doubted that Invesmart is a legal person constituted under the law of The Netherlands. However, the Respondent argues that the Claimant does not have any real connection to the Netherlands and for that reason does not satisfy the notion of an "investor" pursuant to the BIT. The Respondent argues that the Claimant has no real presence and no management in the Netherlands, it being physically located in Italy and controlled by Italian nationals.

179. For its part, the Claimant relies on the wording of Article 1(b) of the BIT and on the fact that it is constituted under the law of the Netherlands. The Claimant argues that there is no "origin of capital" requirement in the BIT and no such requirement may be implied. It notes that the Czech Republic's "origin of capital" argument was rejected by another tribunal's Decision on Jurisdiction of 29 April 2004 in *Tokios Tokelés v Ukraine*.<sup>108</sup>
180. This Tribunal considers that the words of Article 1(b) of the BIT are clear and that, in the case of legal persons, the only requirement is that the legal person is constituted under the law of one of the Contracting Parties. There is no basis for implying any further requirement. Accordingly the Tribunal decides that the Claimant is an investor within the meaning of Article 1(b) of the BIT.

### Investment

181. In its Statement of Defence the Respondent contended that the Claimant never acquired beneficial ownership of the shares in Union Banka and Union Group and made no substantive investment in the sense of committing capital. The Respondent contended that:

[a]s the Respondent has already shown in this Statement of Defence, Invesmart (i) paid no purchase price for the shares, (ii) having agreed (at a shareholder meeting held on 16 October 2002) to a EUR 90 million capital increase in order to allow the Union Banka transaction to proceed, did not increase its capital, (iii) entered into debt assumption agreements in return for the transfer of shares but never met its obligations to Union Banka and Union Group under those debts, (iv) defaulted on its obligation to pay for shares of minority shareholders in Union Banka, which Czech law required it to offer to acquire and (v) is still a party to the Czech Repudiation Claim proceedings in which it argues that the debt assumptions were void *ab initio* as a matter of Czech law.

As a result, even if it could be established that Invesmart had legal title to the shares in Union banka and Union Group (which is denied for the reasons detailed above), the Claimant never became the beneficial owner of the shares in question because it never performed the obligations which were the *quid pro quo* of its acquisition of those shares. Accordingly, Invesmart cannot be said to have invested any assets in the Czech Republic as required under Article 1(a) of the BIT. Therefore, Invesmart made no investment protected by the BIT.<sup>109</sup>

182. In its subsequent Statement of Rejoinder, and at the hearing, the Respondent appeared to retreat from its first contention, that the Claimant did not become the owner of the shares, and emphasised the second aspect of its argument, namely that there had been no investment of capital. As far as ownership of the shares in concerned, the decisions of the Czech courts, which are referred to below, would appear to establish, or at least are consistent with, the

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<sup>108</sup> ICSID Case No. ARB/02/18.

<sup>109</sup> Statement of Defence, paras 276 and 277.

proposition that the Claimant did in fact become the legal owner of the shares in Union Banka and Union Group.

183. The second aspect of the Respondent's argument focuses on the substance of the investment. The Respondent refers to the preamble to the BIT which states that the Treaty's object is to "stimulate the flow of capital and technology and the economic development of the Contracting Parties". The Respondent maintains that merely acquiring legal title over any kind of asset is not sufficient to bring that asset under the protection of the BIT. The Respondent contends that there must be a commitment of money to earn a financial return. The Respondent states that the Claimant has not paid for the shares and that throughout the lifetime of its activities in the Czech Republic, the Claimant has outlayed no expenditure for the benefit of Union Banka. Indeed the Claimant has instead been reimbursed for its due diligence work and for the living expenses of its representatives operating in the Czech Republic.

184. In support of its argument the Respondent refers to a number of cases including *Salini Costruttori S.p.A and Italstrade S.p.A v Kingdom of Morocco*,<sup>110</sup> *Joy Mining Machinery Limited v Arab Republic of Egypt*,<sup>111</sup> amongst others.

185. The Claimant contends that the cases cited by the Respondent are ICSID cases that examine the meaning of the term "investment" in Article 25 of the ICSID Convention, which was purposely left undefined by the drafters. However, the Claimant argues that the definition of investment for the purposes of the BIT is defined and is exclusive.

186. Article 1(a) of the BIT defines "investments" as follows:

- (a) the term 'investments' shall comprise every kind of asset invested either directly or through an investor of a third State and more particularly, though not exclusively:
  - i. movable and immovable property and all related property rights;
  - ii. shares, bonds and other kinds of interests in companies and joint ventures, as well as rights derived therefrom;
  - iii. title to money and other assets and to any performance having an economic value;
  - iv. rights in the field of intellectual property, also including technical processes, goodwill and know-how;
  - v. concessions conferred by law or under contract, including concessions to prospect, explore, extract and win natural resources.

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<sup>110</sup> ICSID Case No. ARB/00/4, Decision on Jurisdiction of 23 July 2001; ILM, vol. 42 (2003), p. 609, para 52.

<sup>111</sup> ICSID Case No. ARB/03/11, Award on Jurisdiction of 6 August 2004, para 53.



187. It will be seen that Article 1(a)ii expressly includes "shares" in the definition of "investments". The Respondent's contention would require the Tribunal to read in a qualification that there be payment or other consideration for the acquisition of the shares. Moreover it would seem to follow that any consideration however small may not suffice. Would a nominal consideration of say one cent or a peppercorn be any different, in substance, from no consideration? The Respondent referred to the aim of the BIT, as set out in its preamble, which is to stimulate the flow of capital and economic development. If the shares were acquired for a nominal value this could hardly be regarded as sufficient to stimulate the flow of capital and economic development.
188. It would seem, then, that the Respondent's submission, if accepted, would require the Tribunal to embark on an inquiry as to whether the consideration paid for the shares was adequate or perhaps substantial. Such an enquiry would necessitate the Tribunal undertaking an assessment of the value of the investment and the consideration paid with no criteria to guide it. Moreover even if the consideration paid was adjudged to be 'adequate', would there have to be a further assessment as to whether the total amount invested was sufficiently substantial having regard to the aim of the BIT to stimulate the flow of capital and economic development?
189. The Respondent's submission would require the Tribunal to qualify the express words of Article 1 by implying an additional requirement of a qualitatively adequate investment. The Tribunal sees no compelling reason for doing so. The Tribunal considers that Article 1 should be given its plain and literal meaning and that the express inclusion of "shares" as an investment means that the acquisition of shares constitutes an investment without further inquiry.

## **Preclusion**

190. The consideration which the Claimant agreed to provide for its acquisition of the shares was an unconditional promise to pay EUR 90 million to discharge Union Banka's related party loans. The Claimant never made the payment, contending that the whole arrangement was conditional on the Czech Government providing aid to the bank. Subsequently Union Banka were placed in liquidation and the bankruptcy trustees commenced some 18 proceedings against the Claimant seeking payment of the EUR 90 million. The Claimant contended that the share acquisition agreements, and in particular its obligation to pay the EUR 90 million, were void or otherwise unenforceable. Three of these cases have been decided. In each, the Czech courts decided that the share purchase agreements were valid and that Invesmart consequently had an obligation to pay the EUR 90 million consideration.

191. The Respondent argues that the Claimant has adopted fundamentally inconsistent positions in the Czech court proceedings and in this arbitration. In this arbitration the Claimant states that it has made an investment in the Czech Republic and seeks relief against the Czech Government with respect to its alleged breaches of obligations under the BIT concerning that investment. However in the Czech court proceedings the Claimant contends that the debt assumptions, and in turn the share acquisitions, were void with the logical consequence that there could never have been an investment.
192. The share acquisition agreements were entered into between the Claimant and third persons who are not parties to this arbitration. Neither party to this arbitration has asked this Tribunal to determine whether the share acquisition agreements are valid and the Tribunal has not heard argument as to whether it has jurisdiction to do so.
193. In the circumstances, the Tribunal assumes the validity of the share purchase agreements unless and until it is established that another court or tribunal with authority has determined that the share purchase agreements are void as a matter of Czech law. Moreover, the evidence before this Tribunal is that in three decided cases, the Czech courts have held that the share purchase agreements as well as the obligation of the Claimant to pay the consideration of EUR 90 million are valid and enforceable. Therefore, this Tribunal has no basis for considering the agreements to be void. The Claimant is not precluded from contending that it made a valid investment in the Czech Republic.

## **Applicable Law**

194. Article 8(6) of the BIT provides:

The arbitral tribunal shall decide on the basis of the law, taking into account in particular though not exclusively:

- the law in force of the Contracting Party concerned;
- the provisions of this Agreement, and other relevant Agreements between the Contracting Parties;
- the provisions of special agreements relating to the investment;
- the general principles of international law.

195. The application of this provision was clarified by representatives of the Netherlands and the Czech Republic who held consultations pursuant to Article 9 of the BIT. As a result of these consultations, Agreed Minutes dated 1 July 2002 provided:

- (i) On the issue of investment disputes and interpretation of Article 8.6 of the Agreement [i.e., the Treaty]:

The arbitral tribunal shall decide on the basis of the law. When making its decision, the arbitral tribunal shall take into account, [in particular] though not exclusively, each of the four sources of law set out in Article 8.6. The arbitral tribunal must therefore take into account as far as they are relevant to the

dispute the law in force of the contracting party concerned and the other sources of law set out in Article 8.6. To the extent that there is a conflict between national law and international law, the arbitral tribunal shall apply international law.<sup>112</sup>

196. The Claimant submits that in practice this means that the Tribunal must apply the substantive legal provision set forth in the Treaty, the applicable international law instrument to the merits of this dispute, along with any relevant general rules of international law.<sup>113</sup> According to the Claimant Czech law plays two roles. First, the Treaty itself provides that Czech law is relevant to the extent that it is more favourable to the investor than the Treaty. Secondly, it is a well-established principle of international law that, before an international tribunal, the host state's domestic law is relevant with respect to factual issues.<sup>114</sup>
197. The Respondent proposes that Czech law enforced during the events described in the Statement of Claim must be applied to the extent relevant to this dispute and to the extent not contrary to international law. According to the Respondent Article 3(5) certainly does not mean that the law of the host state should be disregarded and limited only to cases where it affords better treatment to the investor. There are good reasons why national law needs to be examined before turning to international law. The Respondent further claims that whether the existence of a "commitment" to provide state aid to the Claimant could have arisen in the circumstances must be based upon or consistent with Czech law as in effect.<sup>115</sup>
198. The Tribunal observes that the difference in the position of the Claimant and the Respondent is more apparent than real. The Claimant concedes that a host state's domestic law is relevant with respect to factum and refers to Oppenheim's International Law (9th Edition 1996 by Sir Robert Jennings and Sir Arthur Watts). In the Tribunal's opinion, Czech law is relevant insofar as it prescribes the requirements for making an investment and obtaining state aid. The difference in result if Czech Law is applied as factum or as a governing law is immaterial and to some extent academic. However, the Tribunal notes that Czech law is a governing law under the treaty, although its application as a governing law is always subject to the qualification that in the event of conflict between national law and international law, international law prevails.

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<sup>112</sup> These minutes are quoted in the *CME Czech Republic B.V. v The Czech Republic*, Final Award, dated 14 March 2003, para 91.

<sup>113</sup> Reply Memorial, para 278.

<sup>114</sup> Statement of Claim, paras 227, 231 and 233.

<sup>115</sup> Statement of Rejoinder, paras 40–48

## Fair and equitable treatment

### General standard

199. Chief amongst Invesmart's claims is its submission that the Czech Republic violated the fair and equitable treatment standard which is set out at Article 3(1) of the BIT. This article provides that "each Contracting Party shall ensure fair and equitable treatment to the investments of investors of the other Contracting Party".
200. The Tribunal notes that there has been a growing jurisprudence and case law dealing with the notion of fair and equitable treatment in recent years. The content of this obligation has been variously and not consistently described as including the different strands of protection of an investor's legitimate expectations, protection against manifestly arbitrary or grossly unfair treatment, requiring consistency of governmental decision-making, transparency, due process and adequate notice, protection against discrimination that does not amount to a breach of the national treatment standard and protection against acts of bad faith.
201. The tribunal in *Waste Management v Mexico* sought to bring together various NAFTA awards and to state the law in summary terms:
- [F]air and equitable treatment is infringed by conduct attributable to the State and harmful to the claimant if the conduct is arbitrary, grossly unfair, unjust or idiosyncratic, is discriminatory and exposes the claimant to sectional or racial prejudice, or involves lack of due process leading to an outcome which offends judicial propriety... in applying the standard it is relevant that the treatment is in breach of representations made by the host state which were reasonably relied on by the Claimant.<sup>116</sup>
202. In its Statement of Defence the Respondent correctly noted that the two most fundamental features of the fair and equitable treatment standard are:
- (i) the fact that the violation of that standard occurs only when a certain minimum level of inappropriateness of the host state's conduct is exceeded; and
  - (ii) that the dominant feature of that standard is the protection of the investor's expectations which must, however, be legitimate and reasonable and follow from the state of the domestic law at the time of the investment and the totality of the business environment at the time.
203. In support of these observations the Respondent drew the Tribunal's attention to the *Saluka* Partial Award where that tribunal endorsed and commended ("as a useful guide") *Waste Management's* threshold for infringement of the fair and equitable treatment standard when interpreting the instant Treaty. *Saluka* went on to quote the comments of tribunals in the

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<sup>116</sup> Exhibit C-193, *Waste Management, Inc. v The United Mexican States (No.2)*, ICSID Case No. ARB(AF)/00/3, Award of 30 April 2004, para 98.

*Tecmed, CME, Waste Management* and the *Occidental Petroleum* cases as to the relationship between the notion of “legitimate expectations” and the fair and equitable treatment standard, and stated its view that:

304. This Tribunal would observe, however, that while it subscribes to the general thrust of these and similar statements, it may be that, if the terms were taken too literally, they would impose upon host States’ obligations which would be inappropriate and unrealistic. Moreover, the scope of the Treaty’s protection of foreign investment against unfair and unequitable treatment cannot exclusively be determined by foreign investors’ subjective motivations and considerations. Their expectations, in order for them to be protected, must rise to the level of legitimacy and reasonableness *in light of the circumstances*.

305. No investor may reasonably expect that the circumstances prevailing at the time the investment is made remain totally unchanged. In order to determine whether frustration of the foreign investor’s expectations was justified and reasonable, the host State’s legitimate right subsequently to regulate domestic matters in the public interest must be taken into consideration as well. As the *S.D. Myers* tribunal has stated, the determination of a breach of “fair and equitable treatment” by the host State must be made in the light of the high measure of deference that international law generally extends to the right of domestic authorities to regulate matters within their own borders.<sup>117</sup>

## Legitimate Expectations

### The Claimant

204. The central plank of Invesmart's fair and equitable treatment claim was its contention that it formed a legitimate expectation that the Respondent committed to provide state aid having a certain financial effect upon Union Banka. This expectation was said to have crystallised on 24 October 2002 when, after extensive written and oral communications with various Czech agencies, Invesmart’s third application to acquire control of the bank was approved by the CNB.
205. Invesmart submitted that throughout its discussions with the Czech Government it stated that its investment in the bank was contingent upon a grant of state aid and that its investment was based on an express, or in the alternative an implied, commitment of state aid. The Czech financial authorities were fully aware of its position as Invesmart had communicated this to them. The express promise came from governmental officials and the implicit promise lay in the CNB’s approval which, in the Claimant’s view, would not have been granted had the Ministry of Finance not committed to provide state aid. Therefore, when the CNB approved the acquisition of a controlling shareholding in the bank on 24 October 2002, a promise of state aid enforceable at international law was said to have crystallised.

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<sup>117</sup> See Exhibit C-194, *Saluka* Partial Award of 17 March 2006, paras 288, 304-305, italics in original.

206. Accordingly, Invesmart argued that the Tribunal should find in its favour if it finds that the Czech Republic made an express representation that state aid would be granted, or, alternatively, if the Czech Republic induced Invesmart to acquire the bank and assume the related party loans under circumstances where Invesmart held a legitimate expectation of state aid.<sup>118</sup>
207. The Claimant adduced several categories of evidence in support of its characterisation of the CNB's approval of its acquisition, including:
- (a) written communications between Invesmart, the CNB and the MOF which Invesmart offered as proof that it had stated that its acquisition of Union Banka was subject to state aid being granted;
  - (b) internal government documents which Invesmart offered as proof of the CNB's understanding that Invesmart would not invest in Union Banka absent state aid; and
  - (c) communications surrounding internal government meetings held on 24 September 2002 and 24 October 2002, which Invesmart claimed were pivotal points in its negotiations concerning Union Banka.
208. In developing its submissions it went on to characterise the state aid negotiations following the CNB's approval as changing the rules of engagement once the acquisition had been made.
209. The specific items of evidence adduced by Invesmart in support of its submissions are described in more detail in the paragraphs directly below.

### **Correspondence between Invesmart and the CNB and MOF**

210. The Claimant referred to five examples of written communications with the CNB and the Ministry of Finance where it stated that it would acquire control of Union Banka only if state aid were granted. For example, the minutes of a meeting held on 5 December 2001 between the CNB and Union Banka, just after Invesmart became involved with the bank, noted the contemplated sale of shares in Union Group to Invesmart and recorded that the sale was subject to conditions such as CNB approval and "resolving the Fores (Česká finanční project)" ("**CF Transaction**").<sup>119</sup>

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<sup>118</sup> Transcript, Day 7, Smith, p. 5, lines 20–25, p. 6, lines 1–9.

<sup>119</sup> Exhibit R-34, minutes of a meeting held at the premises of the CNB on 5 December 2001 between the CNB, Union banka, and Union Group.

211. Likewise, by letter dated 26 March 2002 to Pavel Racoča and Vladimír Krejča of the CNB, copied to Marie Parmová (then President of Union Banka), Invesmart's Giuseppe Roselli stated the company's intention to purchase 70 percent of Union Group's shares. Mr Roselli's letter recorded Invesmart's position on the need for the CF Transaction:

In [sic] the same time we are preparing, in cooperation with our advisors, the reconstructing plans for both Union Group and Union banka. We want to finalise the whole transaction in the shortest time, as soon as your approval will be granted, therefore we would appreciate any support for the conclusion of the "Fores-Česká Finanční" deal, which constitutes condition precedent for the contract's completion [sic].<sup>120</sup>

212. Three letters to similar effect followed during the course of the spring and summer of 2002.<sup>121</sup>
213. The Claimant noted that the CNB itself believed that given Union Banka's poor condition, if state aid were not granted, Invesmart would not invest in it. For example, a report prepared by the CNB's Banking Supervision Division, dated 5 September 2002, noted:

Even though Invesmart B.V. has in no written material ever stated entirely unambiguously that if aid is not provided to Union Banka, a.s. it will have no interest at all in acquiring it, it is highly likely, given the bank's situation, that state aid is absolutely essential for the profitability of the whole operation from the point of view of the applicant, and thus also for its decision whether to enter Union Banka, a.s.<sup>122</sup>

214. The Claimant also highlighted a draft unsigned letter that was annexed to the record of the CNB's 5 September 2002 meeting from Governor Tůma to Finance Minister Sobotka. Invesmart argued that the Government "induced" it to acquire the bank through the promise of state aid, citing the draft letter in support of its contention. The draft letter stated:

... it appears that before making a definitive decision on the issue of financing its purchase of a stake in Union Banka, Invesmart B.V. is waiting to find out the Finance Ministry's opinion on the proposal for dealing with the 'Fores problem' that the bank has put forward. The Finance Ministry's decision on this issue is thus likely to have significant consequences for the situation in Union Banka, a.s. The Czech National Bank believes it is unacceptable for the uncertainty concerning the bank's future to be further prolonged for an unlimited time, and so it would welcome if steps could be taken that would induce the applicant to make a decisive statement.<sup>123</sup> [Emphasis added.]

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<sup>120</sup> Exhibit R-36, letter dated 26 March 2002 from Giuseppe Roselli to Pavel Racoča and Vladimír Krejča of the CNB, copied to Marie Parmová.

<sup>121</sup> Exhibit R-31, letter dated 25 June 2002 from \_\_\_\_\_ to Vladimír Franc, Acting Secretary of Česká Finanční; Exhibit R-32, letter dated 28 June 2002 from \_\_\_\_\_ to then-Finance Minister Jiří Rusnok; Exhibit R-53, letter dated 20 August 2002 from Invesmart's Gert H. Rienmüller to First Deputy Finance Minister Eduard Janota.

<sup>122</sup> Exhibit C-291, Report prepared by the CNB's Banking Supervision Division, dated 5 September 2002.

<sup>123</sup> Exhibit C-291, draft letter from the Governor of the CNB to the Minister of Finance annexed to the Report prepared by the CNB's Banking Supervision Division, dated 5 September 2002.

## Meeting of 24 September 2002

215. Invesmart also relied upon two meetings held in the autumn of 2002. The first, held on 24 September 2002, involved the CNB, CKA and Finance Ministry officials, including the newly appointed Finance Minister Bohuslav Sobotka. The troubled state of Union Banka and Invesmart's possible equity participation in the bank was discussed at this meeting.
216. Under the heading "Conclusions", the minutes recorded that the loss from the credit agreement between CF and Union Banka should be covered by the National Property Fund in conformity with the 1996 government stabilisation fund, and in case of a change to the agreement, the Office for the Protection of Economic Competition (OPC) "will need to be consulted and government approval will be required". There was also a discussion of the form of state aid, namely, a reduction of the interest rate for the CF deposit in Union Banka from 11.5 percent to approximately 3.5 percent and the purchase of bad quality loans "according to selection by CKA against a decrease of the Česká Finanční deposits".<sup>124</sup>
217. The Claimant placed particular emphasis on the recording in the minutes that "the minister of finance is ready to submit a document for the state aid defined in this way for the government session".<sup>125</sup> The Claimant submits that this demonstrated that the amount and structure of state aid had been agreed; that, as matters stood, the consent of the OPC was *not* needed for its granting; and that the Minister undertook as of 24 September 2002 to submit the initiative to the government for its approval.<sup>126</sup>
218. The minutes proceeded to set out the next steps to be taken. These were that the Ministry of Finance and the CKA "will discuss the state aid with Invesmart by 25 October 2002 at the latest", the CNB "will notify Invesmart on necessity of submitting the documents" to obtain CNB approval, and the Ministry of Finance and the CKA "will discuss the form of the state aid with OPC as settlement of the stabilization programme following return of OPC representatives from Brussels by 1 October 2002 at the latest".<sup>127</sup>
219. Although Invesmart was not represented at the 24 September 2002 inter-agency meeting, it adduced evidence that the contents of the discussion and the decisions taken were

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<sup>124</sup> Exhibit R-60, minutes of a meeting at the Ministry of Finance on 24 September 2002 regarding Union Banka.

<sup>125</sup> *Id.*

<sup>126</sup> Transcript, Day 1, Smith, p. 25, lines 13–25, p. 26; Transcript, Day 1, p. 159, lines 3–18.

<sup>127</sup> Exhibit R-60, minutes of a meeting held at the Ministry of Finance on 24 September 2002 regarding Union Banka.



communicated to it the next day.<sup>128</sup> This was acknowledged by the CKA's Mr. Pavel Řežábek in his second witness statement.<sup>129</sup>

220. Following the 24 September 2002 meeting, there were a number of communications on the Invesmart proposal between senior Czech officials. These documents were disclosed to the Claimant in response to its request for production of documents. For example, by letter dated 7 October 2002, Minister Sobotka wrote to the CNB Governor advertizing to Invesmart's earlier proposal and noting that the conditions of the entry of the investor to the bank had since been "mutually defined". He referred to the CF matter and noted that on 25 September 2002, a meeting was held at the office of the First Deputy Minister of Finance's office at which representatives of Invesmart gave a binding promise to provide the documents that had been missing in Invesmart's first application for acquisition of control of Union Banka.<sup>130</sup>

221. A reply to Minister Sobotka's letter, dated 11 October 2002, was sent by Oldřich Dědek of the CNB. Referring to the CNB's rejection on 4 October 2002 of Invesmart's second application to acquire the bank due to the missing documents, Mr Dědek noted that while Invesmart had stated that it would supply the requested documents and it had also confirmed that its entry into the bank was "still subject to the state aid in resolving the problem of the receivable of Česká Finanční, s.r.o. due from this bank". Mr. Dědek continued: "Given the above, we may state that, if the state aid is refused, Invesmart B.V. will most probably cease its effort to enter into Union banka, a.s." He thus requested the Ministry of Finance to communicate "its clear standpoint to the representatives of Invesmart B.V."<sup>131</sup> The Claimant construed these letters as confirming its view that the CNB would not have later approved its share acquisition without the Ministry of Finance's having first agreed to provide state aid.

### **Meeting of 24 October 2002**

222. The second meeting upon which Invesmart relied took place on 24 October 2002, the same day as the CNB approved Invesmart's acquisition of indirect control of Union Banka. This was a meeting of the CNB's Bank Board which the Minister of Finance also attended. An excerpt of the record of the meeting, produced by the Respondent in response to the Claimant's request for production of documents, recorded that Union Banka was discussed. The minutes, which were in summary form, noted:

The Bank Board noted the oral details provided by Mr. Sobotka about the Czech Finance Ministry's point of view with regard to negotiations with the foreign

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<sup>128</sup> Transcript, Day 1, p. 159, lines 3–14.

<sup>129</sup> Second witness statement of Pavel Řežábek; Transcript, Day 1, Smith, p. 40, lines 18–25, p. 41, lines 1–2.

<sup>130</sup> Exhibit R-72, letter dated 7 October 2002 from Minister Sobotka to Governor Tůma.

<sup>131</sup> Exhibit R-74, letter dated 11 October 2002 from Oldřich Dědek to Minister Sobotka.

investor and the Banking Supervision Department's approach to dealing with Invesmart's latest application for approval to its purchasing of a stake in Union Group, a.s. and Union Banka, a.s.<sup>132</sup>

223. The Claimant acknowledged that the minutes did not record what the Minister actually said at the meeting, but contended that it could be inferred from the surrounding circumstances that he must have stated his intention to obtain the required state aid package at that meeting.
224. Those circumstances included: (i) Invesmart's application had been expressly conditioned throughout on that requirement; (ii) Invesmart's third application for the CNB's approval had been submitted only two days previously; (iii) the CNB had been pressing the Ministry of Finance for its "clear standpoint" on state aid; (iv) the bank's situation was serious due to a run on the bank after a CNB spokeswoman had commented on the rejection of Invesmart's second application on 22 October 2002; and (v) the fact that CNB's approval of the third application occurred after the Finance Minister made his comments to the Bank Board.<sup>133</sup> The totality of the circumstances, Invesmart argued, allow the Tribunal to infer that the Minister must have stated his support for the requested state aid and Invesmart reasonably formed the expectation that that was the case when its third application was approved only two days after it was submitted to the CNB.<sup>134</sup>
225. Invesmart observed further that the day after the CNB approved its acquisition, a meeting was held between a Finance official, Josef Doruška, and two Euro-Trend representatives and the only form of state aid discussed there was the CF Transaction. The minutes record Mr Doruška asserting that "the only hope, in view of time pressure as well, is to proceed" with an amendment to the loan contract with CF.<sup>135</sup> This indicated, in Invesmart's view, that the form of state aid had been agreed.<sup>136</sup>
226. From the submissions made at the hearing, it appears that for the Claimant the significance of the CNB's approval was twofold. First, it was said to constitute a commitment by the

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<sup>132</sup> Exhibit C-292, record of the 42<sup>nd</sup> meeting of the CNB Bank Board held on 24 October 2002.

<sup>133</sup> Transcript, Day 4, Sobotka, p. 31, lines 815.

<sup>134</sup> During the hearing, counsel for Invesmart also cross examined both Governor Tůma and Mr. Sobotka on precisely what the latter said at the 24 October 2002 meeting: Transcript, Day 4, Smith-Sobotka, p. 28, lines 14–25, p. 30, lines 1–8, p. 32, lines 17–25, p. 33, lines 1–21; Transcript, Day 4, Smith-Tůma p. 156, lines 7–16, p. 157, lines 15–25, p. 158, lines 1–16. The Claimant also referred to Exhibit C-302, letter dated 17 February 2003 from Governor Tůma to Minister Sobotka, which referred back to the 24 October 2002 meeting and in recapitulating the meeting stated that "[a]t this stage, the Ministry of Finance said that it was prepared to submit the proposal for State aid to the Czech Government for discussion, with a view to resolving the situation at Union Banka, subject to approval from the Czech Office for the Protection of Economic Competition." The Claimant considered that the Minister had been more emphatic at the 24 September 2002 meeting than he acknowledged at the hearing: Transcript, Day 7, Smith, p. 12, lines 6–25, p. 17, lines 3–25, p. 18. Counsel also pointed out that Mr. Sobotka's two witness statements failed to address his attendance at the meeting.

<sup>135</sup> Exhibit C-60, record of a meeting held at the offices of Euro-Trend on 25 October 2002 with Josef Doruška, Ministry of Finance.

<sup>136</sup> Transcript, Day 1, Smith, p. 33, lines 6–22.

Respondent that state aid would be granted. Secondly, it was asserted that the CNB approved the acquisition knowing that Invesmart would be taking on a €90 million obligation in connection with the assumption of certain related-party loans.<sup>137</sup> Invesmart pointed out that appended to its 22 October 2002 application to the CNB were its Share Purchase Agreements with the selling shareholders, together with various addenda thereto.<sup>138</sup>

### **Claimant's characterisation of negotiations following CNB approval**

227. During the hearing, the Claimant developed the point that after the CNB's approval was granted, the Czech authorities changed the rules of engagement and began to impose new conditions on the granting of state aid. This culminated in the denial of state aid to Invesmart, contrary to its expectation. The Claimant argued that it was only after the CNB acted and Invesmart had bound itself to acquire the shares in Union Banka and Union Group that these conditions were brought to its attention. Invesmart argued that at this point the structure of what was acceptable to the government changed and hurdles began to be raised that were inconsistent with its expectation that the CNB's prior approval of 24 October had resolved the issue of state aid in its favour.
228. This argument relates both to the legitimate expectations claim and to the separate alleged violation of Article 3, namely, the claimed inconsistent treatment of Invesmart's investment by the Czech authorities. Insofar as the legitimate expectation argument is concerned, the Claimant referred principally to two events.
229. First, it noted that unbeknownst to Invesmart, the Deputy Prime Minister of the Czech Republic had represented to the European Union that the Republic would not grant any new state aid to the banking sector.<sup>139</sup>
230. Secondly, Invesmart adverted to the meeting between the Ministry of Finance, CKA and Invesmart representatives on 5 November 2002 at which the bank's First Plan was reviewed and Invesmart was informed of the internal discussions that had been held with the OPC. It was advised that any aid had to be "targeted, limited and pre-approved by the OPC" and had to be approved by the government. In addition, it was told that if the solution proposed in the material presented was chosen, the material required further work.<sup>140</sup> Invesmart asserted that this marked the beginning of a series of demands for more detail and shifting mechanisms of delivering state aid, the effect of which was inconsistent with what it had been led to believe

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<sup>137</sup> *Id.*, p. 12, lines 18–21.

<sup>138</sup> Transcript, Day 7, Smith, p. 43, lines 14–25, p. 44, p. 45, lines 1–8.

<sup>139</sup> *Id.*, p. 49, lines 3–25.

<sup>140</sup> Exhibit C-61, minutes of a meeting held on 5 November 2002 between the Ministry of Finance, CKA, Invesmart and Euro-Trend.

would occur after the CNB approved its acquisition of indirect control of Union Banka and its shareholders authorised the capital increase. The Claimant emphasised that the 5 November 2002 meeting occurred the day after Invesmart's shareholders had ratified their 16 October 2002 decision to increase the company's share capital by €90 million, i.e., *after* one of the conditions precedent for the completion of the SPAs with the selling shareholders was removed.<sup>141</sup>

231. By way of example, Invesmart pointed to the discussion at the 5 November 2002 meeting where the CKA's Mr Řežábek raised the possibility of whether the CNB (not represented at the meeting) could recognise the BDS Arbitration Claim as a mechanism for providing state aid. Mr Řežábek suggested that this possibility offered a "purely commercial solution" that would bail out the bank but not require the competition authorities' approval.<sup>142</sup> This proposal was rejected by the CNB on 8 November 2002. The Claimant saw this as a troubling sign of inconsistent treatment (a point to which the Tribunal will return below).
232. With the BDS Receivable suggestion off the table, the discussions reverted to variations on the CF transaction and another possibility, which was to issue a state guarantee for the repayment of a selected group of debts. These were examined at another meeting between the Ministry of Finance, the OPC, the CNB, the CKA, Union Banka, Euro-Trend and Invesmart held on 29 November 2002. The meeting "aimed to achieve consensus" on how the Finance Ministry and Invesmart should proceed in relation to the OPC. The minutes noted that a decision from the OPC was a necessary condition for the government's final decision on the granting of state aid.<sup>143</sup>
233. The competition authorities also advised at this meeting that the request and its accompanying material, particularly the restructuring plan, would have to fully respect the EC's *Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty*. It would also have to be shown why the bank could not survive in the market without state aid and the reasons why its existence should be preserved, "in other words, that state aid was essential (including why the shareholders or other parties could not rescue the bank themselves)".<sup>144</sup> The Claimant also asserted that the record showed that the Minister of Finance's requests for state aid regularly succeeded in being approved by Cabinet.<sup>145</sup> This confirmed, in Invesmart's view, the reasonableness of its expectation that once the 24 September 2002 meeting's results had been

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<sup>141</sup> Transcript, Day 7, Smith, p. 58, lines 9–22.

<sup>142</sup> Exhibit C-61, minutes of a meeting held on 5 November 2002 between the Ministry of Finance, CKA, Invesmart and Euro-Trend.

<sup>143</sup> Exhibit C-63, minutes of a meeting held on 29 November 2002 between the Ministry of Finance, the UOHS, the CNB, the CKA, Union Banka, Euro Trend and Invesmart.

<sup>144</sup> *Id.*

<sup>145</sup> Transcript, Day 7, Smith p. 52, lines 16–22.

communicated to it, with the CNB then having approved its acquisition of indirect control of Union Banka, state aid had been promised.

### **Amount of state aid**

234. The disputing parties disagreed as to whether the amount of state aid discussed between August and September 2002 was CZK 650 million in total, or a (larger) grant of state aid that conferred a net benefit of CZK 650 million on the bank. In this regard, Invesmart observed that although the CZK 650 million figure was discussed, from the outset, the Czech authorities understood that the cost to the State would be greater than that sum and that any risk associated with the quality of the CF loan portfolio was clearly to be borne by the government.<sup>146</sup> It pointed to a memorandum dated 10 September 2002 prepared by the Czech Consolidation Agency for Finance Minister Sobotka, which set out the CKA's position on the proposed settlement of relations between CF and Union Banka presented by Invesmart in August 2002. The memorandum noted that the reduction in the interest rate on the Fores deposit would create a retroactive loss to CF of approximately CZK 207 million and a future interest loss of approximately CZK 251. As for the assumption of problem receivables, this would result in a loss of approximately CZK 330–771 million.<sup>147</sup> At the upper end of the estimate, the state aid would cost the government more than CZK 1 billion. Invesmart pointed to this as proof that the parties had previously distinguished between the net impact of the grant of state aid on Union Banka and the cost to the government of providing such aid.
235. The Claimant stressed its view that notwithstanding the Respondent's position in this arbitration, in September-October 2002 the parties were in agreement as to the effect of the state support in connection with Invesmart's acquisition, namely, support in the form of the CF Transaction which would result in an uplift to the net asset value of Union Banka of CZK 650 million.<sup>148</sup>
236. As noted in the Facts, on 20 February 2003, the Minister of Finance decided against recommending state aid for Union Banka. The bank closed its doors the next day and an administrative proceeding for the revocation of its licence was immediately initiated by the CNB. The Tribunal will address these events in its discussion of the expropriation claim. For present purposes, it is not necessary to enter into a discussion of the reasons for the denial of state aid because the consideration of the legitimate expectations claim simply requires the

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<sup>146</sup> Transcript, Day 1, Smith, p. 28, lines 14–25, p. 29, lines 1–3, p. 30, lines 11–16.

<sup>147</sup> Exhibit R-54, letter dated 10 September 2002 with enclosed memorandum from Pavel Řežábek, Chairman of the Board of CKA, to Minister Sobotka.

<sup>148</sup> Transcript, Day 1, Smith, p. 23, lines 21–25, p. 24, lines 1–7, letter from Pavel Řežábek, Chairman of the Board of CKA, to Minister Sobotka., .

Tribunal to proceed on the basis that the expectation said to have crystallised on 24 October 2002 was not met.

### The Respondent

237. The Respondent argued that neither the factual record nor the governing law supported the legitimate expectations claim.
238. It began by asserting that as a matter of Czech law and European Union (EU) law, there was no right to state aid; indeed, state aid is forbidden unless its granting is permitted by the relevant competition authorities. Noting that Article 8(6) of the BIT specifies that the Tribunal must decide “on the basis of the law, taking into account in particular though not exclusively”, *inter alia*, “the law in force of the Contracting Party concerned” and “the provisions of ... other relevant Agreements between the Contracting Parties”, the Respondent asserted that under both its own domestic law and under the various agreements to which The Netherlands and the Czech Republic were party at the time, including the treaty of accession governing the Czech Republic’s admission to the EU, there were prohibitions on the granting of state aid in 2002. Therefore, there could be no legally enforceable right to the grant of state aid.<sup>149</sup>
239. Given that the law of the host state did not confer a general right to state aid, but rather prohibited aid unless an exemption was granted, the Respondent argued that there could be no legitimate expectation which is contrary to the law of the host state:
- No investor, can hold, at least not legitimately and not in the absence of the clearest possible commitment made by the state concerned, an expectation which the law of the host state contradicts.<sup>150</sup>
240. On a related point, the Respondent challenged the Claimant’s general approach to the governing law in this proceeding which, in the Respondent’s view, had avoided dealing in particular with the Czech law aspects of the case. In the Respondent’s view, the Czech law was extremely important in terms of the governing law.<sup>151</sup>
241. The Respondent also took issue with the Claimant’s characterisation of the acts of various Czech entities as constituting a promise or commitment of state aid. In its submission, there must be a concrete, specific promise in writing and there was no such document on the record.<sup>152</sup> With no explicit promise in writing unequivocally promising state aid to Union Banka, the Respondent argued that there could also be no expectation of state aid based upon

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<sup>149</sup> Transcript, Day 1, Crawford, p. 120, lines 12–22.

<sup>150</sup> *Id.*, p. 120, lines 12–15.

<sup>151</sup> Transcript, Day 7, Crawford, p. 159, lines 5–25, p. 160, lines 1–25, p. 161, lines 1–21.

<sup>152</sup> Transcript, Day 1, Crawford, p. 126, lines 15–18.

an implied or constructive promise.<sup>153</sup> In its view, the Claimant was calling upon the Tribunal to construct a promise out of the materials before it. This was not possible because the granting of aid was a voluntary matter and could only be enforced as a legitimate expectation if the State made an actual promise to deliver the aid.<sup>154</sup> One would fully expect in a matter as important as this that the representation sought to be enforced would be in writing and be unequivocal.

242. Insofar as the Claimant sought to tie the CNB's approval of Invesmart's application for approval of its acquisition of control of Union Banka to a commitment of state aid by the Ministry of Finance, the Respondent argued that the CNB's approval was simply an approval of a shareholding interest, a "prior approval" in a multi-stage acquisition process and nothing more.<sup>155</sup> One of the Respondent's Czech law experts, Dr Petr Kotáb, had opined that under Czech law, the CNB's approval is designed to prevent the entry into the banking sector of persons whose activities may be detrimental to the system's stability.<sup>156</sup> This supported the Respondent's view that what the CNB did on 24 October 2002 was no more than a prior approval. The Respondent is, and was at the time, a party to the *Convention on Laundering, Search, Seizure and Confiscation of the Proceeds of Crime* which requires it to ensure that funds invested in its financial institutions were *bona fide*.<sup>157</sup> The CNB had to satisfy itself that Invesmart's funds met this requirement. Beyond that, the CNB's approval was a necessary step in Invesmart's acquisition of indirect control of the bank, but the approval did not oblige Invesmart to complete that acquisition. Therefore, when the CNB issued its approval on 24 October 2002, that act could not reasonably be viewed to be a commitment to grant state aid by another state entity vested with that power, i.e., the Ministry of Finance.<sup>158</sup>
243. The Respondent argued further that there was a fundamental distinction to be drawn between a binding promise and a legitimate expectation. In its closing submission, the Respondent argued that a binding promise occurred when it could be clearly established that the state made a commitment of a particular kind, which was sufficiently specific that the investor could rely on it. A legitimate expectation was, on the other hand, "a modality of fair and equitable

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<sup>153</sup> *Id.*, p. 125, lines 21–25.

<sup>154</sup> *Id.*, p. 125, lines 9–13.

<sup>155</sup> Transcript, Day 7, Crawford, p. 195, lines 7 and 21, p. 196, lines 11–18.

<sup>156</sup> *Id.*, p. 160, lines 10–15.

<sup>157</sup> Exhibit R-127, *Convention on Laundering, Search, Seizure and Confiscation of the Proceeds of Crime* of 8 November 1990, to which the Respondent acceded on 1 March 1997. The Respondent pointed out that under Section 20(a) of the Banking Act, it was expressly prohibited from granting approval for the acquisition of a participation in a Czech bank unless compliance with the Convention was assured. Thus, Section 9(3)(c) of Decree of the CNB No. 166/2002 Coll., dated 8 April 2002 (Exhibit R-307), required an applicant to submit "evidence regarding the origin of funds of the applicant, which will be used in the purchase of the shares in a bank or with the use of which a participation in a person through which an indirect participation in a bank was acquired."

<sup>158</sup> Transcript, Day 7, Crawford, p. 195, lines 13–25, p. 196, lines 1–6.

treatment", not to be equated with anything analogous to a contract. Even assuming *arguendo* that, on the facts of this case, the Respondent had given the Claimant an expectation of aid in the amount sought in the Third Restructuring Plan, CZK 1.762 billion, the state could give an investor an expectation of a certain treatment but in the end, that still did not mean that in failing to accord such treatment, the state had breached the fair and equitable treatment standard. Situations can change and an expectation is not a guarantee; nor is it an estoppel by a government that it could not act in light of changed circumstances.<sup>159</sup>

244. As for the terms of the alleged promise the Claimant sought to enforce, the Respondent argued that there cannot be a commitment without the content being sufficiently agreed. Even if there could have been a legitimate expectation of aid, it had to be a precise expectation and in the Respondent's view, the content and conditions of the alleged commitment changed materially after the date on which the expectation was said to have crystallised.<sup>160</sup> The Respondent took issue with the Claimant's argument that the amount of state aid was agreed as of that date. It also challenged the suggestion made at the hearing that the objective of the exercise had been to return Union Banka to a capital adequacy ratio ("CAR") of 14 percent. In the Respondent's view, there was nothing in the record evidence that made any reference to achieving that capital adequacy ratio.<sup>161</sup> The Respondent suggested that the reason why the Claimant had advanced the 14 percent CAR result was that nothing else would have sufficed. The evidence showed that as the new management of Union Banka familiarised themselves with the bank's finances, they discovered that the problems were greater than they had thought.<sup>162</sup>
245. The Respondent also took issue with the Claimant's contention that the amount and form of state aid had been agreed by 24 October 2002. In its view, the evidence showed that the amount and conditions for the granting of the state aid at issue changed over time and materially so after the CNB's grant of approval which had allegedly crystallised the commitment. Pointing to the Third Restructuring Plan, submitted to the Ministry of Finance on 12 February 2003, the Respondent noted that the amount of aid then being sought was considerably higher than what had been sought by Invesmart in its initial 20 August 2002 letter to the Ministry of Finance.<sup>163</sup>
246. The Respondent also disputed a number of the factual elements of the Claimant's case. It pointed to contemporaneous documents which showed that Invesmart was aware of the need

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<sup>159</sup> *Id.*, p. 163, lines 3–18, p. 164, line 25, p. 165, lines 1–8.

<sup>160</sup> Transcript, Day 1, Crawford, p. 126, lines 24–25, p. 127, lines 1–8.

<sup>161</sup> *Id.*, p. 128, lines 10–24.

<sup>162</sup> *Id.*, p. 129, lines 5–24.

<sup>163</sup> Transcript, Day 7, Crawford, p. 166, lines 8–12, pp. 179–181.



for the OPC's approval months before it filed its third application with the CNB.<sup>164</sup> It asserted that, contrary to its pleading in this proceeding, Invesmart did not make its investment contingent upon the CNB's approval and the implicit approval of state aid now claimed to be bound up in that approval. In this regard, the Respondent reviewed the documents amending the Share Purchase Agreements and argued that Invesmart had become an obligor with liabilities under the amended Share Purchase Agreements in mid-August 2002 (six weeks before Invesmart's second application was rejected by the CNB and over two months before its third application was approved) and hence, contrary to Invesmart's plea in this proceeding, it did not condition its acquisition of liabilities in connection with its assuming indirect control of Union Banka upon the granting of state aid.<sup>165</sup>

247. The Respondent also noted that the legitimate expectation claim had to be evaluated having regard to the state's "margin of appreciation" recognised by international law. This margin is particularly wide, it was argued, when it comes to state aid and there was no case where a breach of fair and equitable treatment had been found as a result of a regular exercise of inherently discretionary governmental powers such as a refusal of state aid.<sup>166</sup>

248. Finally, insofar as the Basel Committee's Guidelines had been relied upon in support of the legitimate expectations claim, the Respondent did not see such standards as being relevant to determining a breach of the fair and equitable treatment standard. The Guidelines addressed "best practices" and were by their own terms non-binding. They could not be equated with an international legal obligation, breach of which gave rise to a breach of Article 3 of the Treaty.

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### **The Tribunal's analysis - General Approach**

249. In the Tribunal's view, six propositions are relevant to its consideration of this claim.

250. First, although an investor's expectation is subjective, i.e., what the investor believed to be the import of its dealings with government officials on which it claims to have relied, for the Tribunal, the test of whether such an expectation can give rise to a successful claim at international law is an objective one. It is not enough that a claimant have sincerely held an expectation; the expectation must be reasonable and the Tribunal must make the determination of reasonableness in all of the circumstances. If the expectation was unreasonable (for

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<sup>164</sup> *Id.*, p. 196, lines 23–25, p. 197, lines 1–25.

<sup>165</sup> Transcript, Day 7, Horáková p. 145, lines 9–16, Douglas, p. 216, lines 5–12, p. 197, lines 3–25, p. 198, lines 7–25.

<sup>166</sup> Transcript, Day 7, Crawford, p. 168, lines 14–21.

<sup>167</sup> *Id.*, p. 192, lines 22–25, p. 193, lines 1–16.

example, ill-informed or overly optimistic), it matters not that the investor held it and it will not form the basis for a successful claim.

251. Secondly, a source of contemporaneous evidence of the investor's expectation can be the contractual documents by which it acquired its investment or otherwise dealt with the seller of the investment where it purchased an existing investment.
252. Thirdly, there is a temporal dimension to evaluating a claimed expectation. To the extent that the expectation is based upon the investor's reliance upon the acts and/or statements of the responsible government officials, it must be based on how the officials actually dealt with the investor at the time.
253. For example, in the Tribunal's view, it is not appropriate to base a claimed expectation upon the content of internal governmental discussions to which the investor was not privy at the time. If the contents of a particular governmental discussion or deliberative process to which the investor was not a party were nevertheless disclosed to it, they can contribute to the investor's expectation. However, if it was not privy to a discussion nor informed of its results, the investor cannot use documents disclosed in a subsequent arbitration as proof of its expectation at the time. Such documents can confirm a claimed expectation, but they cannot be used to establish a particular factual element of a claimed expectation if such element was unknown to the investor at the time.<sup>168</sup>
254. Fourthly, the due diligence performed when the investor made its investment plays an important role in evaluating its expectation. A putative investor, especially one making an investment in a highly regulated sector such as financial services, as in the instant case, has the burden of performing its own due diligence in vetting the investment within the context of the operative legal regime.
255. Fifthly, and related to the fourth point, an investor's expectations must be based on the legal regulatory regime in place in the host state. Although there has been a suggestion in some cases that the investor's subjective expectations are to be given substantial weight, they are not to be the definitive source of the host state's obligations. In this regard, the Tribunal agrees with the point made in *Saluka* that:

The scope of the treaty's protection of foreign investment against unfair and inequitable treatment cannot exclusively be determined by the foreign investor's subjective motivations and expectations. Their expectations in order to be protected

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<sup>168</sup> For example, prior to this proceeding, Invesmart had no knowledge of Minister Sobotka's attendance at a meeting held on 24 October 2002 of the Bank Board of the CNB (Transcript, Day 7, Bernardini-Smith, p. 15, lines 4-16). This evidence could only be used to confirm an expectation then held by Invesmart.

must rise to the level of legitimacy and reasonableness in light of the circumstances.<sup>169</sup>

256. As noted in the decision of the *ad hoc* Annulment Committee in *MTD v Republic of Chile*:

... The obligations of the host State towards foreign investors derive from the terms of the applicable investment treaty and not from any set of expectations investors may have or claim to have. A tribunal which sought to generate from those expectations a set of rights different from those contained in or enforceable under the BIT might well exceed its powers, and if the difference were material might do so manifestly.<sup>170</sup>

257. The Tribunal agrees with that statement and observes that when ascertaining the Respondent's obligations under the Treaty, the Tribunal must have regard to the governing law which, in the instant case, includes the law of the host state and other relevant international agreements to which the Contracting States are party. It is the Treaty which guides the Tribunal in determining whether an investor's subjective expectation is legitimate.

258. Sixthly, it is important to distinguish between the various entities of the state. While the acts of governmental entities are attributable to the state for the purposes of international responsibility, the fact of attribution cannot be used to obscure the allocation of different competencies between different entities of the state when the issue of breach is determined. The investor deals with the state in its various emanations. Barring some kind of agency relationship, one entity of the state not vested with actual decision-making authority cannot be taken to bind the entity which by law possesses the actual authority. In the instant case, to the investor's knowledge, there was a division of jurisdiction, powers and responsibilities between the Ministry of Finance, the CKA, the OPC and the Czech National Bank, a point to which the Tribunal will revert below.

### **Detailed analysis**

259. As noted above, Invesmart's case is that it received an express, or in the alternative, an implicit commitment of state aid from the Respondent. With respect to the latter, Invesmart claims that it held a legitimate expectation that given its repeated prior statements that state aid was an essential condition of its investment and its understanding of what the internal thinking of the Czech financial authorities was (or must have been), the CNB could only have given its approval on 24 October 2002 on the basis of a prior commitment by the Ministry of Finance to provide the requisite state aid. Invesmart claims that it was reasonable on its part to have then ratified its earlier approval of the capital increase and to assume the related party loans.

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<sup>169</sup> Saluka Partial Award of 17 March 2006, para 304.

<sup>170</sup> *MTD Sdn. Bhd. And MTD Chile S.A. v. Republic of Chile*, ICSID Case No. ARB/01/7, Decision on Annulment, 21 March 2007, para 67, cited with approval by *Biwater Gauff (Tanzania) Ltd. v. United Republic of Tanzania*, ICSID Case No. ARB/05/22, para 600.

260. Before proceeding with its detailed analysis of the claim, the Tribunal finds it helpful to summarise certain points elicited from [redacted] because his testimony had the effect, in the Tribunal's view, of narrowing the legitimate expectations claim from the way in which it was advanced in the written pleadings. The Tribunal was struck by three points elicited from [redacted] on: (i) whether an express promise of aid was made to Invesmart; (ii) what the CNB's role in the events at issue was; and (iii) the Claimant's awareness of the potential role of the OPC.

261. [redacted] admitted that Invesmart received no written promise of state aid from the Respondent.<sup>171</sup> In terms of an oral promise, [redacted] was, in the Tribunal's view, vague about who made such a promise. He testified that "several people within the Czech Government" made such a promise.<sup>172</sup> But when asked to name someone who did so, he responded "there was – the information we were given by the Minister of Finance"<sup>173</sup> and when asked whether he was referring to Minister Sobotka, he responded:

Yes. Not directly; from his office. We also consider – and I didn't have the chance to finish what I was saying, but we also consider that the approval from the Czech National Bank to our acquisition of Union banka was implicitly a binding promise or commitment of state aid.<sup>174</sup>

262. He testified further that:

Someone promised me, or we understood a commitment was to help Union banka to increase its value of 650 million.<sup>175</sup>

263. This testimony is not sufficiently cogent and precise to support the claimed express promise of state aid. The witness could reasonably be expected to have a precise recollection of specifically who in the government promised state aid because that is such a material fact for this limb of the Claimant's case. The witness should have been able to specify names and the circumstances in which such an important commitment was claimed to have been given. Yet the testimony on this point was vague and tentative. This, combined with [redacted]'s retreating to the CNB's approval as an implicit promise of aid, leads the Tribunal to view the legitimate expectations claim as being more properly founded upon an alleged implicit promise of state aid.

264. That implicit promise was said to be bound up in the CNB's approval on 24 October 2002. Reflecting Investmart's awareness at the material time of the allocation of different

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<sup>171</sup> Transcript, Day 1, [redacted], p. 166, lines 10–19.

<sup>172</sup> *Id.*, p. 165, line 10.

<sup>173</sup> *Id.*, p. 165, lines 12–13.

<sup>174</sup> *Id.*, p. 165, lines 15–20.

<sup>175</sup> *Id.*, p. 167, lines 10–12.

jurisdictions, powers and responsibilities between the various state entities, conceded that the CNB could not promise state aid because it was a banking regulator.<sup>176</sup> When asked whether Governor Tůma had ever stated that “we understand that by giving permission we accept a commitment to pay state aid”, [redacted] responded, “No, no, he never said that”.<sup>177</sup> Insofar as the period prior to 24 October 2002 was concerned, when asked whether there was any document from the CNB promising state aid if Invesmart obtained CNB approval, [redacted] testified, “No, I don’t remember specifically”.<sup>178</sup>

265. This means, in the Tribunal’s view, that the CNB’s approval in itself cannot be taken to have amounted to an implicit commitment because Invesmart understood that it had no role in the decision whether to grant state aid. This in turn narrows the inquiry to the Claimant’s contention that the CNB would only have approved its application if it had had a concrete statement from the Minister of Finance that state aid was going to be granted. The Tribunal will revert to this below.
266. As for the role of the OPC [redacted] acknowledged that when Invesmart was debriefed about the 24 September 2002 inter-agency meeting, he was told that the advice of the OPC was being sought “in order to get their advice on the viability as far as the EU issues were concerned”.<sup>179</sup> He agreed that the OPC was the entity of the Czech Republic that was to decide whether the reduction of the interest rate on the Fores deposit would constitute state aid.<sup>180</sup> He also acknowledged that he was told by Union Banka’s consultants, Euro-Trend, on 25 October 2002 (one day after the CNB had approved Invesmart’s acquisition of indirect control of the bank) of the commitment made in writing to the EU by Deputy Prime Minister Rychetský that the Respondent did not anticipate providing any further state aid to the Czech banking sector.<sup>181</sup>
267. [redacted]’s testimony that he was made aware of the OPC’s role as a result of the 24 September 2002 meeting, that it would determine whether lowering the Fores interest rate constituted state aid, and that Euro-Trend was informed of the Rychetský letter to the EU on 25 October 2002 – eleven days before Invesmart’s shareholders ratified their earlier approval of the €90 million capital increase – is also relevant to the Tribunal’s consideration of the legitimate expectation claim.

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<sup>176</sup> *Id.*, p. 165, line 25, p. 166, line 1.

<sup>177</sup> *Id.*, p. 169, lines 23–25, p. 170, line 1.

<sup>178</sup> *Id.*, p. 170, lines 4–7 and 22–25, p. 171, lines 1–4.

<sup>179</sup> *Id.*, p. 174, lines 23–25, p. 175, line 1.

<sup>180</sup> *Id.*, p. 176, lines 4–8.

<sup>181</sup> *Id.*, p. 176, lines 14–25, p. 177, lines 1–8.

268. With these points in mind, the Tribunal now turns to what it considers to be the key issues bearing on the claim.

### **The law on state aid**

269. There is no legal entitlement to state aid at international law. As an exercise of its sovereignty, leaving aside any treaty obligations it may have, a State has the discretion to decide whether or not to grant aid. On the facts of this case, there was nothing in Czech law which affirmatively stated that state aid would be granted upon request and a properly advised investor would understand that to be the case.

270. In fact, rather than obliging signatory states to grant aid, the member States of the EU have to the contrary undertaken *not* to grant it within the common market. That is, they have agreed to constrain their previously unfettered right to grant aid in order to achieve the goal of free competition. As an aspiring member of the EU, the Czech Republic was one such state at the material time in this case.

271. Under Article 8(6) of the BIT, the Tribunal must have regard both to Czech law and the provisions of "other relevant Agreements between the Contracting Parties". The relevant EU instruments and the Czech law implementing them fall within these categories. Under those regimes (the national and the supranational, which were consistent with each other in 2002 as the Czech Republic moved towards full accession to the Treaty of Rome), there could be no *prima facie* legal right to the granting of state aid. To the contrary, Section 2 of the Law on state aid affirms that aid is forbidden if the OPC does not authorise an exemption from the prohibition.<sup>182</sup>

### **Due diligence**

272. One element relevant to judging a legitimate expectation claim is whether the investor could have made itself aware of the regulatory issues that faced its investment. Some tribunals have characterised this as an issue of transparency. International agreements that have contained express transparency obligations have cast them in terms of a duty imposed on the state to publish its laws and regulations so as to allow a private party to familiarise itself with them and be able to conduct its business affairs accordingly.<sup>183</sup>

273. Czech law and the relevant international agreements between the two Contracting States to the Treaty were both readily discoverable by the Claimant in 2001-2002. The regulatory practice

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<sup>182</sup> Exhibit R-183, Act on State Aid of 24 February 2000; First and Second Expert Reports of Dr. Claus-Dieter Ehlermann.

<sup>183</sup> See, for example, Article X of the *General Agreement on Tariffs and Trade 1994*.

of the Czech Republic in the area of state aid was becoming more stringent in view of its impending accession to the Treaty of Rome. In the Tribunal's view, this too was discoverable to the Claimant. The expert evidence of Professor Claus-Dieter Ehlermann adduced by the Respondent shows that the relevant law and guidelines were available to be consulted had Invesmart decided to retain counsel on this matter.<sup>184</sup> Those materials posited relatively stringent requirements for granting an exemption to the prohibition on state aid. Counsel would have been able to examine publicly available information on the materials needed to request state aid and the types of considerations applied by national and supranational agencies when evaluating state aid proposals.

274. During the hearing, [redacted] acknowledged that Invesmart did not retain legal counsel to advise it on the competition law issues governing the grant of state aid.<sup>185</sup> The Tribunal found this surprising because the evidence shows that Invesmart knew fairly early on that competition law and the enforcement agency, the OPC, both had a role to play in the resolution of the bank's hoped-for state support.

275. In a letter dated 28 June 2002, addressed to the then-Minister of Finance, Jirí Rusnok, requesting him to "reconsider the possibility to realize the project of 'Finalisation of the Foresbank stabilisation program'", [redacted] recognised that the state aid being sought by Invesmart could be refused on the objection of the competition authorities. He noted in this regard that:

... We are also working on submission of another expert's opinion for selected assets' portfolio and the Economic Competition Office standpoint so that the Office will not prevent us from the realisation of our project.<sup>186</sup> [Emphasis added.]

276. Beyond [redacted], noting the fact that Invesmart was seeking an expert's opinion, there is no record evidence of what that advice amounted to. In the Tribunal's view, [redacted] letter shows an awareness as of 28 June 2002 that the OPC could block the aid.

277. In the Tribunal's view, Invesmart should have sought legal advice on the EU and Czech law so that it understood precisely what the requirements were for making out the case for the granting of an exemption to the restrictions on granting state aid. Had it done so, it could have determined for itself that the law imposed strict guidelines on what information would be required to be submitted to the relevant authorities in order to maximise its chances of obtaining the requested aid to be granted.

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<sup>184</sup> First Expert Report of Claus-Dieter Ehlermann, paras 28–41.

<sup>185</sup> Transcript, Day 1, [redacted] p. 154, lines 21–22, p. 156, lines 1–3, p. 158, lines 20–24.

<sup>186</sup> Exhibit R-32, letter dated 28 June 2002 from [redacted] to Minister Rusnok.

278. [redacted] conceded that “looking back, we should have” obtained legal advice on the state aid issue.<sup>187</sup> His explanation was that Invesmart did not do so because it found an existing transaction on the table and it took it from there and that “my understanding, my shareholders’ understanding throughout the whole process, has been that it was in the primary interest of the Czech Government and the Czech Republic to rescue and save Union Banka”.<sup>188</sup> This does not assist the Claimant because, while the Claimant did indeed receive positive signals from the Respondent, the record shows that they were not all in that direction. There had been attempts by the bank’s existing management to resolve the problem, but those had been unsuccessful.

279. Indeed, when [redacted] approached the newly-appointed Minister of Finance in July 2002 after the parliamentary elections there was no “existing transaction” on the table because Minister Sobotka’s predecessor had *rejected* Invesmart’s approach in May 2002. This is what had led [redacted] to send his letter of 28 June 2002 to Minister Rusnok asking him to reconsider. His reference in that letter to Invesmart’s seeking an expert opinion so that the OPC would not block the project shows an understanding that state aid was not automatic even if the Minister of Finance were inclined to recommend its granting. Likewise, after the Ministry of Finance indicated that it was willing to look at the issue of state aid, as

[redacted] 16 September 2002 letter shows, Invesmart’s 12 September 2002 meeting with the CNB was not entirely positive from the investor’s perspective. [redacted] recorded the CNB’s Mr Jíříček as stating that “he sees no or very little chances for the transaction to be completed”.<sup>189</sup> The CNB’s reply to [redacted] while not prejudging the outcome of the state aid issue, emphasised the MOF’s and OPC’s roles in approving the aid and pointed out that determining whether to grant aid was not the CNB’s responsibility.<sup>190</sup> The information conveyed to Invesmart after the 24 September 2002 intra-governmental meeting highlighted the OPC’s role. In short, even the positive statements made by government officials during the material period did not in any way purport to vary the legal regime applicable to state aid.

280. [redacted] position, though not entirely unreasonable, did not show the prudence that could be expected of an investor whose investment was being conditioned upon the government’s financial support.

281. The Tribunal considers that Czech counsel would have been aware of the tightening of the Czech rules on state aid and the increasing oversight of the EC. Not surprisingly, as the state aid regime became more stringent for the Czech Republic, the onus upon a party seeking such

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<sup>187</sup> Transcript, Day 1, [redacted], p. 156, line 3.

<sup>188</sup> *Id.*, p. 156, lines 3–10.

<sup>189</sup> Exhibit R-64, letter dated 16 September 2002 from [redacted] to the CNB.

<sup>190</sup> Exhibit R-66, letter dated 19 September 2002 from the CNB to Invesmart.



aid and indeed upon a state inclined to grant it became heavier. What might have passed muster in the mid-1990s would not necessarily pass muster in 2002.

282. The failure to seek legal advice reflected an underlying feature of the case: that the entire venture seemed to be driven by frequent requests for state aid bound up in undoubted enthusiasm and drive to secure ownership of a cleaned up bank which he could then sell to an established Western European bank. While the Tribunal considers that and de Sury brought financial acumen to the project, there appears to have been relatively little substantive legal due diligence performed by Invesmart. This is also reflected in Invesmart's contractual dealings with the bank and the selling shareholders, a matter to which the Tribunal now turns.

### **Invesmart's contractual relations with Union Banka and the selling shareholders**

283. An important theme of the Claimant's case was that at all material times, it informed various government entities that it would not proceed with the investment unless the state provided aid resulting in an uplift to the net asset value of the bank of some CZK 650 million.<sup>191</sup> There is ample correspondence and records of meetings that demonstrates that this position was communicated by Invesmart throughout the period leading up to 24 October 2002.
284. In the Tribunal's view, however, there is something of a disjuncture between those statements and the legal documents relating to Invesmart's relationship with Union Banka and Union Group, some of which show that Invesmart did not act consistently with its position as articulated to the Czech Republic.
285. First, the Receivables Assignment Agreement was executed on 13 August 2002. At this point in time, according to the Agreed Statement of Facts, Invesmart had been communicating its interest in acquiring control of the bank for over eight months. Invesmart's Gert H Rienmüller informed the CNB by letter dated 12 August 2002 that it had decided to "support" the bank "without closing the purchase of the bank".<sup>192</sup>
286. The text of the letter warrants reproducing because it shows that prior to even submitting its first summary proposal for the resolution of the bank's issues with Česká Finanční, Invesmart assumed obligations in relation to the Česká Finanční loan portfolio. Mr Rienmüller stated:

... with reference to your letter dated 25 July 2002 ... I would like to inform you that in the above mentioned matter intense talks between the current shareholders and the investor, Invesmart, B.V. regarding the financial statements for the year

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<sup>191</sup> Transcript, Day 1, Smith, p. 23, lines 21–25, p. 24, lines 1–22; Transcript, Day 7, Miles p. 134, lines 5–8, p. 136, lines 3–10.

<sup>192</sup> Exhibit R-52, letter dated 12 August 2002 from Gert H. Rienmüller to Vladimír Krejča of the CNB.

2001 have taken place. The result of the talks is that without closing the purchase of the bank Invesmart has decided to support Union banka by a grant of a guarantee in the amount of CZK 300 million in order to secure an acceptable auditor's report on the bank for 2001.

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Meantime, Invesmart was also acquainting itself with the Česká Finanční case. After unsuccessful attempts of the existing shareholders of the bank Invesmart is attempting to solve this problem itself through direct negotiations with the CNB, Česká finanční and the MOF. The results of these contacts cannot be predicted at this time. However, taking into account that Invesmart increased its purchase price by CZK 300 million, it cannot be expected that it would assume additional obligations against Česká finanční, which were represented by the seller in negotiations as solved.<sup>193</sup> [Emphasis added.]

287. Although Mr Rienmüller's letter referred to a CZK 300 million guarantee being issued by Invesmart, that was only one aspect of the transaction. In the Receivables Assignment Agreement, Invesmart and Union Banka recognised that the bank was attempting to sell the loan portfolio to CF.<sup>194</sup> Invesmart agreed to an irrevocable assumption and purchase of that portfolio if it was not transferred to CF, subject to the proviso that Union Banka would only be able to require such assumption if and after it had failed to, for any reason whatsoever, assign the receivables to CF by 1 December 2002.<sup>195</sup> In that event, Invesmart agreed to pay CZK 1.2 billion for the portfolio and the CZK 300 million guarantee to which Mr Rienmüller referred was to secure that obligation. In the event that it failed to take over the loan portfolio, the guarantee, valid until 15 December 2002, was enforceable by the bank after its having given notice to Invesmart.<sup>196</sup>
288. The Receivables Assignment Agreement appears to have had at least two effects.
289. First, as Mr Rienmüller anticipated in his 12 August 2002 letter to the CNB, it permitted the bank to secure the issuance of the auditor's report for the year ending 31 December 2001.<sup>197</sup> On 16 August 2002, Deloitte & Touche issued its audit report on the bank's 2001 financial statements. Without such an audit report, the evidence showed, the bank's situation would have been extremely tenuous.

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<sup>193</sup> *Id.*

<sup>194</sup> Exhibit R-49, Receivables Assignment Agreement dated 13 August 2002 entered into between Union Banka and Invesmart, Recital.

<sup>195</sup> *Id.*, Clause II.1.

<sup>196</sup> *Id.*, Clause II.5.

<sup>197</sup> In Exhibit C-31, Audit Report of Union Banka for 2001 issued by Deloitte & Touche on 16 August 2002, p. 2, Deloitte & Touche noted that the bank might not be able to continue as a going concern absent Invesmart's capital entry into the bank.

290. Secondly, the Receivables Assignment Agreement evidently led to an amendment of the SPAs because on 14 August 2002, the day after its execution, Invesmart entered into Addendum No 4 to the two SPAs. In the Tribunal's view, the importance of these contractual developments is this: Invesmart assumed the obligation to pay for the CF loan portfolio – a key element of the state aid that it was seeking – 7 days *before* submitting its proposal on the settlement of the bank's relationship with CF to the MOF. That is, Invesmart's first proposal to the MOF was made on 20 August 2002, seven days *after* it executed the Receivables Assignment Agreement.<sup>198</sup>

291. In the Tribunal's view the Receivable Assignment Agreement and Addendum No 4 tend to undermine the Claimant's contention that it made its participation in Union Banka conditional upon the grant of state aid. In mid-August 2002, it bound itself to having to deliver the substantial part of what it later proposed the state should grant. Moreover, although Addendum No 4 still reserved the power to approve the share purchase to Invesmart's shareholders, its conditions for completing the transaction did not reflect the position that Invesmart was consistently articulating to different government agencies. When asked by the Chairman as to whether Invesmart sought legal advice on the amendments to the SPAs, I answered:

I believe it was not very much a legal issue at the time, it was very much contained in a business decision at the time.<sup>199</sup>

292. The Tribunal recognises that it is not privy to the negotiating history of the entire transaction and it is loath to impose legal perfection on an evolving situation after the fact. However, it considers that the Claimant exposed itself in a sense in the way in which it structured the conditions for the acquisition of the shares and the assumption of the related-party loans and when it assumed the CF loan portfolio.

293. If the grant of state aid was the *sine qua non* of Invesmart's acquisition of control of Union Banka, it might have been expected that it would have either: (i) completed its acquisition of control of the bank only upon receipt of a written undertaking from the Minister of Finance that the requested state aid would be provided; or (ii) to be even more certain, have completed the acquisition simultaneously with the aid being granted. Invesmart did not follow either course of action.

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<sup>198</sup> As noted in the Agreed Statement of Facts, at p. 8, on that date, "Invesmart submitted its state aid proposal to the Ministry of Finance ... Invesmart proposed the following measures: (i) the early termination of the Fores Deposit; (ii) the investment of the proceeds from the Fores Deposit in subordinated debt of Union banka; and (iii) CF's purchase of a CZK 1.6 billion portfolio of non-performing loans."

<sup>199</sup> Transcript, Day 2, Pryles-t, p. 104, lines 2–4.

294. [redacted] frankly admitted that they had erred in not obtaining a written promise of state aid, testifying that “stupidly enough, looking back, we didn’t ask for it”.<sup>200</sup> Invesmart’s failure to relate its requirements for completing the transaction, as communicated to various Czech agencies, to its contractual documents with the selling shareholders and the bank created exposure in the event that state aid was not granted. Such exposure is precisely what has forced the Claimant to argue that if there was no express promise of state aid, the CNB’s approval constituted an implicit promise to grant it. It would have been more prudent for Invesmart to have formally conditioned its obligation to assume the related-party loans upon the grant of state aid rather than rely upon what it now contends was an implicit promise of aid bound up in the CNB’s approval.
295. The Tribunal will discuss the last amendment to the SPAs, Addendum No 5, in the course of its discussion of the events of October 2002 below.

**The Claimant’s general awareness of the domestic competition law regime prior to 24 October 2002**

296. Consistent with its view as to the related roles of due diligence and the host State’s law and relevant international agreements between the investment Treaty’s Contracting Parties, the Tribunal now turns to consider the role of competition law and the competition authorities in the events at issue. This is an important issue when considering the legitimate expectations claim, because the regulatory approval structure for state aid provides the legal context in which the various government entities and indeed Union Banka and Invesmart itself operated at the time.
297. The Claimant’s legitimate expectations claim emphasised that it was only after Invesmart’s application was approved by the CNB that the role of the OPC in approving any aid and what it saw as increasingly onerous conditions for the aid’s granting became clear.<sup>201</sup>
298. The Tribunal has already noted at paragraphs 274-276 that Invesmart was aware by June 2002 that the OPC would have a role in approving state aid. By letter dated 25 June 2002 to the Acting Secretary of CF, [redacted] noted that Invesmart was trying “to get a standpoint of the Economic Competition Office”.<sup>202</sup> A letter dated three days later addressed to the then-Minister of Finance explicitly recognised that the aid being sought could be prevented by the competition authorities and for that reason Invesmart was “working on submission of another

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<sup>200</sup> Transcript, Day 1, [redacted] p. 166, lines 13–16.

<sup>201</sup> Transcript, Day 7, [redacted] p. 156, lines 19–25, pp. 156–157.

<sup>202</sup> Exhibit R-31, letter dated 25 June 2002 from [redacted] to the Acting Secretary of Česká Finanční.

expert's opinion for selected assets' portfolio and the Economic Competition Office standpoint "so that the Office will not prevent us from the realisation of our project"<sup>203</sup>.

299. The minutes of the 24 September 2002 meeting at the Ministry of Finance, on which the Claimant placed significant reliance, also show that the state aid issue and the need to consult the competition authorities was part of the government's internal discussions. The testimony is that the substance of this meeting was accurately and fully communicated to Invesmart the next day and [redacted] acknowledged that he was told that the advice of the OPC was being sought "in order to get their advice on the viability as far as the European Union issues were concerned".<sup>204</sup>

### **The issue of "old" versus "new" aid**

300. One issue that arose during the hearing concerned whether the OPC had to consent to a resolution of the bank's issues with CF. The Claimant contended that that was not seen as state aid that required the OPC's approval because it was settling a previous arrangement that dated back to the mid-1990s.<sup>205</sup> There was no new state aid being discussed, in its view, and the statements of government officials seemed to show that they likewise held that view, at least until after Invesmart decided to acquire the shares of Union Group.
301. In the Tribunal's view, looked at on their own, the 24 September meeting's minutes are not clear on precisely what the Ministry of Finance believed the competition authorities' role to be in relation to the CF Transaction then being discussed.
302. Strictly speaking, the Ministry of Finance could not speak for the OPC. But on the basis that Invesmart thought that significant progress was being made towards a grant of state aid, the Tribunal will examine what was conveyed to Invesmart on the issue of state aid prior to its increasing its share capital and approving the SPAs.
303. On the one hand, the 24 September 2002 meeting's minutes record that "in case ... [there is a] change to the agreement" the "Office for the Protection of Competition will need to be consulted and government approval will be required". This, as the Claimant argued, suggests that the then-contemplated form of state aid (i.e., reduction of the Fores deposit interest rate and the purchase of bad loans at book value or something closely related to book value) did *not* have to be approved by the OPC.

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<sup>203</sup> Exhibit R-32, letter dated 28 June 2002 from [redacted] to Minister Rusnok.

<sup>204</sup> Transcript, Day 1, [redacted] p. 174, lines 23–25, p. 175, line 1.

<sup>205</sup> *Id.*, p. 157, lines 6–12.

304. On the other hand, as the Respondent pointed out, the "next steps" identified by officials in the same minutes record that the "Ministry of Finance and CKA will discuss the form of the state aid with OPC as settlement of the stabilisation programme following return of OPC representatives from Brussels by 1 October 2002 at the latest". This suggests that the competition authorities had to be consulted on any deal that might constitute state aid and that they might determine that the Finanční interest rate and receivables deal *did* fall within their mandate.
305. The minutes are ambiguous on the issue of whether the competition authorities had to approve the CF deal sought by Union Banka and Invesmart. Since the substance of the discussions was disclosed to Invesmart, it would have been told that the OPC had some role to play in the approval of state aid (a point which was already known to it. However, the Tribunal cannot infer one way or the other whether the description of the meeting accorded with the part of the minutes that the Claimant emphasised or the part that the Respondent emphasised (or both).
306. Were this to be the only contemporaneous document that discussed the state aid issue, the Tribunal would be unable to judge what was conveyed to Invesmart. Further light can be shed on this issue, however, by two other contemporaneous documents showing that the competition authorities would play a role in a decision to grant state aid of any kind.
307. The first document was generated after the 12 September 2002 meeting between Invesmart representatives and the CNB. The meeting had evidently not gone well from Invesmart's perspective because of the CNB officials' statements about Invesmart's second application for approval and what its rejection might mean for Union Banka's licence. (As shall be seen (at paragraphs 543-546), a representative of certain shareholders in Invesmart attended the meeting and evidently formed a less than positive view of the bank's prospects.) In a letter dated 16 September 2002 sent after the meeting to the Governor of the CNB and four of his colleagues, [redacted] stated that the CNB's Mr Jirí Jířicek had informed them that if enough information on the financial aspects of the acquisition was not received by 16 September 2002, he would start the process to deny authorisation of the acquisition by Invesmart. [redacted] also recorded Jířicek's stating that in such a case he will also start the proceeding to withdraw the banking licence to Union Banka".<sup>206</sup>
308. [redacted] letter spurred a reply from the CNB dealing with among other issues the process by which the requested state aid would be addressed. At point 3 of its letter, the CNB recorded the fact that its representatives had informed Invesmart that:

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<sup>206</sup> Exhibit R-66, letter dated 16 September 2002 from [redacted] to Zdeněk Tůma, Pavel Racoča, Vladimír Krejča, Petr Jířicek, and Renate Vernerova, p. 2.

[redacted] to Zdeněk Tůma, Pavel Racoča, Vladimír

3. As regards the CNB's standpoint concerning the successful completion of the transaction to acquire a qualifying holding and the possibility of the Bank's receiving state assistance, the CNB stated that any such assistance is primarily a matter for the Ministry of Finance, requires the approval of the Czech Government and must have the support of the Office for the Protection of Economic Competition, which is also assessing this matter in the context of the preparations for the Czech Republic's accession to the European Union. The CNB's opinion on the completion of the overall transaction was not expressed at the meeting.<sup>207</sup> [Emphasis added.]

309. This passage is instructive because it expressly brought to [redacted] attention the division of competencies between the CNB, Ministry of Finance and the OPC, the need for Czech government approval above and beyond the Minister's approval, the need for the support of the competition authorities, and the fact that the proposal was "also" being assessed within the context of the accession to the EU, the plain implication being that EU issues would be taken into consideration. At the hearing, [redacted] acknowledged that by this letter Invesmart was told by the CNB, before it approved the share acquisition, what the requirements for the granting of state aid were.<sup>208</sup>

310. The second document, a letter from Minister Sobotka to Governor Tůma, dated 7 October 2002, referred back to the meeting with Invesmart on 25 September 2002 at which the government's deliberations were disclosed to it. The Minister noted that:

On 25 September 2002 a meeting was held in the office of the First Deputy Minister of Finance with the representatives of Invesmart B.V. (Mr. Roselli, Mr. Rienmüller, Mr. Braun) in the presence of CEO of the Czech Consolidation Agency. In the context of the meeting, the representatives of Invesmart B.V. were informed of the requirements of the Bank Supervision Department for completion of the documents needed for grant of approval with entry of the investor to the bank with the deadline of 4 October 2002. Mr. Roselli gave a binding promise to provide the missing documents to the Bank Supervision Department in due course. At the same time the representatives of Invesmart B.V. were informed of the planned meeting with the Office for the Protection of Economic Competition in Brno with the aim to assess the procedure and options for resolution of the investor's requirement for settlement of the problems of Union Banka a.s. with regard to public support.<sup>209</sup> [Emphasis added.]

311. Any ambiguity in the 24 September 2002 minutes as to the state of thinking within the Government and as to what was communicated to Invesmart is thus resolved by a clear statement in writing sent to Invesmart just before the 25 September meeting and corroborated by the letter sent by the Finance Minister to the CNB Governor recapitulating what occurred in the meeting held the preceding day.

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<sup>207</sup> Exhibit C-52, letter dated 18/19 September 2002 from the CNB to Invesmart.

<sup>208</sup> Transcript, Day 2, [redacted] p. 206, lines 21–25.

<sup>209</sup> Exhibit R-72, letter dated 7 October 2002 from Minister Sobotka to Governor Tůma.

312. In the Tribunal's view, the role of the competition authorities in vetting *any* proposed state aid, including a settlement of the bank's relations with CF, was brought to the Claimant's attention before it submitted its third application on 22 October 2002.

### **The Czech Republic's commitment to the European Union**

313. The Claimant argued further that the Respondent did not advise it prior to its shareholders approving the capital increase on 16 October 2002 that a statement had been made to the EC that the Czech Republic did not expect any further provision of state aid to the banking sector.<sup>210</sup> It also complained that it was not until a meeting held on 29 November 2002 that Invesmart was advised that Union Banka needed to submit a Restructuring Plan in accordance with the EU's *Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty*.<sup>211</sup>
314. In this regard, the Claimant pointed to a document which showed that at a meeting held on 16 May 2002 between the Ministry of Finance, the CNB, CF, and the Czech Consolidation Commission, Invesmart's potential acquisition of control of Union Banka was discussed by officials and in light of the undertaking given to the EU and the participants' view that there was little reason to provide state aid to the bank, it was resolved that CNB would proceed with the approval procedures but the "Ministry of Finance will inform the investor about the infeasibility of provision of state aid".<sup>212</sup> [Emphasis added.] The Claimant argued that it was not informed of this complicating factor until after it approved the capital increase.
315. The consideration of this complaint requires the Tribunal to first take note of the amendment to the SPAs that was effected just before Invesmart's shareholders approved the €90 million capital increase at a meeting held on 16 October 2002. Addendum No 5, which cancelled its predecessor, No 4, was concluded on 14 October 2002. The purchaser and the sellers agreed in this addendum that Invesmart would assume the debts of the selling shareholders without undue delay. The assumption of debts obligation was made conditional upon (i) the CNB's approval of Invesmart's application to acquire control of the bank and its assumption of the selling shareholders' debts; and (ii) the approval of Invesmart's shareholders.<sup>213</sup>
316. Two features of this addendum are salient. First, consistent with its predecessor's removal of Clause 3.3 from SPA B (the condition precedent relating to state aid), nothing in this addendum expressly made the completion of the Share Purchase Agreements conditional upon

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<sup>210</sup> Exhibit R-432, minutes of a meeting held on 16 May 2002 between the Ministry of Finance, the CNB, Česká Finanční, and the Czech Consolidation Commission.

<sup>211</sup> Transcript, Day 7, Smith, p. 48, lines 12-25, p. 49, lines 1-7.

<sup>212</sup> Exhibit R-432, minutes of a meeting held on 16 May 2002 between the Ministry of Finance, the CNB, Česká Finanční, and the Czech Consolidation Commission, p. 2.

<sup>213</sup> Exhibit R-75, Addendum No. 5 to the Share Sale and Purchase Agreements "A" and "B", dated 14 October 2002.



the granting of state aid. Secondly, Invesmart nevertheless still had a right *not* to complete the deal because its shareholders had to approve the transaction before it could bind the company.

317. The second point is relevant to the legitimate expectations argument because there is a temporal issue relating to the Claimant's decision to approve the SPAs. The Claimant argued that it did not know about the Respondent's commitment to the EC until after its shareholders approved the capital increase.<sup>214</sup> This may be so, but it is not the end of the matter.
318. Due to Invesmart's failure to properly convene the 16 October 2002 meeting at which its shareholders approved the capital increase, that decision had to be put to another vote on 4 November 2002 whereupon the shareholders ratified their earlier decision.<sup>215</sup> It was at this same meeting that the SPAs were approved.<sup>216</sup> Thus, the relevant time for determining whether Invesmart irrevocably committed to its investment in the bank without knowledge of the Czech Government's undertaking to the EC is not 16 October, but 4 November 2002.
319. It is clear from the record that Invesmart was advised in the CNB's letter of 19 September 2002 that the aid issue was being considered in "the context of the preparations for the Czech Republic's accession to the European Union".<sup>217</sup> To the extent that this failed to fully disclose the Minister's undertaking, the Tribunal notes that at a meeting held on 25 October 2002, ten days before Invesmart's shareholders approved the SPAs, the company's advisors, Euro-Trend, were informed of the Rychecký letter to the EC that there would be no more public subsidisation of the banks.<sup>218</sup>
320. Thus, although the Claimant correctly points out that this discussion occurred one day after the CNB approved the acquisition, this information was conveyed to Invesmart's representatives well before Invesmart held its second shareholders meeting on 4 November 2002 at which the shareholders approved the Share Purchase Agreements.
321. The Tribunal also notes that with respect to the need to draw up a Restructuring Plan, it appears from the record that that was explicitly discussed for the first time at a meeting held on 29 November 2002. The Claimant has sought to attribute responsibility for this to the Respondent in the sense that this was "sprung" on Invesmart after it completed its acquisition of its shareholding interests. The Tribunal notes however that at the 25 November meeting,

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<sup>214</sup> Transcript, Day 7, Smith, p. 49, lines 8–14, p. 51, lines 7–14.

<sup>215</sup> Exhibit R-469, minutes of the extraordinary meeting of shareholders of Invesmart B.V. held at Rotterdam on 4 November 2002, proposal 1.

<sup>216</sup> *Id.*, proposal 5.

<sup>217</sup> Exhibit C-52, letter dated 19 September 2002 from the CNB to Invesmart.

<sup>218</sup> Exhibit C-60, minutes of a meeting held on 25 October 2002 between Josef Doruška of the Ministry of Finance and Euro-Trend representatives.

Union Banka's new Director, Mr Radovan Vávra, provided a different explanation. The minutes record him informing the meeting that:

... The UB's director then explained why the former management has not made any efforts for granting of state aid earlier and had not prepared a restructuring plan – the reason was that they had assumed that the bank would win the arbitration against the CNB regarding the compensation of damages of CZK 1.9 billion.<sup>219</sup> [Emphasis added.]

322. Mr Vávra's remark must have been directed to the management personnel who held senior positions prior to his joining Union Banka in the autumn of 2002.
323. There is also record evidence that suggests that Invesmart had reason to appreciate that competition law considerations pertaining to EU accession could thwart its request for state aid for some months. As noted earlier, the inter-agency meeting which discussed the EU commitment was held on 16 May 2002. Invesmart met with the then-Minister of Finance shortly thereafter. The precise message conveyed to Invesmart when the Ministry of Finance then refused to consider granting state aid is not on the record, although the fact of that rejection is. [redacted] wrote to the CNB's Pavel Racoča by letter dated 20 May 2002 (four days after the inter-agency meeting was held), noting that:

... As you probably already know our meeting with the Minister of Finance was not particularly positive.

The Minister stressed that at this time they do not consider to conclude the acquisition of Fores by Česká Finanční.

As I mentioned to you last Friday we consider that transaction a main condition for completing our acquisition of 70 per cent of Union Group.

Nevertheless, considering the upcoming elections and the fact that Union Banka application at Česká Finanční has not been formally rejected, we have decided to follow up with our application with the Central Bank and to confirm our commitment to the project...<sup>220</sup>

324. The Tribunal has already adverted to [redacted] 28 June 2002 letter which recognised that the OPC could block the transaction.
325. Thus, although there is no direct evidence of precisely what was communicated to Invesmart by the Respondent after the inter-agency meeting of 16 May 2002, it can be inferred from [redacted] contemporaneous letters that Invesmart was informed of issues relating to competition law as it affected the granting of state aid to Union Banka. There would have been

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<sup>219</sup> Exhibit R-115, minutes of a meeting held on 29 November 2002 between Ministry of Finance, OPC, CNB, CKA, Union Banka, Euro-Trend and Invesmart representatives.

<sup>220</sup> Exhibit R-41, letter dated 20 May 2002 from [redacted] Pavel Racoča of the CNB.

no reason for                      to advert to the OPC's role had that not been brought to Invesmart's attention.

326. Finally, assuming *arguendo* that the Czech authorities did not inform Invesmart of the undertaking to the EU in May 2002 and instead referred only to competition law issues generally, the question is whether that undertaking was materially different from what Invesmart knew or should have known was the situation under Czech and EU law.
327. Here the Tribunal is of the view that: (i) the Czech Republic's accession to the Treaty of Rome was well known; (ii) Invesmart knew from June 2002 that the OPC could, to use Mr Catalfamo's words, "prevent us from the realisation of our project"; (iii) Invesmart was advised in mid-September 2002 that the state aid was being assessed "in the context of the preparations for the Czech Republic's accession to the European Union"; (iv) Invesmart's advisors were informed on 25 October 2002 of the Rychetský letter; (v) reasonable due diligence into the governing Czech and EU law would have confirmed that state aid is prohibited unless an exemption is granted; and (vi) the Czech Republic's undertaking was communicated to Invesmart at the latest by 25 October 2002, prior to 4 November 2002 when its shareholders approved the Share Purchase Agreements. The Claimant was in a position to understand that state aid had to be justified because it would be scrutinised by both Czech and EU competition authorities.

#### **What did the Ministry of Finance commit to do?**

328. The Tribunal turns to the seminal issue, namely; what did the Minister of Finance agree to do at the 24 September 2002 meeting? The parties disagree over the meaning and import of the 24 September 2002 meeting minutes' statement that "the minister of finance is ready to submit a document for the state aid defined in this way for the government session". The question is whether a document which by its own words indicates a willingness to follow a process of seeking approval of aid constituted a promise, to deliver that aid, enforceable under the Treaty.
329. The disagreement centres on whether the Minister undertook an obligation of result such that, beginning with the debriefing on 25 September 2002 and crystallising on 24 October 2002, the Claimant formed a legitimate expectation that state aid was approved (the Claimant's view), or whether the Minister undertook an obligation of process, i.e., that he would evaluate the bank's planned restructuring and if he formed the view that it had a reasonable prospect of success, he would submit it to the Cabinet and the OPC for approval (the Respondent's view).
330. In the Tribunal's view, the weakness for the Claimant's case is that the evidence shows that as of 24 October 2002, the form of state aid and the modalities of getting approvals from the Ministry of Finance, the Cabinet and the OPC were not fully defined. Put simply, on 24 October 2002, the bail-out plan was a proposal from Invesmart dating back to 20 August 2002

which lacked the kind of detail and definition that would be required to obtain regulatory approval.

331. The Tribunal finds support for this finding in the following facts derived mainly from contemporaneous documents prepared prior to and after 24 October 2002.

332. First, although the Claimant relied upon the inter-agency meeting of 24 September 2002 as proof of the Minister's commitment to deliver state aid in a particular form,<sup>221</sup> the evidence strongly suggests that the CNB did not consider that the Finance Minister had made such a commitment at that meeting. Otherwise, there would have been no reason for the CNB's Mr Dědek to write to Minister Sobotka on 11 October 2002 to outline the CNB's subsequent discussions with Invesmart, noting that the investor had stated its intention to deliver all of the missing documents (pertaining to the source of its funds for the acquisition of its shareholding in the bank) very soon, and to "ask you, dear Minister, that the Ministry of Finance of the Czech Republic ... [communicate] its clear standpoint to the representatives of Invesmart B.V."<sup>222</sup> Had the Ministry already promised to deliver state aid, a letter from the CNB requesting him to communicate his clear standpoint on the aid issue would have been unnecessary.

333. Secondly, the testimony of both Governor Tůma and former Minister Sobotka was consistent that up to 24 October 2002, including at the meeting of the CNB's Bank Board that day, the Ministry of Finance had indicated its willingness to proceed with the process of considering state aid, but that no commitment to deliver state aid had been undertaken by the Ministry up to and including that date.<sup>223</sup>

334. The minutes recording the Bank Board's 24 October 2002 meeting are cryptic in that they record the fact of that the Minister spoke but not what he said. Due to the seminal importance of this issue, the Tribunal has examined the contemporaneous documents with care in order to determine whether there is any document that corroborates the witnesses' testimony on this point. It notes that after the CNB approved Invesmart's entry into Union Banka, the minutes of the meeting of 5 November 2002 record the Ministry of Finance's view that the CNB's approval of 24 October 2002 had been the MOF's *pre-condition* for the resumption of negotiations between the Ministry and Invesmart. The minutes record him as stating that:

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<sup>221</sup> Transcript, Day 7, Smith, p. 9, line 25, p. 10 lines 14-25, p. 11, lines 1-5.

<sup>222</sup> Exhibit R-74, letter dated 11 October 2002 from Oldřich Dědek to Minister Sobotka.

<sup>223</sup> Transcript, Day 4, Sobotka, p. 35, lines 1-14; Day 4, Tůma, pp. 208-209.

The MOF's condition for negotiations to be reopened was an unambiguous position of CNB on the approval of the investor Invesmart B.V. entry into Union banka, a.s. This condition was fulfilled.<sup>224</sup> [Emphasis added.]

335. This record, from a document prepared two weeks after the Bank Board meeting but prepared well before the instant dispute arose, is in the Tribunal's view, corroboration of the two Respondent witnesses' testimony on this point. It is consistent with Governor Tůma's testimony that prior to 24 October, a certain deadlock had arisen between the CNB and the Finance Ministry: "On the one hand, the Finance Ministry wanted to know whether Invesmart was acceptable for us, and once again we are back to the question that Invesmart was not a substantial company and so on". He continued, "... on the other hand, we certainly would prefer to know from the State whether they would have been willing to provide the state aid or not". Somebody had to break the deadlock, he testified, "... so we said, 'Okay, this investor is acceptable for the Czech National Bank', and then it was up to the Finance Ministry to decide".<sup>225</sup> The Tribunal also notes that there is no record of anyone representing Union Banka or Invesmart taking issue with the Ministry of Finance's characterisation of its "condition for negotiations to be reopened".
336. Thirdly, roughly one week *before* the CNB issued its approval, on 16 October 2002, Union Banka retained Euro-Trend to advise it on the state aid issue.<sup>226</sup> The letter of authorisation specifically contemplated Euro-Trend's conducting negotiations "aimed at the restructuring" with "the Ministry of Finance of the Czech Republic, the Czech Consolidation Agency, Česká finanční s.r.o. and other state institutions".<sup>227</sup> Reference to the terms of the contract shows that Union Banka's objective was to negotiate "the restructuring of its balance sheet with the participation of the Czech State", and Euro-Trend was to "perform ... all necessary negotiations with all involved parties, in particular with the Czech Ministry of Finance, Česká konsolidační agentura, and Česká finanční s.r.o. in order to successfully implement the objective" just described.<sup>228</sup> [Emphasis added.] The Agreement further provided that Euro-

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<sup>224</sup> Exhibit R-461, minutes of the meeting held at the offices of the First Deputy Minister of Finance on 5 November 2002 between Finance officials and representatives of Euro-Trend, Union Banka and Invesmart. During the hearing, former Minister Sobotka adhered to the position that throughout the September–October 2002 period, although Invesmart had a proposal on the table in the form of its 20 August 2002 letter, the negotiations were not advanced and since Invesmart's application had twice been rejected by the CNB, the Ministry was interested in whether the CNB would approve its entry into Union Banka.

<sup>225</sup> Transcript, Day 4, Tůma, p. 207, lines 3–16. He also emphasised this point at another stage of his testimony: Transcript, Day 4, Tůma, pp. 165–168.

<sup>226</sup> Exhibit R-59, letter of authorisation dated 16 October 2002 issued by Union Banka, a.s. in favour of Euro-Trend, s.r.o. "to carry out all negotiations aimed at the restructuring of the Union Banka balance with state participation on behalf of Union Banka."

<sup>227</sup> *Id.*

<sup>228</sup> Exhibit R-470, Agreement between Union banka a.s. and Euro-Trend, s.r.o., dated 16 October 2002.

Trend would be paid a fixed monthly amount of CZK 100,000 and a contingency fee of CZK 5 million in "the event the Customer's objective is successful".<sup>229</sup>

337. The timing and content of this agreement indicates that having received a debriefing of the 24 September 2002 inter-agency meeting and having appointed Mr Vávra as its new CEO, Union Banka then retained professional advisors to negotiate on its behalf.<sup>230</sup> The retention of advisors to assist in negotiations is indicative that a state aid package had not been agreed, even in Union Banka's view. Moreover, with the contract's heavy weighting of compensation towards a success fee, both parties explicitly recognised that the substantial part of Euro-Trend's fee would be paid only upon the attainment of the objective, i.e., the grant of the aid being sought.

338. This contract, executed on the same day as the shareholders of Invesmart initially voted on the capital increase, supports the finding that all parties, including Union Banka and Invesmart, considered that they were about to engage in a process of negotiation, the outcome of which was plainly hoped-for by the bank and the Claimant, but which could not be guaranteed.

339. Although it does not place great weight upon it, the Tribunal notes that an interview given by [redacted] on 24 February 2003, after the aid was refused, was consistent with its finding. The interview quoted [redacted] as stating that:

After obtaining a majority stake in Union banka, our first steps quite logically led to the Ministry of Finance, where we wanted to begin discussion on what would happen with the bank from now on. We received a letter signed by Mr. Janota stating that the Ministry of Finance was ready and willing to look for a solution and to assist in the restructuring of Union banka. In November, we therefore started negotiations...<sup>231</sup> [Emphasis added.]

340. This was put to [redacted] during cross examination. He testified that he could not remember what was said on 24 February 2003 because the situation was very hectic and he participated in many press interviews. He asserted that the quote attributed to him, that there had been no negotiations before November 2002, was not accurate. He did accept, however, that there were "many differences, absolutely" between the story published by *Euro* magazine on 24 February 2003 and the case pleaded before the Tribunal.<sup>232</sup>

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<sup>229</sup> *Id.*

<sup>230</sup> The Tribunal notes that the parties to this Agreement understood the potential need for legal advice in supporting the negotiations. Article 1.3 permitted Euro-Trend, with Union Banka's consent, to seek advice on legal matters "provided by subcontractors-specialized firms or by individuals conducting business pursuant to special regulations (tax advisors, commercial lawyers, auditors etc.)."

<sup>231</sup> Exhibit R-431, "We Invested Three Billion," *Euro Magazine*, 24 February 2003.

<sup>232</sup> Transcript, Day 2, [redacted] pp. 65-66.

341. Fourthly, the Tribunal notes that Euro-Trend's First Proposal for Union Banka, dated 4 November 2002, was submitted to the Ministry of Finance 11 days after the Claimant says that its expectation crystallised. The Plan set out the proposed CF Transaction (lowering of the interest rate and the sale of the loan portfolio to CF) but also noted that there was a potential connection between this aid (which Euro-Trend argued could not be characterised as a grant of new state aid as suggested by what it called a "potential opinion" of the OPC<sup>233</sup>) and the resolution of Union Banka's arbitration claim against the CNB:

The proposed grant of state aid may be further connected to the resolution of the existing dispute between Union banka, a.s. and CNB, concerning the additional reimbursement of losses from transactions of overtaken banks amounting to approx. CZK 1.9 billion, such that no further requirement on fiscal funds would arise.<sup>234</sup>

342. This indicates that the form of the aid was still up for consideration even from Union Banka's perspective. Indeed, the BDS "receivable" can be seen as an attempt by the bank to find an alternative to the CF Transaction, because Euro-Trend had been told on 25 October that that transaction raised competition law issues.

343. Fifthly, the view of government officials who reviewed the First Proposal was that it required more work. The minutes of the 5 November 2002 meeting recorded the view that "any aid must be targeted, limited and pre-negotiated with the UOHS [OPC]" and that the "submitted document, if the solution proposed therein is chosen, must be further supplemented by the description of evaluation method, averaging of gained values, if appropriate, and by the clarification of procedure used in 'final calculation of the aid up to CZK 1.2 billion'".<sup>235</sup>

344. Sixthly, the Tribunal notes that in the meetings held on 25 October, 5 November and 29 November 2002, there is no record of Union Banka, Euro-Trend or Invesmart ever complaining that the issues then being discussed by the participants were inconsistent with their earlier expectation that a concrete state aid package had been promised when the CNB approved the share acquisition on 24 October 2002. The bank's representatives did express concern at the length of time that it would take to obtain the OPC's approval, but there is no suggestion in the minutes that the government was being accused of renegeing on a prior promise to deliver an agreed amount of state aid.

345. In brief, the documentary evidence surrounding 24 October 2002 indicates that the form of state aid was not agreed and that negotiations were expected by all sides of the proposed transaction. If there is any doubt on this point, it is put to rest by the next meeting of the parties at which Euro-Trend's Second Plan was discussed. This proposed changing the form of state

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<sup>233</sup> Exhibit R-13, First State Aid Plan elaborated by Euro-Trend, dated 4 November 2002, p. 8.

<sup>234</sup> *Id.*, Part I, p. 2.

<sup>235</sup> *Id.*

aid, envisaging that the state would implement one or more of the following measures: (i) the lowering of the fixed interest rate on the Fores Deposit of 11.5 percent to a floating market rate; (ii) the early termination of the Fores Deposit and its transformation into five-year subordinated debt; (iii) the acquisition by CKA of a portfolio of non-performing assets at a price determined by independent experts plus an additional amount of state aid; *and* (iv) a state guarantee of a portfolio of loans.<sup>236</sup> The possibility of a state guarantee was raised by Euro-Trend. There is no indication from the record that it had been discussed previously.

346. Having regard to all the evidence, the Tribunal considers that although Invesmart could reasonably have held the view after 24 September 2002 that the Minister supported a potential bail out of Union Banka, it could not have a legitimate expectation either as of that date or as of 24 October 2002, when the CNB approved its acquisition of control of the bank, that the Czech government had promised to grant state aid. Had it retained counsel to advise on the competition law aspects of the state aid issue, it would have understood that the aid proposed through the settlement of the bank's relations with CF almost certainly did constitute state aid under EU and Czech law and that the process of preparing a detailed justification for its granting was necessary and without such a document the Minister and the Cabinet, let alone the OPC, could not approve it.

### **Conclusion on legitimate expectations**

347. Before concluding on the legitimate expectations claim, the Tribunal wishes to address one other limb of the Claimant's case.
348. It appeared to the Tribunal that the Claimant argued that to the extent that the evidence showed that the Respondent had undertaken a commitment to a process as opposed to a result (the latter being the Claimant's primary position), the Respondent could not take advantage of its own failure to comply with its domestic laws in failing to obtain the requisite approvals of the Czech Cabinet and the OPC.<sup>237</sup> In its closing submissions, Invesmart argued that its case was not that state aid would be supported in violation of Czech or EU law, but rather that the Respondent "would take such steps needed to lawfully supply the promised state support."<sup>238</sup> At another point, it asserted that its legitimate expectation was "a clean bank with a combination of the Česká Financní transaction and a contribution of the assumption of the related-party loans with a net asset value of CZK 1.162 million".<sup>239</sup>

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<sup>236</sup> Exhibit R-14, Second Euro-Trend Proposal.

<sup>237</sup> Transcript, Day 7, Smith, p. 7, lines 20-25.

<sup>238</sup> *Id.*, p. 7, lines 11-15.

<sup>239</sup> Transcript, Day 1, Smith, p. 32, lines 21-25, p. 33, line 1.



349. No matter how the proposition is put, in the Tribunal's view, the Claimant's legitimate expectation argument presupposed the approval of the Cabinet and the OPC. That is, on the basis of what was communicated to Invesmart prior to 24 October 2002, state aid would have been granted if the Minister had only submitted the request.
350. In the Tribunal's view, this was not the case. Having regard to the legal framework that governed the granting of state aid, the Minister could not simply rubberstamp the bank's application without evaluating its merits in terms of its potential to meet the requirements of Czech and EU law.<sup>240</sup> For an application to be submitted to the Cabinet, let alone be approved by the OPC, the Minister had to be satisfied that it had a reasonable prospect of achieving the goal of stabilising the bank. This required the applicant to submit a restructuring plan that met the requirements of the law, and the Minister, the Cabinet and the OPC had to agree that the plan met those requirements.
351. The Tribunal does not see how the Claimant's legitimate expectation that the Ministry of Finance would follow a process meant that such expectation would deliver the desired result. At the time that the expectation was said to have crystallised, the Respondent was not, in the Tribunal's view, in a position to promise that state aid would be granted. It could, and did, undertake a commitment of process, but not of result and the Claimant should have understood that to be the case. As the evidence shows, ultimately, the Minister concluded that the Restructuring Plan did not have a reasonable prospect of success.

## **Inconsistency and ambiguity**

### **The Claimant**

352. The Claimant relied on a recent line of case law to argue that the Czech Republic breached the fair and equitable treatment standard by failing to treat its investments "consistently" and "without ambiguity".<sup>241</sup>
353. Specifically, the Claimant submitted that the Respondent had acted inconsistently by:

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<sup>240</sup> By the end of the hearing, it was common ground between the parties that the CNB is not vested with the authority or power to decide whether state aid should be granted. That falls within the remit of the Minister of Finance. Even then, the evidence is that the Minister does not possess final decision-making power; rather, having evaluated a proposal, he decides whether to put it to Cabinet for its approval and by virtue of Czech law implementing EU law, the Cabinet decision is not effective without the approval of the OPC. This is fundamental to, and expressed in, the operation of the host state's law on state aid and the Tribunal must have due regard to it.

<sup>241</sup> *Técnicas Medioambientales Tecmed, S.A. v. United Mexican States*, (ICSID Case No. ARB(AF)/00/2) (Award of 29 May 2003); *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile* (ICSID Case No. ARB/01/7) (Award of 25 May 2004); *Saluka v Czech Republic* (Partial Award of 17 March 1996).

- (a) Approving Invesmart's acquisition of Union Banka and then simultaneously causing a run on Union Banka by making irresponsible comments to the Czech media on 22 October 2002;<sup>242</sup>
- (b) Adopting inconsistent positions towards Invesmart and Union Banka after Invesmart's assumption of Union Banka's RPLs. Invesmart submitted that it had invested in Union Banka and Union Group in the belief that the Government would provide state aid under the CF Transaction. Following the Invesmart's acquisition of Union Banka and Union Group the CNB continued to support the CF Transaction whilst the Ministry of Finance and the CKA did not;<sup>243</sup>
- (c) Further, Invesmart submitted that it was caught between the inconsistent proposals of different organs of the Czech Government in relation to the form of state aid.<sup>244</sup> Specifically, at the 5 November 2002 meeting, discussed at paragraph 124 above, the CKA supported the settlement of the BDS Arbitration Claim as a "purely commercial solution that should not meet with a negative response from the UOHS".<sup>245</sup> However, the CNB was not prepared to settle the BDS Arbitration Claim;<sup>246</sup>
- (d) Resiling from its position held prior to Invesmart's acquisition of Union Banka that the OPC need only be "consulted" with respect to state aid. Following the investment, the Czech Republic "changed the rules of engagement" by requiring that the OPC "pre-approve" any grant of state aid;<sup>247</sup>
- (e) After Invesmart prepared the restructuring plan, the MOF failed to submit it for review and approval by the OPC as promised;<sup>248</sup>
- (f) Failing to publicly declare its support for Invesmart and Union Banka through the making of a Resolution as it had promised to do on 29 November 2002, which would have aided the bank.<sup>249</sup>

354. Invesmart's claim of "ambiguity" in the context of, or in addition to, "inconsistency" related to the Respondent's failure to disclose, before approving Invesmart's acquisition of Union Banka

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<sup>242</sup> Statement of Claim, para 303.

<sup>243</sup> *Id.*

<sup>244</sup> Statement of Claim, para 303.

<sup>245</sup> Exhibit R-81, Minutes of Meeting held on 5 November 2002.

<sup>246</sup> first witness statement of Governor Tůma, para 39; first witness statement of Mr. Vávra, para 63.

<sup>247</sup> *Id.*

<sup>248</sup> Claimant's Opening Statement, p. 36.

and Union Group, that the Deputy Prime Minister of the Czech Republic had made a commitment to the EC that the Czech Republic would not provide any new aid to banks.<sup>250</sup>

### The Respondent

355. The factual basis for each of these allegations was rejected by the Respondent. Its defence of these claims can be summarised thus:

- (a) The run on Union Banka was not caused by inaccurate statements made by the CNB to the media but arose instead from the public's loss of confidence in Union Banka's capacity to resolve its long-standing difficulties when the deadline for Invesmart to appeal the rejection of its Second Application for state aid expired. This was of common public knowledge;<sup>251</sup>
- (b) It did not adopt conflicting positions toward Invesmart and Union Banka for it was Invesmart and Union Banka, and not the Government, who introduced the CNB Receivable as a potential mechanism to secure delivery of state aid in January 2003 even though the CNB Receivable had been discussed and rejected by the Government a full two months earlier;<sup>252</sup>
- (c) The requirement that state aid be "pre-approved" by the OPC was not arbitrary; rather it flowed from the then applicable Czech and EU law with which it was not erroneous of the Government to insist compliance on the part of Invesmart. Failure to comply warranted the denial of state aid;<sup>253</sup>
- (d) The Czech Republic was under no obligation to publicly declare its support of Union Banka before a decision on the grant of state aid was given just as it was similarly under no obligation to grant state aid.<sup>254</sup>

356. With respect to the Claimant's allegation that the Czech Republic failed to provide adequate notice of its decision not to grant state aid, the Respondent points out that Invesmart was given notice of the decision not to grant aid orally on the day the decision was taken.<sup>255</sup> Further a letter informing Invesmart of the decision in writing was sent to Union Banka's official

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<sup>249</sup> *Id.*, para 304.

<sup>250</sup> Statement of Reply, para 365.

<sup>251</sup> Statement of Defence, paras 393–394.

<sup>252</sup> *Id.*, paras 396–399.

<sup>253</sup> *Id.*, paras 403–404.

<sup>254</sup> *Id.*, para 405.

registered address where the Bank publicly professed to have its place of effective management.<sup>256</sup>

## **Tribunal's analysis**

### **Inconsistency - OPC approval**

357. At the core of Invesmart's claim that is the allegation that the Government changed the rules of engagement and following its assumption of the RPL's introduced a new requirement: that state aid be subject to OPC approval.
358. This issue was also raised in the context of legitimate expectations. The Tribunal concludes at paragraph 327 that the role of the competition authorities in vetting any proposed state aid, including in respect of the CF transaction, was brought to the Claimant's attention before it submitted its third application to acquire Union Banka on 22 October 2002. It follows from this conclusion that when the Government informed Invesmart on 5 November 2002 that the CF Transaction constituted "new" state aid and would be subject to OPC approval that there was no change in position as the Claimant alleges.<sup>257</sup>

### **The run on Union Banka**

359. At the hearing the parties agreed as to the specific wording of the comment Ms Frišaufová made to the Czech media on 22 October 2002. Specifically, Ms Frišaufová made the following statement:

In this administrative proceeding the CNB did not grant its approval to Invesmart for the acquisition of qualified interest in Union Banka because the investor failed to provide the source of funding for the acquisition. As far as this proceeding is concerned, the decision is final. This does not, however, preclude Invesmart from filing a new application and commencing new administrative proceedings on granting the approval with the transfer of the shares.<sup>258</sup>

360. The Tribunal's considers that these comments were ill-considered, given Union Banka's already weak financial position. In late October 2002 the uncertainty surrounding Union Banka was, in part, a consequence of the CNB Governor's advice to Invesmart submit a new application to acquire a controlling interest in Union Banka rather than appeal the CNB's

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<sup>255</sup> See Exhibit R-154, minutes of a meeting held on 20 February 2003 between the CNB and members of the Supervisory Board of Union Banka, a.s. and Exhibit R-155, minutes of a meeting held on 20 February 2003 between the CNB and Union Banka, a.s.

<sup>256</sup> Statement of Rejoinder, para 232. See also Exhibit R-121, minutes of the general meeting of Union Banka held on 20 December 2002; Exhibit R-446, press article, "Union banka's headquarters to remain in Ostrava", *Mladá Fronta Dnes* dated 8 November 2002.

<sup>257</sup> Exhibit C-61, minutes of a meeting held on 5 November 2002 between the Ministry of Finance, CKA, Invesmart and Euro-Trend.

rejection of Invesmart's second application during the appeal period 4 - 22 October 2002. The CNB was aware that Invesmart had submitted a revised submission on 22 October 2002 and this was recognised by the CNB spokeswoman. In consequence, the CNB's approval of the new application and the OPC's approval of state aid were, at that time, open issues.

361. The destabilising impact of the CNB's comments is illustrated by the way the issue was reported by the Czech media. In particular, a report published by Česká Tisková Kancelár included the following sentence "Frišaufová said she did not want to anticipate future developments, but did not rule out that taking away the bank's license was one possibility".<sup>259</sup>
362. That the run on Union Banka might have been avoided is shown by the fact that it was ended when on 24 October 2002, the CNB approved Claimant's application to acquire a share in Union Banka and Union Group.
363. The statements in question, having been made publicly by the CNB spokeswoman, are imputable to the CNB; the conduct of a state entity such as the CNB being attributable to the Czech Republic. The Respondent cannot escape criticism in view of the recognised sensitivity of public announcements in the banking sector.
364. That being said, the Tribunal holds that this conduct cannot amount, *per se*, in isolation, to a violation of fair and equitable treatment. The Tribunal notes that at the time this statement was made it was, strictly speaking, factually accurate. The purpose of making the statement was explained by Governor Tůma in cross-examination:
- Everybody knew at that time that Union banka was in [a] difficult position, and the pressure for the bank didn't occur after the statement by Mrs Frišaufová. The pressure was long -- longer, for a longer period. We decided, and everybody knew, or the general public knew that -- and by the way, it was used as the argument that the investor is applying and there is a chance that the investor would take over, and this is -- so it was used also by the Union banka as the argument for the general public that the situation would calm down.<sup>260</sup>
365. These comments by Governor Tůma are persuasive. In particular, that the problems at Union Banka existed many months prior to October 2002 and that the comments made by Ms Frišaufová are capable of being characterised as an attempt to reassure the public. Whilst these comments may be criticised in retrospect, given the run that occurred on 23 October 2002, the Tribunal is not satisfied that the conduct constitutes a breach of fair and equitable treatment.
366. The Respondent also asserted that the information contained in Ms Frišaufová's statement was already in the public domain. This contention is strongly supported by public statements made

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<sup>258</sup> Transcript, Cross-examination of Governor Tůma, Day 4, p. 191, lines 6–14.

<sup>259</sup> Exhibit C-54, newspaper article published 22 October 2002 by Česká Tisková Kancelár.

<sup>260</sup> Transcript, Day 4, Cross-examination of Governor Tůma, p. 191, lines 4–13.

by \_\_\_\_\_ prior to the comments made by Ms Frišaufová. The Respondent tendered evidence that on 22 October 2002 *Mlada fronta Dnes*, one of the principal Czech National dailies, reported that Invesmart had confirmed that it did not appeal against the decision of the CNB to deny its second application to acquire Union Banka. This paper quoted as saying "It is very complicated. It cannot be definitively said that we do not continue in our negotiations. We are in contact with the CNB".<sup>261</sup>

367. Ultimately, the run on Union Banka occurred as a result of public perception that the prospects of Union Banka being acquired by a foreign investor had declined. It may be equally fair to speculate that this perception existed as a result of \_\_\_\_\_ comments, or both \_\_\_\_\_ and the CNB's comments taken together.

### **The CKA's proposal to settle the BDS arbitration claim**

368. At the 5 November meeting CKA proposed settlement of the BDS Arbitration Claim for CZK 1.8 billion as a means of conferring a benefit on Union Banka "that would not meet with a negative response from the UOHS".<sup>262</sup> The minutes of the meeting record that the proposal would be put to the CNB expeditiously,<sup>263</sup> the latter having not attended the meeting. However, few days later, at a meeting held on 29 November 2002, the CNB rejected the proposal since it "did not admit the Union Banka's claim".<sup>264</sup> Mr Vávra for Union Banka, present at the meeting together with a representative of Invesmart, took note of the CNB's position, no remarks or objection on his part being reflected by the minutes of the meeting.
369. Thus, Union Banka and Invesmart were made aware, about three weeks after the CKA's proposal, that the same could not be implemented due to the CNB's opposition. The Tribunal considers that a governmental entity against which an arbitral claim had been made, and which was not represented at the meeting at which the settlement of the claim against it was discussed, was entitled to state its objection when it became apprised of the discussion.
370. This conduct by the various entities of the Czech Republic does not amount to a violation of Article 3.

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<sup>261</sup> Exhibit R-78, article published by *Mlada fronta Dnes* on 22 October 2002.

<sup>262</sup> Exhibit C-61, minutes of a meeting held on 5 November 2002 between the Ministry of Finance, CKA, Invesmart and Euro-Trend.

<sup>263</sup> *Id.*, conclusion.

<sup>264</sup> Exhibit C-63, minutes of a meeting held on 29 November 2002 between the Ministry of Finance, the OPC, the CNB, the CKA, Union Banka, Euro-Trend and Invesmart, p.2, line 1.

### **The MOF's failure to submit the Third Restructuring Plan to the OPC**

371. The reasons for the MOF's rejection of the Third Restructuring Plan were given by Minister Sobotka in his letter to Union Banka dated 20 February 2003.<sup>265</sup> The application for state aid having been rejected, there was no reason for the MOF to submit Union Banka's application to the OPC for an exemption from state aid prohibition, as mentioned by Minister Sobotka in the same letter. The MOF's prior approval was in fact a necessary pre-condition of the OPC's review of state aid proposals. Further, the MOF, after the many months spent in an attempt to find a solution to the state aid issue, had no obligation to meet again with Union Banka to explore alternative solutions. Union Banka's financial situation at that point in time, as confirmed by its CEO, Mr Vávra, on 19 February 2003, was so critical ("catastrophical", regarding the liquidity situation) as to suggest that no time was left for further discussions.<sup>266</sup>

### **The MOF's "undertaking" to issue a resolution in support of Union Banka**

372. The minutes of the 29 November 2002 meeting do not appear to reflect the Claimant's assertion that the Government undertook "to issue a public commitment in the form of a resolution allowing an exemption on the ban on State aid" with the view of reassuring the public and Union Banka's customers that the bank had the full support of the Government.<sup>267</sup> The record shows that Mr Vávra proposed that:

Given the time needed to draw up a restructuring plan and the time it would take the UOHS to issue a decision, the UB CEO asked if it would be possible to make use of this period by submitting all the necessary material to the government, which would then issue a resolution stating that the government had considered the issue and would only assess the possibility of providing state aid to the bank on condition that the UOHS allowed such aid to be provided under Law 59/2000 on State aid - in other words, issue a decision allowing an exemption from the ban on state aid.<sup>268</sup>

373. The somewhat confused record of this part of the minutes prompted a clarification by the First Deputy Finance Minister (present at the meeting), who suggested that the exemption by the MOF was not meant to refer to the ban on state aid but rather "to the comments procedure".<sup>269</sup>
374. Following that meeting, based on its understanding that the Government had accepted to issue a resolution allowing an exemption on the ban on state aid, Union Banka circulated a draft of

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<sup>265</sup> Exhibit R-151, letter dated 20 February 2003 from then-Minister of Finance Sobotka to Union Banka.

<sup>266</sup> See Exhibit R-150, minutes of a meeting held on 19 February 2003 between Mr. Vávra for Union Banka, and Mr. Krejča, Mr. Jiríček, Ms. Goldscheiderová, and Mr. Majer of the CNB.

<sup>267</sup> Exhibit C-63, minutes of a meeting held on 29 November 2002 between the Ministry of Finance, the UOHS, the CNB, the CKA, Union Banka, Euro-Trend and Invesmart and Statement of Claim, para 122.

<sup>268</sup> *Id.*

<sup>269</sup> *Id.*

the Government's resolution to that effect.<sup>270</sup> The draft resolution was unacceptable to the Government since it amounted to the approval of state aid to Union Banka on condition of a positive decision of the OPC,<sup>271</sup> providing further that the amount and form of state aid resulting from UB's restructuring plan "shall be accepted by the Office for the Protection of Competition".<sup>272</sup> [Emphasis added.]

### The Czech Republic's renewed commitment to the EC

375. As already mentioned, the Czech Republic cannot be reproached for its alleged failure to alert Invesmart about the need of the OPC's approval of the state aid. The Claimant contends that the Respondent should have informed Invesmart in a timely manner that obtaining such approval had become more difficult following the Deputy Prime Minister's commitment to the EC that the Czech Republic would not provide any new aid to banks. Due to the terms of the commitment so made (as reflected in the minutes of 29 November 2002 meeting),<sup>273</sup> the prospects of obtaining the EC's approval of new state aid by the Czech Republic were reduced.
376. The minutes mention that "possible further aid to UB would mean a violation of the commitment made by Deputy Prime Minister Pavel Rychetsky that the Czech Republic would not provide any new aid to banks".<sup>274</sup> In the Claimant's view, this wording underlines the fact that a serious additional obstacle existed to the granting of state aid to Union Banka, although the OPC's representatives indicated at the meeting that "they would not rule out the provision of aid to the bank on principle".<sup>275</sup>
377. According to the Claimant, the significance of the Czech Republic's failure to inform Union Banka and Invesmart in a timely manner is made manifest by the fact that by 29 November 2002 Invesmart had already completed its acquisition of Union Banka and Union Group. The Debt Assumption Agreements signed by Invesmart on 17 November 2002 had in fact become effective upon the transfer of shares in Union Banka and Union Group to Invesmart on 18 November 2002.<sup>276</sup>
378. The Claimant's complaint is misplaced in more than one respect. As already indicated at paragraph 319 above, the Deputy Prime Minister's commitment to the EC that there would be

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<sup>270</sup> Exhibit R-15, Third Euro-Trend Proposal, dated 7-8 January 2003.

<sup>271</sup> *Id.*, Point II, front page.

<sup>272</sup> *Id.*, Point III, front page.

<sup>273</sup> See Exhibit C-63, Exhibit C-63, minutes of a meeting held on 29 November 2002 between the Ministry of Finance, the UOHS, the CNB, the CKA, Union Banka, Euro Trend and Invesmart.

<sup>274</sup> *Id.*,

<sup>276</sup> Exhibits R-83 and R-102 and Statement of Defence, para 132.



no more public subsidisation to the banks had been disclosed to Union Banka's advisors, Euro-Trend, at a meeting held on 25 October 2002.<sup>277</sup>

379. Further, as also already discussed at paragraph 318 above, the relevant time for determining whether Invesmart irrevocably committed to its investment in the bank without knowledge of the Respondent's commitment to the EC is not 16 October, but 4 November 2002.
380. The facts at hand may therefore be distinguished from the cases to which Invesmart referred in making its claim. In the present case, no decisions or permits had been issued by the State on which Claimant could reasonably rely to assume its commitments. This was the case in *Tecmed* and *MTD*. No such reliance was justified by the CNB's approval of Invesmart's acquisition of shares in Union Banka and Union Group since state aid had still to be cleared by the OPC. Contrary to the *Saluka* case, where the tribunal found that the Czech Republic had "acted inconsistently in its overall communications with IPB and Saluka/Nomura",<sup>278</sup> no such inconsistency may be imputed in the present case to the Czech Republic.
381. In the light of the foregoing, the Tribunal holds that Claimant's claim of breach by the Czech Republic of fair and equitable treatment for inconsistency and ambiguity of conduct fails.

## **Discrimination**

### **The Claimant**

382. With regard to its fair and equitable treatment claim, Invesmart also submitted that the Czech Republic's denial of state aid to Invesmart was discriminatory. The basis of this claim was Invesmart's contention that between 1990 and 2004 the Czech Republic routinely provided state aid to Czech banks whose circumstances were comparable to those of Union Banka whether viewed in terms of size, the amount of aid to be provided, the form of aid or the purpose of aid.<sup>279</sup>
383. Invesmart also argued that several of these banks had received emergency liquidity loans from the Czech Republic and that the Czech Republic's refusal to provide similar support to Union Banka was discriminatory.
384. In developing its submissions Invesmart referred the Tribunal to the *Saluka* arbitration in which the Czech Republic was found to have discriminated against a large Czech bank (IBP) without justification when it denied IBP's requests for state aid while granting state aid to three

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<sup>277</sup> Exhibit C-60, minutes of a meeting held on 25 October 2002 between Josef Douruška of the Ministry of Finance and Euro-Trend representatives.

<sup>278</sup> *Saluka*, Partial Award, dated 17 March 2006, para 419.

<sup>279</sup> Statement of Claim, para 346.

of the four other major Czech banks. In *Saluka* the tribunal accepted that this discrimination violated the fair and equitable treatment standard and the impairment clause. The Claimant argued that Union Banka's circumstances were analogous to those of IBP and that it was similarly discriminated against.

385. Invesmart went on to refer the Tribunal to its own analysis of state aid provided by the Czech Republic, and its predecessor state, to banks between 1990 and 2004.<sup>280</sup> This analysis was largely derived from information provided to the EC by the Czech Republic.<sup>281</sup> The Claimant's submissions on discrimination were also supplemented by Appendix A of the Statement of Claim which summarised the main forms of state aid that the Czech Republic provided to banks between 1990 and 2004. This evidence was summarised in the following way by the Claimant in opening submissions:

- (a) 12 mid-sized and small Czech banks received state aid from 1996 to 2001, including Prago Banka (1997), Agrobanka (1998) and PMB (2000, 2001);
- (b) Four Czech banks received state aid from 2001 to 2005 including PMB, Ceska Sportielna, Komerčni Banka and CSOB;
- (c) The Czech Republic provided vast amounts of state aid to promote restructuring and onward sales to strategic investors including IPB, Komerčni Banka, Ceska Sportielna, CSOB and Agrobanka.<sup>282</sup>

386. Invesmart also tendered expert evidence in support of its discrimination claim in the form of two reports by Associate Professor Raj M Desai dated 6 December 2007 and 11 July 2008. Professor Desai's first report was on the "relevant policies, methods and interests used in the provision of state support and assistance to the banking sector in the Czech Republic between the mid 1990s and mid 2000s".<sup>283</sup> Professor Desai's second report was in the form of a reply opinion which sought to evaluate the submission made in the Statement of Defence that Union Banka "could not be reasonably compared with other banks that received direct or implicit state budgetary or off-budgetary assistance".<sup>284</sup>

387. Professor Desai's first report described the state aid provided to Czech banks under the first and second Consolidation Programs and the Stabilisation Program in the 1990s. He opined that from 1998 onwards it was the policy of the Czech Republic to find a strong private "strategic

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<sup>280</sup> Statement of Claim paras 29–50; Transcript, Day 1, Fleuriet, p. 64, lines 9–15.

<sup>281</sup> Transcript, Day 1, Fleuriet, p. 63, lines 13–14.

<sup>282</sup> Claimant's opening statement, pp. 43–44.

<sup>283</sup> Report of Associate Professor Raj Desai, dated 6 December 2007, p. 3.

<sup>284</sup> Report of Associate Professor Raj Desai, dated 11 July 2008, para 1.

investor" to assist with the privatisation and restructure of banks.<sup>285</sup> A number of Czech banks were privatised during this period and acquired by foreign investors, including IBP, Komerční Banka, Ceska Sporitelna, COB and Agro Banka. Each was provided with state aid in various forms.<sup>286</sup> Finally, Professor Desai described a number of small and medium sized banks that were granted state aid in the 1990s.<sup>287</sup>

388. In Professor Desai's second report much was made of the similarities between Nomura's acquisition of IBP, that was the subject of the *Saluka* arbitration, and Invesmart's acquisition of Union Banka. This was based on the contention that the problems afflicting both banks were typical of those experienced by Czech Banks throughout the 1990s. The report stated:

Insufficient capital adequacy, related lending, non-transparency in ownership, and consequent asset stripping and non-performing loans, were common across all types of Czech Banks in the 1990s -big and small, formerly state-owned or *de novo*.<sup>288</sup>

389. Professor Desai also opined that state aid was provided to numerous Czech banks from 2000 onwards. In paragraph 13 he states:

State aid was provided to numerous Czech banks after 2000. In particular, state support to Česká Spořitelna, a.s., took the form of bad-asset transfers (in March 2000) and contingent guarantees (June 2000 and June 2001). In the case of Komerční Banka, a.s. (KB), state aid was provided through rescue and restructuring support (March 2000) and guarantees as part of a sale of stock (October 2001). Československé Obchodní Banka, a.s., (CSOB) received state aid in conjunction with its acquisition of IPB (in June 2000), as well as through state-supported rescue and restructuring operations (throughout 2000, 2001, and 2002).<sup>289</sup>

## **The Respondent**

390. The Respondent submitted that the factual record did not support Invesmart's discrimination claim.
391. The Respondent referred the Tribunal to the test for discrimination enunciated by the *Saluka* tribunal, namely as being whether (i) similar cases are (ii) treated differently (iii) without reasonable justification.<sup>290</sup>
392. The Respondent submitted that the Tribunal should distinguish Union Banka's circumstances from the facts in *Saluka* on the basis that in *Saluka* there was differential treatment between four clearly analogous banks. The Respondent pointed to a number of similarities between IBP

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<sup>285</sup> Report of Associate Professor Raj Desai, dated 6 December 2007, p. 20.

<sup>286</sup> *Id.*, pp. 20-29.

<sup>287</sup> *Id.*, pp. 30-34.

<sup>288</sup> Report of Associate Professor Raj Desai, dated 11 July 2008, para 8.

<sup>289</sup> *Id.*, para 13.

<sup>290</sup> Statement of Defence, para 417 referring to *Saluka* Partial Award, para 313 (Exhibit C-194).

and the three other major Czech banks: the four banks were all of a similar size; all had portfolios of non-performing loans; all were undergoing a process of privatisation; the failure of any of the banks would have had systemic consequences for the Czech banking sector.<sup>291</sup>

393. The Respondent went on to argue that no Czech banks operated under conditions similar to those of Union Banka. It submitted that:

(a) Union Banka was one of a more diverse group of small privately owned banks, some of which had been allowed to fail without the provision of state aid or following the provision of state aid,<sup>292</sup>

(b) Union Banka's balance sheet problems were the unique consequence of its acquisition of the four smaller banks in the 1990s;<sup>293</sup> and

(c) No similarly situated Czech bank was granted state aid in 2002 or 2003.<sup>294</sup>

394. The Respondent's submissions were supported by two expert opinions prepared by Professor Dr Dr h.c. Claus-Dieter Ehlermann dated 25 March 2008 and 2 October 2008, respectively.

395. In particular, Professor Elhermann's analysis introduced a temporal aspect to the discrimination case. Professor Ehlermann opined that "the situation in February 2003 was different from and not comparable to the situation in which earlier privatisations and takeover operations had taken place".

396. Professor Elhermann advanced two main arguments in support of this position.

397. First, the Czech Act on state aid, which was enacted on 1 April 2000 and entered into force on 1 January 2001, restricted the Czech Republic's legal right to grant state aid unless the OPC approved the grant.<sup>295</sup> The implementation of the new law had a significant impact on the preparedness of the Czech Government to make grants of state aid. Professor Elhermann acknowledged that the Czech Republic made grants of state aid after the implementation of the Act between January and June 2001. However, he suggested that these grants of state aid related to 'older' negotiations that pre-dated the Act.<sup>296</sup>

398. Secondly, state aid controls were imposed on the Czech Republic as part of its accession to the EU. Large sections of Professor Elhermann's first report were dedicated to describing how the

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<sup>291</sup> *Id.*, para 418.

<sup>292</sup> *Id.*, para 419

<sup>293</sup> *Id.*,

<sup>294</sup> *Id.*, para 420.

<sup>295</sup> First Report of Professor Elhermann, para 285.

EC required that state aid control be implemented by the Czech Republic. These requirements were not strictly observed by the Czech Republic between 1998 and 2001. However, Professor Elhermann opined that the observance of these controls crystallised during the pre-accession period which coincided with Invesmart's and Union Banka 's negotiations with Czech government officials concerning state aid.<sup>297</sup>

399. At the core of Professor Elhermann's analysis was the distinction between the granting and payment of aid. As Professor Elhermann stated in his second report:

... there is a fundamental difference between the act of entering into a legally binding commitment, i.e. the grant, on the one hand, and the acts of implementation, i.e. the payments etc., on the other. These two different acts do not have the same character and should therefore not be characterised to be "alike" for a meaningful comparison under the principle of non-discrimination.<sup>298</sup>

400. The Respondent conceded that since 2000 there have been many examples of state aid being paid pursuant to arrangements made prior to 2001. However, the Respondent submitted that from 2001 onwards only two grants of state aid were made to banks by the Czech Republic.<sup>299</sup>

401. In closing submissions these grants were described by Professor Crawford in the following terms:

Since 2001 State aid was given to two banks and this aid was subsequently notified to the European Commission in the document exhibits C17 and C18. Each of those transactions has special features.

First in relation to PNB, this was a small bank in which the City of Prague had an interest, and under an indemnity of 27 December 2001 an amount of [CZK] 3.43 million was paid by way of aid. That amounts to €114,000 by my calculation.

Secondly, Komerční Banka was granted a tax relief in relation to State aid previously granted in an earlier year, which gave it an extraordinary profit. So in effect the government accepted the argument that the earlier aid shouldn't, as it were, be taken away in the form of taxation.<sup>300</sup>

402. In closing submissions the Respondent also tendered, without objection from the Claimant, a table listing 21 examples where OPC denied requests for state aid between 2001 and 2004.<sup>301</sup> Similarly, in the Statement of Defence the Respondent listed four small and medium sized banks that had been allowed to fail without the provision of state assistance.<sup>302</sup>

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<sup>296</sup> First Report of Professor Elhermann, para 286.

<sup>297</sup> *Id.*, paras 288–289.

<sup>298</sup> Second Report of Professor Elhermann, para 11.

<sup>299</sup> Transcript, Day 7, Professor Crawford, p. 237, lines 11–21.

<sup>300</sup> Transcript, Day 7, Professor Crawford, p. 237, lines 6–7.

<sup>301</sup> Transcript, Day 7, Professor Crawford, p. 235, line 25, p. 236, 1–25, p. 237. 1–5.

<sup>302</sup> Statement of Defence, para 418: the banks are listed in fns 608 and 609.

### **The Tribunal's analysis**

403. On the basis that the parties adverted to *Saluka*, when making submissions on the discrimination issue and without engaging in an analysis of the correctness of that tribunal's treatment of discrimination as a part of the fair and equitable treatment standard, the Tribunal will consider whether the evidence other Czech banks were (i) similarly situated to Union Banka, yet (ii) treated differently (iii) without reasonable justification.

### **Were the other recipients of state aid similarly situated to Union Banka?**

404. The Tribunal is not satisfied that Union Banka was similarly situated to other Czech Banks who received state aid at the time Union Banka sought it.
405. In its submissions the Claimant referred the Tribunal to numerous banks that received state aid following the State's transition from a communism, many as part of the Consolidation and Stabilisation Programs during the 1990s. The Tribunal notes that the parties agreed that throughout the 1990s the Czech banking system was in crisis and that as a result the Czech Republic, and its predecessor state, implemented three state aid programs to restructure and stabilise the banking system.<sup>303</sup> The parties also agreed that following the end of the Stabilisation Program in 1998 aid was provided to Czech banks in order to avert the failure of banks and to facilitate the sale of banks to foreign "strategic" investors.<sup>304</sup>
406. The Claimant placed significant emphasis on the state aid provided to Czech Banks during the Second Consolidation Program in 1995-1996 and the Stabilisation Program between 1996 and 1998. For example, in its opening submissions Invesmart referred the Tribunal to 12 mid-sized and small Czech banks that received state aid from 1996 to 2001. However, based on the evidence contained in the first report of Professor Desai it is apparent that the arrangements for the provision of this state aid were made between 1996 and 1998.
407. The Claimant said that Union Banka's problems were similar to those experienced by these other Banks because they were typical of systemic problems that plagued the Czech banking system throughout the 1990s. To wit, the key element of the Claimant's discrimination case was that the Czech Republic, in denying state aid, including emergency liquidity loans, had treated Union Banka differently to other banks that had similar problems.
408. In the Tribunal's opinion there are four key factors that arise from the Respondent's rebuttal of the discrimination claim which contradict this analysis.

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<sup>303</sup> Agreed Statement of Facts, paras 2, 4 and 5.

<sup>304</sup> Agreed Statement of Facts, para 6.

409. First, the Respondent's claim that the policy of the Czech Republic towards the granting of state aid changed as a consequence of its accession to the EU significantly. The entry into force of the Czech Act on State Aid on January 2001 was a critical step in this process and it was clear that after this time there was a marked reluctance by the Czech Republic to grant state aid. This is supported by the fact that only two grants of state aid were made to banks between 2001 and 2003. It is also supported by the numerous denials of requests for state aid made by the OPC between 2001 and 2004. Further, it seems logical that the onus would be on the Czech Republic to strictly observe its commitments to the EU in the pre-accession period, particularly in respect of state aid control. No evidence was advanced by the Claimant that contradicted this claim.

410. Secondly, the Respondent was correct to draw a distinction between the granting and the paying of state aid. It is necessary for the Tribunal to compare the Government's decision to deny state aid with other instances where the state aid was granted. The point at which the decision was made and the Czech Republic assumed an obligation to pay state aid is the relevant factor in the Tribunal's inquiry in respect of discrimination.

411. The Tribunal notes that questions regarding the relevance of the distinction between granting and paying aid were put to Professor Desai in cross-examination. However, it is apparent from the following exchange that Professor Desai did not incorporate this distinction or specifically compare Union Banka's circumstances with those of banks who were granted state aid in 2002 and 2003.

Professor Crawford: You say in paragraph 13 of your opinion: "State aid was provided to numerous Czech Banks after 2000". If, by that, you mean State aid was disbursed to a number of Czech Banks after 2000, then I can agree with you. I think that is certainly true. But do you give any example of - and, of course, the words "after 2000" need clarification as well. By "after 2000" I mean any event after 1st January 2001.

Professor Desai: I understand.

Professor Crawford: So after the end of the calendar year 2000. Do you give any example in your opinion of a decision to grant State aid made after the end of the calendar year 2000?

Professor Desai: In this section I wasn't trying to make a distinction between grants and payments, which I do appreciate is a distinction that is important, as you've presented it. However, there are examples. From my understanding of the record, there are examples of grants, new grants, made. I believe in - certainly in 2000, you say --

Professor Crawford: I said after the end of 2000

Professor Desai: One, my understanding, for the record, is that there were some cases of grants made in 2001 I did not draw a

distinction between them in this paragraph because I was not trying to make the distinction for the legal basis.<sup>305</sup>

412. Thirdly, the circumstances of the two banks that received state aid in 2002-2003 can be readily distinguished from the circumstances of Union Banka. In this regard, the distinction drawn by the Respondent in closing submissions seems sound. The Claimant did not seek to contradict this analysis, despite having been given the opportunity to do so.

413. Fourthly, it is highly relevant that there were other banks that were denied state aid and allowed to fail between 2000 and 2004. There can be no finding of discrimination if banks similarly situated to Union Banka are found to have been treated similarly to Union Banka. The fact that other banks were denied aid suggests this may be the case. Neither party made detailed submissions on the similarities between the small and medium banks that were denied aid, other than by reference to their size and the widespread problems affecting numerous Czech banks. The Claimant did not seek to distinguish Union Banka's circumstances from the banks that failed.

414. Finally, it is necessary for the Tribunal to refer to the analogy drawn by the Claimant between the facts in *Saluka* and the facts at hand. The Tribunal is of the opinion that the discrimination against IBP in *Saluka* was fundamentally different to that to the Czech Republic's treatment of Union Banka. This is because of the close comparison that the *Saluka* tribunal was able to draw between IBP and the three other major Czech banks. In its award, the *Saluka* tribunal noted that:

... irrespective of whether the bad debt problem with which the Big Four banks were face from 1998 to 2000 may properly be characterised as "systemic" or not, these banks were in a sufficiently comparable situation: All of them had large non-performing loan portfolios resulting in increase provisions and consequently insufficient regulatory capital. None of them was able to absorb the losses by calling on shareholder equity. The survival of all of them was sooner or later seriously threatened unless the Czech State was willing to provide financial assistance. On the other hand, due to the macroeconomic significance of the Big Four banks, the Czech State apparently could not afford to let any one of these banks fail.<sup>306</sup>

415. The Tribunal is not satisfied that Union Banka was in a situation comparable to that of any other Czech bank, let alone to all the other members of an identified class of Czech banks. The question of whether Union Banka was similarly situated to other banks requires more than an identification of single points of similarity, such as size, origin or private ownership. There must be a broad coincidence of similarities covering a range of factors. The comparators must

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<sup>305</sup> Transcript, Day 5, Cross examination of Associate Professor Desai, p. 66, lines 20-25 and p. 67, lines 1-19.

<sup>306</sup> *Saluka* Prtial Award, 17 March 2006, para 322.



be similarly placed in the market and the circumstances of the request for state aid must be similar. Therefore, the Tribunal concludes that Invesmart has not demonstrated that Union Banka was subject to discrimination by the Czech Republic.

## **Bad faith**

### **The Claimant**

416. The final strand of Invesmart's claim for breach of fair and equitable treatment is its claim that the Czech Republic acted in bad faith. In its Statement of Claim Invesmart advanced several examples of conduct undertaken by the Czech Republic which it claimed were examples of bad faith, including:

- (a) The Respondent induced Invesmart to acquire Union Banka by committing to undertake the CF Transaction in exchange for Invesmart's assumption of the RPLs. It then refused to complete the CF Transaction;
- (b) The Respondent's decision (or effective decision) to deny state aid had the result of saddling Czech taxpayers with a loss of CZK 18.5 billion, rather than providing some CZK 650 million in aid to Union Banka;
- (c) The Respondent mishandled the bankruptcy proceedings against Union Banka in Ústí nad Labem and in Ostrava. These proceedings, combined with criminal prosecutions of senior officials involved with the Ostrava proceedings, constituted a "deliberate conspiracy" by the Czech Republic against Union Banka.<sup>307</sup>

417. In its opening submissions Invesmart also claimed that the Czech Republic had acted in bad faith by engaging in a course of conduct that comprised the following actions:

- (a) failing to provide Invesmart with any notice of its decision to deny state aid;
- (b) leaking the decision to deny state aid to the media the same day that Invesmart was informed of the decision;
- (c) commencing administrative proceedings to revoke Union Banka's banking licence the day after state aid was denied;
- (d) making inflammatory press statements over the course of 21 February 2003; and

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<sup>307</sup> Statement of Claim, paras 335-336.

- (e) refusing to seriously consider four different plans put together by Invesmart and Union Banka to salvage Union Banka.<sup>308</sup>

### **The Respondent**

418. The Respondent rejected the Claimant's allegation of bad faith. It submitted that the allegation was primarily based on the existence of a commitment of state aid that, in fact, never existed. In all other respects, the Respondent said, the Claimant's allegations of bad faith were unsubstantiated and it was entitled to a presumption of good faith.<sup>309</sup>

### **The Tribunal's analysis**

419. In making its allegation of bad faith the Claimant correctly pointed out that while acts of bad faith violate the fair and equitable treatment standard, bad faith is not required to make out a violation of the standard.

420. This was noted by the tribunal in *Mondev International Ltd. v United States of America* when it stated that:

To the modern eye, what is unfair or inequitable need not equate with the outrageous or the egregious. In particular, a State may treat foreign investment unfairly and inequitably with out necessarily acting in bad faith.<sup>310</sup>

421. Similar sentiments were expressed by the tribunal in the *Loewen* case:

Neither state practice, the decisions of international tribunals nor the opinion of commentators support the view that bad faith or malicious intention is an essential element of unfair and inequitable treatment.<sup>311</sup>

422. In the Tribunal's opinion these statements notably draw an appropriate distinction between other forms of unfair and inequitable conduct, such as manifest unreasonableness, inconsistency and arbitrariness, and bad faith conduct, which has malicious or egregious intent, such as deliberate conspiracy, as an essential ingredient.

423. The Tribunal was unable to identify this essential ingredient in the Respondent's conduct on the evidence presented to it.

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<sup>308</sup> Claimant's Opening Statement, pp. 47-51.

<sup>309</sup> Statement of Defence. paras 429-431.

<sup>310</sup> *Mondev International Ltd. v United States of America*, ICSID Case No ARB(AF)/99/1, Award dated 11 October 2002, para 16.

<sup>311</sup> *The Loewen Group, Inc. and Raymond L. Loewen v. United States of America* (ICSID Case No. ARB(AF)/98/3), Award dated 26 June 2003, para 185.

424. The factual aspects of many of the Claimant's bad faith allegations have been considered by the Tribunal in assessing other aspects of the Claimant's fair and equitable claim and its claims under Article 5.1 of the BIT.

425. Rather than restate this analysis the Tribunal only raises those aspects of the evidence that are specifically pertinent to the Claimant's allegation of bad faith.

#### **Inducement to assume the RPLs**

426. For the reasons set out in paragraphs above the Tribunal is not persuaded by the Claimant's submission that the Czech Government induced Invesmart to assume the RPLs by undertaking to complete the CF transaction. At paragraphs 347-351 the Tribunal has already concluded that Invesmart could not have had a legitimate expectation that the Czech Republic would provide any form of state aid.. Further, at paragraphs 290-291 the Tribunal observes that Addendum No 4, which removed the provision of state aid as a pre-condition to SPA B, was dated 14 August 2002, seven days before it made its first proposal to the MOF on 20 August 2002. It follows from these findings that there was no inducement by the Czech Republic and therefore no bad faith.

427. Arguably, Invesmart entered these arrangements on the hope that state aid would be provided. However, this was a commercial judgment, the risk for which must be borne by Invesmart.

#### **Failure to choose the least cost option**

428. The Tribunal next turns its attention to Invesmart's contention that in revoking Union Banka's banking license the Czech Republic opted for a more costly alternative than providing the requested state aid to Union Banka.

429. Invesmart raised this same argument in relation to its expropriation claim. Specifically, Invesmart argued that the Czech Republic's expropriatory actions breached the BIT because the revocation of the banking licence was not in the public interest; the Czech Republic opted for the more costly course of action rather than grant state aid.

430. This argument mischaracterises the concept of bad faith. A government cannot be accused of acting in bad faith merely because it chooses one of several policy alternatives. Even where the course of action adopted is capable of criticism there is no showing of bad faith absent egregious intent.

431. The allegation is especially misguided given the evidence that it was not clear that the provision of state aid was the least-cost alternative given the dire financial circumstances of Union Banka in February 2003. It was reasonable, given the fragile liquidity situation of Union Banka, for the Minister of Finance to consider that even if aid were provided the future

solvency of Union Banka would still be highly uncertain. It was, by February 2003, a case of putting good money after bad.

### **The proceedings in Ústí nad Labem and the allegation of deliberate conspiracy**

432. In its opening submissions the Claimant described these proceedings thus:

That was a criminal proceeding to steal the bank's assets. The Czech Government itself has prosecuted the judge, the bankruptcy trustee and several other Government official that were involved in the Ústí nad Labem debacle ... As a result of this sham proceeding the bank was actually seized by a band of armed men ... who described himself as the bankruptcy trustee. and others were forced out of the bank. The situation was resolved to the Czech Republic's credit, in four or five days, but it may say something about motive in this case.<sup>312</sup>

433. The Tribunal assumes that the reference to motive in the Claimant's opening submissions is a reference to the allegation that the Ústí nad Labem proceedings represented a deliberate conspiracy against Union Banka pertaining to high levels of the Czech Government.

434. The Tribunal finds that there is no evidence that such a conspiracy existed. Whilst the conduct of the judge in the proceedings is attributable under Article 4 of the BIT to the Czech Republic, the Tribunal notes that the Czech Republic took swift action to ameliorate the situation, that the assets of Union Banka were not in fact looted as a result of the decision, that the judge actually reversed the decision himself and that the Czech Republic has taken criminal action against him. Given the efficiency with which the Czech Republic acted in relation to the Ústí nad Labem proceedings it is impossible to conclude that a conspiracy was afoot.

### **Impairment clause**

#### **Applicable legal standard**

435. Article 3(1) provides that with reference to the investments of investors of the other Contracting Party

Each Contracting Party ... shall not impair, by unreasonable or discriminatory measures, the operation, management, maintenance, use, enjoyment or disposal thereof by those investors.

436. Before considering the parties' submissions in respect of alleged breaches of the impairment clause it is necessary to consider whether this standard operates as separate and freestanding protection that offers protection to investors independently of the first limb of Article 3(1) of the BIT, the fair and equitable treatment standard.

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<sup>312</sup> Transcript, Day 1, p. 70, lines 9-21.

437. The Tribunal notes that the parties disagree on this question.

438. In its Statement of Defence the Respondent contended that the impairment standard in Article 3(1) of the BIT "is not, in fact, a separate, free-standing standard that can add anything" to Invesmart's claims under the fair and equitable treatment and expropriation standards.<sup>313</sup>

439. The Respondent based this analysis on comments made in *Saluka* that

[in] so far as the standard of conduct is concerned a violation of the non-impairment requirement does not therefore differ substantially from a violation of the "fair and equitable treatment" standard. The non-impairment requirements merely identifies more specific effects of any such violations.<sup>314</sup>

440. By contrast the Claimant described the relationship between the standards of protection described in Article 3(1) in the following terms:

The Czech Republic is required to treat the investments of Dutch investors fairly and equitably, and it is additionally prohibited from impairing such investments by unreasonable or discriminatory measures ... Furthermore, since the phrase "unreasonable or discriminatory measures" in Article 3(1) uses the disjunctive "or" instead of the conjunctive "and", it is clear that either "unreasonable" or "discriminatory" measures will violate the impairment clause.<sup>315</sup>

441. In the Tribunal's opinion the Claimant's characterisation of Article 3(1) as comprising two separate standards is correct. It is not for the Tribunal to speculate about the circumstances in which a factual allegation may be held to constitute a breach of the impairment clause but not fair and equitable treatment. However, the Claimant is entitled to invoke the protections afforded by both clauses.

442. The *Saluka* tribunal acknowledged that the standards of "reasonableness" and "discrimination" contained in the impairment clause have no different meaning than in fair and equitable treatment. However, it also recognised that it offered a separate standard of protection. This is borne out by the tribunal's separate analysis of *Saluka*'s claims under the impairment clause.

443. In the Tribunal's opinion the Claimant was thus correct when it stated:

The plain wording of Article 3(1) demonstrates that it contains two distinct legal standards. Additionally, under cardinal principles of treaty interpretation, the impairment clause must be interpreted in a manner that gives it substance and meaning, rather than as mere surplusage that adds nothing to the fair and equitable treatment clause.<sup>316</sup>

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<sup>313</sup> Statement of Defence, p. 434.

<sup>314</sup> *Saluka* Partial Award, paras 460–461.

<sup>315</sup> Reply Memorial, para 374.

<sup>316</sup> Reply Memorial, para 377.

444. The Tribunal further agrees with the *Saluka* tribunal's analysis about the meaning of the standard enshrined in the impairment clause when it states:

"Impairment" means, according to its ordinary meaning (Article 31 of the Vienna Convention on the Law of Treaties), any negative impact or effect caused by "measures" taken by the Czech Republic.

The term "measures" covers any action or omission of the Czech Republic. As the ICJ has stated in the *Fisheries Jurisdiction Case (Spain v Canada)*...

[I]n its ordinary sense the word is wide enough to cover any act, step or proceeding, and imposes no particular limit on their material content or on the aim pursued thereby ...

The standard of "reasonableness" therefore requires, in this context as well, a showing that the State's conduct bears a reasonable relationship to some rational policy, whereas the standard of "non-discrimination" requires a rational justification of any differential treatment of a foreign investor.

445. The Tribunal need not replicate its analysis of the Claimant's discrimination claim here. It will limit its analysis to those aspects of the unreasonableness claim that have not been dealt with above.

## **Unreasonableness**

### **The Claimant**

446. In its Statement of Claim Invesmart listed more than a dozen actions or courses of conduct taken by the Czech Republic which it claimed were unreasonable and, in consequence, in breach of the impairment clause.

447. These actions included:

- (a) approving an investment predicated on the CF Transaction without confirming its ability and willingness to carry out that commitment;
- (b) approving an investment predicated on state aid and then failing to provide any form of state assistance;
- (c) causing a run on the bank by suggesting that it was struggling to find an acceptable investor at the very moment it was approving Invesmart's application;
- (d) insisting upon state aid alternatives and pre-approval from the UOHS, working with Invesmart to put together a new restructuring plan that satisfied those conditions, and then rejecting the plan;
- (e) promising to make a public declaration supporting the bank and then failing to do so;

- (f) refusing to give Invesmart or Union Banka any notice or warning about its decision to reject the restructuring plan and to deny state aid, thereby preventing them from locating alternative sources of capital, and thus ensuring the bank would fail;
- (g) leaking that decision to the press, thereby commencing another run on the bank and further ensuring the bank would fail;
- (h) refusing a liquidity loan on the basis that the bank could not provide "liquid collateral", when the applicable regulations contained no such requirement;
- (i) refusing to seriously consider the salvage plans put together by Invesmart and Union Banka to avoid liquidation, thereby ensuring the complete loss of Invesmart's investments;
- (j) saddling Czech taxpayers with a financial burden, through the liquidation of Union Banka, that was at least 28 times greater than the CZK 650 million in state aid that the Government refused to provide;
- (k) subjecting Union Banka to the fraudulent bankruptcy proceeding in Ústí nad Labem;
- (l) subjecting Union Banka to the corrupt bankruptcy proceedings in Ostrava; and
- (m) failing to notify Invesmart of the bankruptcy proceeding for Union Group.<sup>317</sup>

448. In its Reply Memorial Invesmart reformulated this claim and submitted that four aspects of this conduct were particularly egregious. Specifically:

- (a) The Czech Republic acted unreasonably when the CNB approved Invesmart's acquisition of Union Banka with the understanding that the acquisition was the first step in a three-step restructuring plan, only then to renege on step two, namely, the Government's completion of the Foresbank settlement;
- (b) The various organs of the Czech Republic failed to take a coordinated and consistent position regarding the provision of state aid after approving Invesmart's acquisition of Union Banka;
- (c) The Government's decision to deny state aid was made on grounds that were unreasonable. Invesmart's primary complaint against the Czech Republic was that Mr Sobotka's decision to deny state aid was made on the basis of the Government's

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<sup>317</sup> Statement of Claim, para 342.

strategy in the *Saluka* arbitration. Invesmart also claimed that the decision to deny state aid was unreasonable because:

- (i) Minister Sobotka disregarded the opinion of Governor Tůma, which was given at the request of Minister Sobotka, that "a sufficient media presentation of public support which would lead to a suspension of deposit outflow"; and
  - (ii) Minister Sobotka concluded that the settlement was legally unviable without seeking legal advice.
- (d) The Government failed to give Invesmart adequate notice of its decision to deny state aid.<sup>318</sup>

449. The Claimant has itself acknowledged that these allegations replicate many of those made in respect of fair and equitable treatment and expropriation claims. For this reason the Tribunal will consider only aspects of Invesmart's unreasonableness claim that require elaboration in relation to the application of the reasonableness standard. Specifically, the question of whether it was unreasonable for the CNB to approve Invesmart's acquisition of Union Banka and then for the MOF to deny Invesmart's request for state aid.

### **The Respondent**

450. In answer to the allegation that it had acted unreasonably by renegeing on its obligations under a three-step restructuring plan, the Czech Government denied that such a restructuring plan existed.<sup>319</sup> The Respondent argued that this allegation was unfounded given that Invesmart had no specific expectation of state aid and that such a commitment could not reasonably be gleaned from the CNB's approval of Invesmart's application to acquire Union Banka.

451. The Respondent further argued that Invesmart had failed to demonstrate that this conduct had no rational policy basis when viewed in light of Czech law or international standards of banking regulation. The Respondent submitted:

There could be no doubt at the time the CNB prior approval was issued that all that approval did was a clear and necessary regulatory hurdle for Invesmart to invest in the Czech banking sector. This followed transparently both from a legal provisions establishing a need for such approval (section 20A of the Banking Act at Exhibit R-304) and from the clearly delineated distinction between the role of the CNB as the authority of the State responsible for monetary policy and banking system

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<sup>318</sup> Reply Memorial, paras 384–388.

<sup>319</sup> Statement of Rejoinder, paras 94-97.



supervision and that of the MOF as the fiscal authority, delineated not only in Czech Law, but also as a matter of general international practice.<sup>320</sup>

## The Tribunal's analysis

### The reasonableness of the CNB's approval

452. The question of what the parties understood to be the significance of the CNB's approval is considered in the Tribunal's discussion of legitimate expectations at paragraphs 264-265 above. The Tribunal has concluded that the evidence does not demonstrate that any of the parties, including Invesmart, understood that approval by the CNB constituted a commitment that the Foresbank settlement or any other form of state aid would be provided.
453. The remaining question is therefore whether it was unreasonable for the CNB to approve Invesmart's application to acquire Union Banka and for the MOF to deny its request for state aid.
454. The standard to apply in assessing this question is whether the conduct of the Czech Republic bore a reasonable relationship to some rational policy. This question is to be distinguished from any consideration of the merits of the policy adopted by the Czech Republic.
455. The Tribunal notes that Professor Shin, in his first expert report, suggested that on any view the conduct of the CNB and the MOF fell short of international regulatory best practice.
456. For example, in his first expert report Professor Shin stated:

The CNB as the bank supervisor approved the acquisition of Union Banka by Invesmart on October 24 2002. I see three mutually exclusive possibilities concerning consultations between the CNB and the Ministry of Finance:

- a. **Either** the CNB did not consult the Ministry of Finance before giving approval of the acquisition;
- b. **Or** the CNB consulted the Ministry of Finance, but the CNB approved the acquisition without receiving formal approval from the public funding support by the MOF.
- c. **Or** the CNB consulted the MOF and the CNB received formal approval of public funding support from the MOF before granting approval of the acquisition.

I find (a) inconceivable for a responsible banking supervisor. If the CNB did not consult the MOF at all this would be highly irresponsible, this would be a highly irresponsible act by a banking supervisor. The Basel Committee report makes it clear that such a course of action would run counter to international best practice ....

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<sup>320</sup> Statement of Defence, para 411.

Leaving (a) to one side, I am left with (b) and (c). Here I am faced with a great deal of uncertainty concerning the facts of the case. However, neither (b) nor (c) put the Czech authorities (collectively) in good light.

a. If (b) is true, so that the CNB gave approval of the acquisition without obtaining formal approval of funding from the Ministry of Finance, then the CNB did not follow international best practice. It sanctioned a course of action that entailed the use of public funds without authorisation from the Ministry of Finance. Thus, if (b) is true, the CNB acted against international best practice.

b. If (c) is true, then the Ministry of Finance gave the formal go-ahead to the CNB to approve the acquisition of Union Banka by undertaking to fund the cost of public support. If this is the case, then I am puzzled by why the MOF did not provide public funding support for the acquisition as contemplated. Thus, if (c) is true, the actions of the Ministry of Finance are at fault.<sup>321</sup>

457. This opinion was rejected by the Respondent, who tendered the expert opinion of Professor Saunders. Professor Saunders stated that:

It is well-established best practice to separate the central banking function from the political and fiscal governmental authorities..

These entities [the MOF and Central Bank] have different policy objectives and potentially different views as to what is least cost policy.<sup>322</sup>

458. Professor Saunders went on to make the following conclusion:

The behaviour of the Czech National Bank was entirely reasonable. In contrast, it would not have been reasonable for the CNB to deny the regulatory approval under the information that was available to it at the time, since it would have eliminated any possibility that Invesmart and the Ministry of Finance could come to an agreement.<sup>323</sup>

459. The Tribunal does not consider that it is required to form an opinion about the merits of the policies that underpinned the decisions made by the MOF and CNB. A state should not be held to an obligation to act in accordance with international best practice. To read such an obligation into a BIT is untenable.

460. The Czech Republic can be held to have acted reasonably so long as, in the Tribunal's view, it did so out of some reasonable policy consideration, as opposed to conduct that was motivated by the intention to deprive an investor of the value of its investment.

461. At paragraph 264 above the Tribunal explained why in its opinion the CNB acted in accordance with its supervisory functions when it approved the acquisition by Invesmart of Union Banka. This involved a number of elements, including that the CNB be satisfied of the providence of Invesmart's funds. Once the CNB was satisfied of Invesmart's bona fides it

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<sup>321</sup> First report of Shin, paras 76–77. [Emphasis added.]

<sup>322</sup> Report of Saunders, paras 11–13.

<sup>323</sup> *Id.*, para 20.

approved the acquisition because, in the absence of any other investor, Invesmart's involvement was the best chance available of securing the bank's stability. This view point is consistent with evidence given by Governor Tůma at the hearing:

THE CHAIRMAN: Why did you approve its [Invesmart's] acquisition?

GOVERNOR TŮMA: Because in the end we believed they would be able to deliver that money. They committed themselves. It means -- generally speaking, it's not an easy decision to close the bank. So that you look for chances how to avoid that. You look for potential mergers and so on. So there was an investor, and I believed at that time, I trust, that : was fair and honest person. Unfortunately it was my biggest mistake, probably, and -- but in the end we believed that that commitment by the shareholders meeting was fair and that Invesmart would be able to deliver the money. So -- but we are speaking about that wasn't a substantial company, so explaining that at the time this was -- I am just saying this was a crucial issue, but in the end we decided to try it. So it was a chance and we didn't want to kill it.<sup>324</sup>

462. Whilst the merits of this decision may be questioned, this is not a matter for this Tribunal. It is clear that the Czech Republic acted in the interests of legitimate policy concerns, being the ongoing survival of Union Banka, and cannot, therefore be said to have acted unreasonably.
463. Similarly, the evidence clearly suggests that the MOF acted in accordance with rational policy consideration. There is no need to restate the Tribunal's analysis about the justification for the MOF's decision to deny state aid. These actions were clearly reasonable in the circumstances. Any fault that may be found in the Czech Republic's actions falls far short of establishing a breach of the impairment clause.

## Expropriation

464. The Claimant alleged that the Respondent expropriated its investment in Union Banka through a combination of measures ranging from the denial of state aid to the revocation of Union Banka's licence, and to various measures taken in the course of the bank's liquidation.
465. Article 5 of the Treaty provides:

Neither Contracting Party shall take any measures depriving, directly or indirectly, investors of the other Contracting Party of their investments unless the following conditions are complied with:

- (a) the measures are taken in the public interest and under due process of law;
- (b) the measures are not discriminatory;
- (c) the measures are accompanied by provision for the payment of just compensation. Such compensation shall represent the genuine value of the investments affected...

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<sup>324</sup> Transcript, Day 4, pp. 186–187, lines 1–4 and 13–25.

466. Although this claim was advanced in the Claimant's written pleadings, it did not figure prominently at the oral hearing.<sup>325</sup> The Claimant did not abandon the claim however and the Tribunal will consider its merits.

### **The Claimant**

467. The Claimant's expropriation claim primarily focused on the Respondent's revocation of Union Banka's licence and placing the bank into bankruptcy and liquidation, which according to the Claimant, amounted to a direct expropriation or, in the alternative, an indirect expropriation.<sup>326</sup> The revocation and ensuing measures "overtly purported to interfere with Invesmart's rights" and as a result it was "legally and practically deprived of its rights in Union Banka".<sup>327</sup> The Claimant also submitted that in taking these measures the Respondent did not comply with the three requirements of Article 5 which, if cumulatively satisfied, make an act of expropriation lawful under the Treaty.

468. In respect of Article 5(a), Invesmart claimed that the measure were not in the public interest because by closing and liquidating Union Banka the Government saddled Czech taxpayers with a financial burden that was many times greater than granting state aid (estimated by the Claimant to be some 28 times as much as the aid sought).<sup>328</sup> Invesmart's expert on banking regulation, Professor Hyun Song Shin, noted that this could not be in the public interest under the "least cost principle", observed in international best practices for the resolution of weak banks.<sup>329</sup> In this case, the Respondent deliberately chose the most expensive solution, thereby acting against the public interest.<sup>330</sup>

469. In Invesmart's view the Respondent also violated Article 5(b) because notwithstanding its majority ownership of Union Group, it received no notice of the bankruptcy petition. Moreover, the bank's assets were then liquidated as part of a fraudulent bankruptcy proceeding in Ostrava.<sup>331</sup>

470. Invesmart further argued that contrary to Article 5(b) the closure and liquidation of the bank and Union Group was discriminatory. The treatment accorded to Union Banka was said to be

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<sup>325</sup> Statement of Claim, paras 236–272; Reply Memorial, paras 298–302. In its closing submissions, the Claimant focused on its two primary claims in relation to the fair and equitable treatment standard but in doing so indicated that it was not abandoning its other claims, such as its expropriation claim: Transcript, Day 7, Fleuriet, p. 78, lines 4–8.

<sup>326</sup> Statement of Claim, paras 241 and 249.

<sup>327</sup> *Id.*, para 241.

<sup>328</sup> *Id.*, para 257.

<sup>329</sup> *Id.*, paras 258–265.

<sup>330</sup> *Id.*, para 259.

<sup>331</sup> *Id.*, para 267.

“markedly less favorable than that received by a number of other similarly situated Czech banks”.<sup>332</sup> (This aspect of the expropriation claim was developed in more detail in the Claimant’s separate discrimination complaint under Article 3).

471. The Claimant also asserted that Article 5(c) was violated since the Czech Government never paid compensation to Invesmart for the expropriation of its investments in the bank and Union Group.<sup>333</sup>

472. In developing its submissions the Claimant endorsed the proposition that foreign investors are not presumptively immune from a host state’s police or regulatory powers:

... a well-founded, non-discriminatory exercise of a state’s police or regulatory power, conducted for the purpose of protecting the public interest and with respect for due process, does not entail an “expropriation” under international law. However, neither of these propositions is responsive to Invesmart’s position in this case, which is that the Czech Republic’s taking of Invesmart’s investments was not a proper exercise of governmental power.<sup>334</sup> [Emphasis in original.]

473. In developing this point, the Claimant referred back to the merits of the Minister’s decision to deny state aid and his failure to provide any notice of that decision, as well as the CNB’s refusal to provide a liquidity loan. The resulting bankruptcy and liquidation process imposed the large financial burden already noted and the measures at issue in this case were said to be very far removed from a proper, legitimate exercise of regulatory power.

474. The Claimant distinguished Union Banka’s situation from the situation that existed in *Saluka*. Here there was an “abject failure of notice or due process” in relation to the decision to deny state aid, the leaking of that decision to the public which inevitably resulted in the bank’s failure, the revocation of its licence and its liquidation. Moreover, unlike the present case, *Saluka* did not raise any public interest questions.<sup>335</sup>

475. The Claimant also submitted that the Minister acted on improper grounds, namely its ‘litigation strategy’, in the *Saluka* arbitration when denying state aid to Union Banka.<sup>336</sup> In support of this assertion, the Claimant relied upon a letter of legal advice dated 3 December 2002, which was produced by the Respondent, advising the MOF that:

From the point of view of the possible impact on the on the [sic] arbitration proceedings in progress between Saluka and the Czech Republic, we feel it would be best if the State aid was not provided. We must stress, though, that this is a very narrowly defined perspective. If, in view of the wider context and economic reasons

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<sup>332</sup> *Id.*, para 268.

<sup>333</sup> *Id.*, para 269.

<sup>334</sup> Reply Memorial, para 288.

<sup>335</sup> *Id.*, para 292.

<sup>336</sup> Transcript, Day 7, Smith, p. 72, lines 1–25.

in particular, the decision is taken to provide aid, we are ready to defend this decision in arbitration proceedings, subject to the condition that the State aid is duly authorized by the Czech Office for the Protection of Economic Competition. In view of the sensitive nature of this matter, we would prefer to let you know the arguments on which our standpoint is based face-to-face.<sup>337</sup>

476. Invesmart listed further procedural complaints, including that:

- (a) the Government failed to communicate with Invesmart and Union Banka for several critical weeks in February 2003;
- (b) the Ministry failed to inform Invesmart of the denial of state aid until after the decision was leaked to the press;
- (c) CNB denied a liquidity loan to Union Banka on spurious grounds in order to ensure that the bank would be forced to close and then commenced revocation proceedings; and
- (d) the proceedings to bankrupt and liquidate Union Banka were marred by procedural irregularities, including the dismissal of the principal trustee for fraud.<sup>338</sup>

### **The Respondent**

477. The Respondent's submissions on the Minister's decision for denying state aid have already been recorded in the Tribunal's discussion of the legitimate expectations claim. They need not be repeated here.

478. Insofar as the licence revocation and the ensuing measures are concerned, the Respondent denied that anything approaching a direct expropriation had occurred. It observed that the revocation of the licence and the bank's subsequent liquidation left intact Invesmart's shareholding in Union Group and Union Banka and did not affect its shareholding as such. This meant that the Claimant was left to argue that the State's actions constituted an indirect expropriation insofar as they deprived it of any value that it might have had.<sup>339</sup>

479. The Respondent also took issue with the Claimant's characterisation of the measures as expropriatory. The Respondent submitted that the CNB's administrative proceeding was a lawful regulatory measure within the state's police powers, for which no compensation was

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<sup>337</sup> Exhibit C-305, letter dated 3 December 2002 from Squire, Sanders & Dempsey to the Ministry of Finance.

<sup>338</sup> *Id.*, paras 294–297.

<sup>339</sup> Statement of Defence, para 301.

required. The powers pursuant to which the CNB took action were based in published Czech law and pre-dated the Claimant's involvement with Union Banka.<sup>340</sup>

480. Referring to the *Saluka* case for the proposition that when exercising banking regulatory powers the CNB enjoyed "a margin of discretion" which had to be considered by a tribunal applying Article 5 of the Treaty, the Respondent noted that that tribunal concluded that the deprivation of that claimant's investment constituted a non-compensable deprivation because it was based on an exercise of regulatory powers in the public interest.<sup>341</sup>
481. The Respondent went on to argue that in any event, even if the CNB's measures could be characterised as expropriatory, the steps taken met the various requirements of Article 5 for a lawful expropriation in that they were (i) in the public interest and under due process of law; (ii) not discriminatory; and (iii) since the value of Invesmart's investment (if it actually had made one) was at the time negative, there was no failure to compensate the Claimant for the value of its investment.<sup>342</sup>
482. Finally, in the Respondent's view, the Claimant's reliance on the "least cost principle" was inapposite. Even if it constituted a generally accepted bank regulatory practice and it was violated in the instant case (which was denied), it would not rise to the level of a breach of an international obligation and would not support a claim for breach of the Treaty.<sup>343</sup>

## **The Tribunal's Analysis**

### **The Minister's decision to deny state aid**

483. The expropriation claim has been linked to the fair and equitable treatment claim in that the Minister's reasons for denying state aid and the means by which that information was conveyed to Invesmart (and allegedly to the public) have figured in both claims. The Tribunal has already explained that it does not consider that the denial of state aid amounted to a breach of Article 3.
484. Turning to the expropriation claim, the Tribunal begins with a consideration of the law. It agrees with the Respondent's argument that in relation to ministerial decisions on expenditures of state revenues, a "margin of appreciation" that recognises the discretionary features of such decisions must be accorded to them.<sup>344</sup> Ministers must make often difficult, multi-variable

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<sup>340</sup> *Id.*, paras 302–303.

<sup>341</sup> *Id.*, para 306.

<sup>342</sup> *Id.*, paras 310–324.

<sup>343</sup> *Id.*, paras 313–316.

<sup>344</sup> Transcript, Day 7, Crawford, p. 168, lines 4–13, p. 171, lines 15–19.

decisions that do not necessarily admit of clear right or wrong answers. For example, a minister who chooses to deny state aid, as in this case, faces questions about the possibly greater expense attached to such a denial. As the Claimant argued forcefully, why deny the aid when the cost of doing so is so much higher than granting it?<sup>345</sup> The answer lies in other policy and legal considerations which a minister must have regard to.

485. The Tribunal also agrees with an observation made by the *Saluka* tribunal in the context of its fair and equitable treatment discussion:

It is also very doubtful whether a Government can be said to be under an international legal obligation always to choose the least cost alternative and not to waste taxpayers' money.<sup>346</sup>

486. An international tribunal must approach a minister's decision not to spend taxpayers' money with circumspection.
487. This is not to say that the Tribunal considers that the Minister's decision in this case is beyond review, for it is not. Were it convinced that the Minister acted for wholly improper reasons, for example, in denying aid that he and his advisors considered should have been granted to Union Banka solely because granting the aid might complicate the defence of the *Saluka* claim, the Tribunal would not hesitate to find that the Minister's act attracted international responsibility (though more likely under Article 3 than Article 5).
488. However, the Tribunal is of the view that the *Saluka* litigation strategy concern was not the primary or even a significant reason for the denial of state aid. In the Tribunal's view, it was likely a factor but not a dominant factor because the legal advice itself was qualified. Furthermore, there are other compelling reasons that explain the Minister's actions.
489. The record shows that by January 2003, before the Third Restructuring Plan was submitted to the Ministry of Finance, grave problems had been identified by the bank's new management.
490. First, the new management had carried out an in-depth inspection of the bank and had decided to create extra adjustments to cover bad loans totalling CZK 1.8 billion.<sup>347</sup> Secondly, in principle this was covered by the "BDS Receivable", but if that claim was "taken off the balance-sheet at Union Banka, a.s., the Bank would not be able to satisfy the basic ratios set for managing a bank and would have to cease operating as a bank".<sup>348</sup> Thirdly, although the

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<sup>345</sup> Statement of Claim, paras 258–262.

<sup>346</sup> *Saluka* Partial Award, para 411.

<sup>347</sup> Exhibit R-18, Third Restructuring Plan, p. 5. At p. 31, the Plan noted that: "The proposed figures for adjustments and provisions to be created considerably exceeds the previously anticipated figures, primarily as a result of the more realistic approach towards the quality of the assets and risk of the Bank's portfolio adopted by the new management team for restructuring."

<sup>348</sup> *Id.*, p. 5.



amount now being sought from the Respondent was higher than in previous plans, the result of the plan if state aid was granted was modest: after cleaning up its balance sheet, the bank “will be capable of generating an [annual] net profit of between CZK 30 million and CZK 50 million”. The Plan acknowledged that this “figure is wholly insufficient in terms of the bank’s balance-sheet, number of branches, workforce and capital and would not allow the bank to continue to operate in the long-term”.<sup>349</sup> Finally, there was a gap between what Invesmart had committed to in terms of a capital injection, and what was needed to rescue the bank:

The investor has repeatedly stressed that they cannot make any further investments to complete restructuring of the bank’s balance-sheet. Instead they are relying on the repeated assurance that the State would contribute to rectifying the effects of the Consolidation Programme and Stabilisation Programme to a not insignificant extent.

It is unrealistic to assume that another investor could be found who would be willing to intervene as a very minor shareholder and yet contribute to a significant improvement in the bank’s balance-sheet. Invesmart on the other hand is refusing to increase the registered capital because they do not have the funds to invest in increasing the registered capital and they do not agree to their stake being watered down, because this does not form part of their investment strategy and the price of their stake would then cease to make economic sense.<sup>350</sup>

491. In short, the additional work completed on the restructuring plan showed that the bank’s situation was even more grave than had previously been understood and Invesmart was not prepared to contribute more capital than it had stated it was already committed to provide.
492. In making its finding that the denial of state aid does not amount to an expropriation, the Tribunal has not relied principally on the testimony of then-Finance Minister Sobotka (who denied that the *Saluka* case was the reason that he denied the aid), but rather has examined the contemporaneous documents.<sup>351</sup>
493. The Tribunal considers that the record, viewed in its entirety, shows that:
- (a) the bank’s financial condition was very poor, and indeed if not technically insolvent in January–February 2003, it was perilously close to being so;
  - (b) the Restructuring Plan’s projections, *even if the state aid and Invesmart’s €90 million were injected into the bank*, showed a minimal improvement in the bank’s fortunes;
  - (c) the bank did not submit an auditor’s opinion with the Plan such that the reliability of the Plan was suspect (particularly in light of the bank’s history of lack of

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<sup>349</sup> *Id.*, p. 35.

<sup>350</sup> *Id.*, p. 27.

<sup>351</sup> Transcript, Day 3, Sobotka, pp. 79–83.

transparency – a problem which, as just noted, was being dealt with by the bank’s new management); and

- (d) the plan could well fail, in which case the Ministry would be throwing away taxpayers' money on a rescue that was destined to fail.

494. These factors had to be evaluated within the regulatory framework for state aid and the increased scrutiny by the European Union of Czech governmental measures in this area. In short, a review of the Third Restructuring Plan in light of all the surrounding circumstances shows that the Minister not unreasonably found that the Plan did not present a sufficient degree of certainty for the Finance Ministry to support its submission to the Cabinet and the OPC for their respective approvals.

495. Accordingly, that part of the expropriation claim which relies upon the denial of state aid is rejected.

#### **The revocation of Union Banka’s licence**

496. Turning to the revocation of the bank’s licence, before addressing the facts and considering this aspect of the claim at the level of principle, the Tribunal observes that it is confronted with a measure taken under a banking statute of general application, which statute predated the Claimant’s investment. Section 26(b) of the Czech Banking Act, the statutory power pursuant to which the CNB acted, provides as follows:

(1) If the Czech National Bank ascertains shortcomings in the operations of a bank or a branch of a foreign bank, depending upon the nature of the ascertained shortcoming(s), it is authorized:

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b) to change the banking licence by excluding or restricting certain activities stipulated in the licence;<sup>352</sup>

497. There is no doubt that Section 26(b) is a *bona fide* non-discriminatory regulation aimed at the general welfare. All states with modern banking regulatory regimes vest a licensing power in their regulators. Inherent in such regimes is the power not only to grant but to revoke the licence.

498. International investment treaties were never intended to do away with their signatories’ right to regulate. As found in *Saluka*, where the instant Treaty was being applied, notwithstanding the breadth of its prohibition against expropriation and the absence of an express regulatory power exception, Article 5 imports into the Treaty the customary international law notion that a deprivation can be justified if it results from the exercise of regulatory actions aimed at the

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<sup>352</sup> Exhibit R-304, Act No. 21/1992 Sb., Banking Act, in wording effective from 1 May 2002 until 30 April 2004.

maintenance of public order.<sup>353</sup> This is common sense. Otherwise, once having granted a licence to operate a bank, the regulator could be constrained from revoking a licence if such action were automatically to be labelled an expropriation at international law.

499. The Tribunal thus agrees with the *Saluka* tribunal's finding that:

It is now well established in international law that States are not liable to pay compensation to a foreign investor when, in the normal exercise of their regulatory powers, they adopt in a non-discriminatory manner *bona fide* regulations that are aimed at the general welfare.<sup>354</sup>

500. Although there is no question as to the regulatory *bona fide* of Section 26(b), the Tribunal must also determine as a matter of international law whether the licence revocation on the facts of this case was improper, which plainly could constitute an expropriation. Reverting to *Saluka*:

It thus inevitably falls to the *adjudicator* to determine whether particular conduct by a state "crosses the line" that separates valid regulatory activity from expropriation. Faced with the question of *when, how and at what point an otherwise valid regulation becomes, in fact and effect, an unlawful expropriation*, international tribunals must consider the circumstances in which the question arises. The context within which an impugned measure is adopted and applied is critical to the determination of its validity.<sup>355</sup> [Italics in original.]

501. A decision to revoke a bank's licence, which takes place within a detailed national legal framework that includes administrative and judicial remedies, is not reviewed at the international law level for its "correctness", but rather for whether it offends the more basic requirements of international law. Numerous tribunals have held that when testing regulatory decisions against international law standards, the regulators' right and duty to regulate must not be subjected to undue second-guessing by international tribunals. Tribunals need not be satisfied that they would have made precisely the same decision as the regulator in order for them to uphold such decisions. The proposition first enunciated in the *Myers* case (in the context of the fair and equitable treatment standard) that international law extends a "high level of deference to the right of domestic authorities to regulate matters within their own borders" has been adopted in subsequent cases.<sup>356</sup> Indeed, in *Saluka*, that tribunal observed:

... Even though Article 3 obviously leaves room for judgment and appreciation by the Tribunal, it does not set out totally subjective standards which would allow the Tribunal to substitute, with regard to the Czech Republic's conduct to be assessed

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<sup>353</sup> *Saluka*, para 254.

<sup>354</sup> *Id.*, para 255.

<sup>355</sup> *Id.*, para 264.

<sup>356</sup> The comment made by the tribunal in *S.D. Myers, Inc. v. Canada*, Partial Award, at para 261, although made in the course of discussing the fair and equitable treatment standard, is apposite to the circumstances facing the CNB at the time. The *Myers dictum* has been quoted with approval in a number of subsequent awards, including *Saluka v. Czech Republic*, para 284, *Waste Management, Inc. v. United Mexican States*, Final Award, para 94, and *GAMI Investments, Inc. v. United Mexican States*, Final Award, para 93.

in the present case, its judgment on the choice of solutions for the Czech Republic's

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502. This comment, made in the context of that tribunal's interpretation of Article 3 is also applicable to Article 5. The *Saluka* tribunal noted, after it reviewed the CNB's forced administration of the bank, that:

The Czech State, in the person of its banking regulator, the CNB, had the responsibility to take a decision on 16 June 2000. It enjoyed a margin of discretion in the exercise of that responsibility.<sup>358</sup> [Emphasis added.]

503. The Tribunal agrees.
504. In the Tribunal's view, the decision to revoke the licence cannot be viewed as an expropriation. This was not a case where the regulator arbitrarily decided to deprive a licensee of its licence. To the contrary, the most senior officer of the bank, Mr Vávra, expressly stated his view on 19 February 2003 that due to its illiquidity, the bank could no longer operate and that notice was being given pursuant to the statutory provision under which the CNB subsequently acted. The Tribunal cannot characterize the CNB's acting in response to such notice as a breach of Article 5 of the Treaty.
505. It is true that Union Banka's Supervisory Board dismissed Messrs Vávra and Truhlář shortly after they signed the 20 February 2003 letter and it might be suggested that they did not act in the best interests of the bank. The Tribunal would reject such a contention because the very difficult circumstances in which the bank was operating, combined with the certainty of a catastrophic run had it opened its doors on 21 February 2003 after news of the denial of state aid was publicised, point both to the reasonableness of the opinion expressed by the bank's three senior officers and the CNB's response thereto.
506. The administrative proceeding to revoke the licence was completed on 18 March 2003. As noted in the review of the Claimant's allegations, there were other aspects of the bankruptcy and liquidation process that were said to breach the Treaty. The Tribunal does not consider that these allegations, even if made out, would change its determination under Article 5.
507. Quite apart from the bank's CEO and senior officers giving formal notice of the bank's inability to carry on, the evidence shows that at the point that the revocation proceeding was initiated, having regard to all the circumstances, there is no question that it had been propped up and in imminent risk of collapse for some months.

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<sup>357</sup> *Saluka* Partial Award, para 284.

<sup>358</sup> *Saluka*, Partial Award, para 272.

508. During the hearing the Claimant directed the Tribunal's attention to a letter dated 19 February 2003 to the Minister of Finance (who had solicited Governor Tůma's opinion on the bank's standing) in which the Governor advised that although "there is a danger that the bank may become insolvent as soon as next week", the "capital adequacy of the bank is currently over 8%" and hence it did not fall below the capital adequacy minimum.<sup>359</sup>

509. This letter was put to Governor Tůma during the course of the hearing with counsel pointing out that the bank was not technically insolvent as of 19 February 2003:

Q. So the bank was not insolvent at this point in time; it had a liquidity problem, correct? If the bank had been insolvent, I assume you would have told the Ministry.

A. Technically it wasn't insolvent, that is right, but you must take into account that a part of that, let's say, capital was the receivable against the Czech National Bank.

Q. I understand, Governor Tůma, and I understand that was disputed, but in response to the Minister of Finance's enquiry, you made a note in your letter back to him, which you did not have to put in your letter if you chose not to or didn't agree with, that the capital adequacy ratio of the bank was in excess of 8 per cent; correct?

A. That is what I say here.

Q. So the bank was not insolvent.

A. The bank was not technically insolvent.

Q. It had a liquidity problem, at this point in time.

A. Well, I would disagree with this point. The fact that -- once again, it technically wasn't insolvent; it doesn't mean that the situation is, from the point of view of solvency, sustainable in the medium term. By the way, it was mentioned also by the auditor, in the annual report, that without a strategic investor the situation would not be viable.<sup>360</sup>

510. It appears from the Governor's testimony that whether the bank was technically insolvent or not as of 19 February 2003 depended upon whether one gave any credence to the BDS Receivable which had been recorded in Union Banka's balance sheet in September 2002. This is an important issue to which the Tribunal now turns.

511. In a letter to the First Deputy Minister of Finance dated 22 January 2003, Mr Vávra alluded to the fact that the CNB Receivable had kept the bank from being insolvent throughout the months leading up to the denial of state aid.<sup>361</sup> Mr Vávra sought "a new round of negotiations ... which would result in a formulation of a revised proposal of a material for discussion within your Ministry and later even for the discussion by the Government of the Czech

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<sup>359</sup> Exhibit R-1149, letter dated 19 February 2003 from Governor Tůma to Minister Sobotka.

<sup>360</sup> Transcript, Day 4, Smith-Tůma, p. 128, lines 23-25 and p. 129, lines 1-22.

<sup>361</sup> Transcript, Day 7, Crawford, p. 172, lines 13-19. Exhibit R-18, Third Restructuring Plan, p. 5.

Republic". He indicated that since Invesmart had taken over the bank which "enabled the first complete complex and sufficiently deep assessment of the bank's economic situation," the results showed the "necessity of significant increase of provisions which cannot be solved only by a foreign investor's entry".

Missing funds in the balance, which are for the time being covered by the receivable against the CNB, which are subject to arbitration proceedings, reached the amount of 1.7 billion Czech crowns.<sup>362</sup> [Emphasis added.]

512. Mr Vávra conceded at the hearing that had the bank de-recognised the receivable at the time that the CNB had so requested (22 October 2002, coincidentally the same day that Invesmart filed its third application to acquire indirect control of Union Banka), it would have fallen below the capital adequacy minimum and its banking licence would have had to be withdrawn.

513. In cross examination, the following questions were put to Mr Vávra:

Q. So, Mr. Vávra, the former management, as we have discussed, realised because of the CNB's inspection that there was a provisioning gap of some 1.8 billion [CZK]. Essentially, it sued the CNB for that amount and then recorded that claim as an asset on its books, correct?

A. Correct.

Q. If it hadn't recorded that asset on its books, it would have been below the capital adequacy minimum and the bank's licence would have to be withdrawn. Is that correct?

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A. Sorry. Yes, the answer is yes.<sup>363</sup>

514. Mr Vávra's testimony was confirmed by the Third Restructuring Plan submitted by Euro-Trend on 12 February 2003, one week before Mr Vávra gave notice to the CNB under Section 26(b) of the Banking Act. The Plan noted that:

If this claim was taken off the balance-sheet at Union banka, a.s., the Bank would not be able to satisfy the basic ratios set for managing a bank and would have to cease operating as a bank.<sup>364</sup>

515. Likewise, the minutes of a meeting held on 28 January 2003 between [redacted] and Mr Racocho of the CNB contain a revealing contemporaneous exchange as to the role of the "receivable" and what the bank's true financial condition was. Mr Racocho's record notes as follows:

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<sup>362</sup> Exhibit R-140, letter dated 22 January 2003 from Mr. Vávra to First Deputy Minister Janota.

<sup>363</sup> Transcript, Day 2, Vávra, p. 167, lines 16-25, p. 169, line 6.

<sup>364</sup> Exhibit R-18, Third Restructuring Plan, p. 5.

1. informed that the biggest risk for the bank was its fragile liquidity situation. The situation resulted, among other things, from resignation of the old management and connected departures of some of the clients.

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7. According to , booking of the CNB receivable enabled the bank to create necessary provisions to the loan portfolio and provided the bank with some time for solution of the situation. Discussions have been held with the auditor (John Locke – DT) about correctness of the booking of the claim. I called attention to IAS 37, pursuant to which contingent assets should not be included in the balance sheet. I confirmed our interest in meeting with the auditor. I also confirmed determination of the CNB to defend itself against the (in our opinion) unjustified claim.

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10. I informed him of my opinion that the bank was technically bankrupt and that any other intended steps were generally useless without a solution of the bank's problems with its solvency. Therefore they should focus their attention in that direction in particular. As a supervisory body we shall proceed correctly exactly in accordance with the law.<sup>365</sup> [Emphasis added.]

516. The BDS Receivable was thus critical to propping up Union Banka. In the event, on 24 April 2003, an arbitral tribunal rejected the bank's claim.<sup>366</sup>
517. The Respondent adduced the expert evidence of Dr Milan Hulmák who opined that the BDS Receivable claim was without merit in light of the previous settlement agreement between the parties.<sup>367</sup> The Tribunal examined the settlement agreement concluded by the parties and considers that the CNB took a defensible position in rejecting the bank's claim. Reference to the agreement shows that in Clause 3.5 it is stated:

This Settlement Agreement replaces and supersedes any and all previous agreements and understandings, written or oral, made between CNB and Union banka in connection with the takeover of Bankovní dům SKALA a.s. by Union banka, in particular, the Agreement and Amendment no. 1 thereto. The Parties expressly declare that (i) the settlement hereunder shall regulate ... any and all of their mutual rights and obligations arising out of the takeover by Union banka of Bankovní dům SKALA a.s. ... , and that (ii) upon the execution hereof, none of the Parties shall have against the other Party any other rights and obligations relating to the takeover of Bankovní dům SKALA a.s. by Union banka of any kind and description whatsoever other than the rights and obligations expressly specified herein, not [sic] will they mutually assert against one another any of such rights or obligations.<sup>368</sup>

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<sup>365</sup> Exhibit R-138, minutes of a meeting held on 28 January 2003 between and Mr. Racocha.

<sup>366</sup> Exhibit C-137, arbitration award of the Court of Arbitration at the Chamber of Commerce of the Czech Republic issued on 24 April 2003.

<sup>367</sup> Expert report of Dr. Milan Hulmák, paras 57–63; Transcript, Day 7, Crawford, p. 160, lines 5–9.

<sup>368</sup> Exhibit R-6, Settlement Agreement between the CNB and Union Banka, dated 27 December 1999, cl 3.5.

518. In the Tribunal's view, the CNB was within its rights to demand that a contingency of such doubtful validity not be recorded in full as an asset on the bank's balance sheet nor as profit in its profit and loss account.<sup>369</sup>
519. Had that "asset" been removed when first requested, the bank's real condition would have been exposed even before the CNB's approval was given on 24 October 2002 and well before the deterioration of liquidity that prompted Mr Vávra to seek meetings with the CNB and the Minister of Finance on 19 February 2003.
520. In short, the evidence shows overwhelmingly that the bank was in the most serious of financial straits and the CNB's decision to accept and act upon Mr Vávra's oral and subsequent written notice of Union Banka's inability to meet its obligations *vis-à-vis* its depositors was a *bona fide* regulatory measure that does not fall within the scope of Article 5. The measure falls clearly on the *bona fide* regulation side of the regulation/expropriation divide.

### **Umbrella clause**

521. Article 3(4) of the BIT provides "Each Contracting Party shall observe any obligation it may have entered into with regard to investments of investors of the other Contracting Party". This provision, which is commonly described as an "umbrella clause" brings obligations of a host state which arise outside the BIT under the protective "umbrella" of the Treaty.
522. The Claimant refers to a number of cases including *Eureko v Poland*<sup>370</sup> where the Tribunal observed that "'any' obligations is capacious; it means not only obligations of a certain type, but 'any' - that is to say, all-obligations entered into with regard to investments of investors".
523. The Claimant relies on this passage for the proposition that an umbrella clause is not confined to contractual obligations but extends to obligations of any sort.
524. The Respondent asserts that the *Eureko* case concerned the assumption of contractual obligations and that "umbrella clauses" have never been held to mean anything else than that (at least some) contractual claims might be raised to the level of international investment claims.
525. The Respondent further says that the Claimant does not and cannot have a claim under Article 3(4) of the BIT because it does not even plead the existence of an obligation on the part of the Czech state to grant to it aid. Its case is based on a "legitimate expectation" to receive a grant of aid, not an obligation.

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<sup>369</sup> Exhibit R-70, letter dated 22 October 2002 from the CNB to Union Banka.

<sup>370</sup> *Eureko, B.V v Republic of Poland*, Partial Award, 19 August 2005.



526. The Tribunal is of the opinion that the claim founded on Article 3(4) of the BIT cannot succeed. Even if the existence of an "umbrella clause" elevates breaches of a contract to breaches of the BIT, a point on which tribunals before and after *Eureko* have reached opposite conclusions, or extends beyond contractual breaches, the Claimant has not established that there was any firm, unconditional undertaking, whether contractual or not, to provide state aid. An "obligation" to provide aid would require the establishment of a clear, unconditional commitment which would specify its essential terms including the amount of aid, the date to be provided and so on. No such obligation has been proven by the Claimant. An encouragement by the state to an investor to apply for aid or an expectation by an investor that aid will be provided is not sufficient by itself to constitute an "obligation" to provide aid.

## **Concluding comments**

### **Invesmart's financial capacity**

527. A factor of some significance, in the Tribunal's estimation, is the Claimant's capacity to effect the transaction which it claims to have been denied the opportunity to consummate. This was not a case where the investor was fully funded and ready to complete the transaction (even according to the "three step plan" that Invesmart contended governed the acquisition<sup>371</sup>).

### **Invesmart did not pay off the RPLs it assumed**

528. It is common ground that although on 17 November 2002, Invesmart assumed the debts of certain Union Banka and Union Group shareholders in the aggregate amount of CZK 2.67 billion and payment obligations towards Union Group in the aggregate amount of CZK 330 million as consideration for 22.6 percent of shares in Union Banka and 60 percent of shares of Union Group, it never paid for the shares.<sup>372</sup>

529. The Claimant argued in this proceeding that it would have paid for them had the Respondent complied with its commitment to grant state aid. It argued further that with the Respondent failing to provide the necessary funds, it made no sense for it to pay for the shares.<sup>373</sup>

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<sup>371</sup> Reply Memorial, para 21: "The Government always understood that the restructuring of Union Banka would occur in three steps, that the first step would be Invesmart's assumption of the debts under the DAAs [Debt Assumption Agreements] and its acquisition of the shares under the SPAs [Share Purchase Agreements], that the second step would be the Government's completion of the Foresbank Settlement, and that the third step would be Invesmart's repayment of the debts."

<sup>372</sup> Exhibits R-83-R-100, 18 agreements on debt assumption entered into on 17 November 2002.

<sup>373</sup> Reply Memorial, paras 21 and 34: "With respect to the capital contribution of €90 million for the RPLs, it is true that once the Czech Republic decided not to honor its commitment to provide state aid, Invesmart decided not to perform the futile act of injecting €90 million into a bank that the Government had just destroyed. But there is no rule of international law – jurisdictional or otherwise – that requires an investor to maximize its damages in order to seek the protection of a BIT."

530. During the hearing, Mr Vávra was cross-examined as to why Union Banka did not call upon Invesmart to pay for its shares after the execution of the debt assumption agreements. It was pointed out that the bank was suffering liquidity problems and the repayment of the RPLs would have been a welcomed source of new capital.<sup>374</sup> A document prepared by the CNB, dated 13 January 2003, which was put to Mr Vávra, noted that the bank rolled over ten related party loans in December 2002, contrary to a CNB regulation.<sup>375</sup> Mr Vávra explained his decision to roll over the loans as follows:

Q. ... The contractual documentation gave Union banka the right to immediate payment. But for your prolongation, they would have had to pay. That is correct, isn't it?

A. Correct.

Q. Can I just ask you: your fiduciary duty was to Union banka and not to Invesmart?

A. Absolutely.

Q. So how could you responsibly have prolonged Invesmart's obligation to pay liquidity into the bank when the bank desperately needed liquidity?

A. Because I knew if we didn't roll those loans over, Invesmart would not have repaid those loans, it would have defaulted on those loans.

Q. Because you were aware Invesmart had no money behind it.

A. No, I was aware that Invesmart's conditions for making this money available was not being met.

Q. Except those conditions aren't reflected in the contractual documents.

A. Correct. But if I may for a minute -- if I may for a minute just say that asking Invesmart to repay those loans at that very point in time would just mean end to an effort of saving Union banka, and we just didn't feel it was in the interest of any investor.<sup>376</sup>

531. Mr Vávra thus decided not to call upon the Claimant to make payment when it was due. Although he did not attribute this to Invesmart's lack of the necessary funds, the Claimant

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<sup>374</sup> Transcript, Day 2, Douglas, p. 192, lines 10–12.

<sup>375</sup> Exhibit R-128, minutes of a meeting held on 13 January 2003 between Union Banka and the CNB, para 5: "The Banka was informed of § 14 of the CNB measures no. 9/2002 Coll., which – starting from the 20<sup>th</sup> of November 2002 – does not enable an extension of maturities with regard to loans provided for financing of certain types of assets."

<sup>376</sup> Transcript, Day 2, Vávra, p. 192, lines 2–25.

itself has conceded that the shareholders never made the €90 million capital contribution that they authorised and then ratified on 16 October and 4 November 2002 respectively.<sup>377</sup>

### **The shifting sources of the funds**

532. As has already been seen, Invesmart was obliged to include in its application to acquire control of Union Banka information as to the provenance of the funds it would use to effect the acquisition. Invesmart did not have such funds at its disposal during the period leading up to the CNB's approval on 24 October 2002. There is some evidence that it initially intended to borrow the money.<sup>378</sup> It then informed the CNB that it would raise the funds by means of a shareholders' capital contribution.<sup>379</sup>
533. Invesmart's first formal application for the approval of its indirect acquisition of a controlling interest in Union Banka, filed on 4 April 2002, did not include the required information and the application was discontinued on 3 July 2002.<sup>380</sup> Evidently as a means of providing some assurance on the matter, by letter dated 25 June 2002, Mr Gert H Rienmüller of Invesmart wrote to Vladimír Krejča, manager of the CNB's Bank Supervision Section, referring to previous correspondence and discussing the supplementation of the Invesmart's application concerning the origin of funds. Mr Rienmüller informed the CNB that Fortis, a large Benelux international financial group, "has issued a guarantee for the payment of the price in accordance with a contract which matures in September and December 2002".<sup>381</sup>
534. This appears to be the first and last reference in the record of this proceeding to any role that Fortis might play in financing the transaction, including its having issued a guarantee. The representation evidently did not satisfy the CNB which, on 3 July 2002, discontinued the administrative approval proceeding after the expiry of the statutory three month deadline for its decision on the application.<sup>382</sup>
535. Invesmart re-applied for CNB approval on 4 July 2002. Throughout the time that its second application was under consideration, the CNB requested further information on the source of the funds to be used to purchase the shareholding interest.<sup>383</sup> The second application was also

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<sup>377</sup> Reply Memorial, para 35: "Invesmart did not make the capital contribution of €90 million for the RPLs – the third step in the agreed restructuring plan – because the Czech Republic did not honor its commitment to provide state aid – the second step in the restructuring plan."

<sup>378</sup> Exhibit R-66, letter dated 16 September 2002 from Invesmart to the CNB.

<sup>379</sup> *Id.*

<sup>380</sup> Exhibit C-43, letter dated 3 July 2002 from the CNB to Invesmart.

<sup>381</sup> Exhibit R-62, letter dated 25 June 2002 from Gert H. Rienmüller to Vladimír Krejča.

<sup>382</sup> Exhibit C-43, letter dated 3 July 2002 from the CNB to Invesmart.

<sup>383</sup> Exhibit C-52, minutes of a meeting held on 12 September 2002 between the CNB and Invesmart representatives; Exhibit R-66, letter dated 16 September 2002 from Invesmart to the CNB; Exhibit C-52, letter dated 19 September

rejected for lack of information on the source of the funds.<sup>384</sup> The Tribunal will revert to this below.

### **Invesmart did not comply with the Receivables Assignment Agreement**

536. It will be recalled from the Tribunal's discussion of the legitimate expectations claim that in mid-August 2002, Union Banka's auditors were balking at issuing their report for the bank's financial statements for the year ending 31 December 2001. To resolve the auditors' need for adequate provisioning of loans in light of concerns expressed by the CNB, Invesmart concluded the Receivables Assignment Agreement pursuant to which it assumed the troubled loan portfolio that Union Banka (and Invesmart) hoped to transfer to CF as part of the Fores transaction.<sup>385</sup> This relieved Union Banka from having to record a provision of CZK 300 million against the loans which it hoped to transfer to CF.

537. Under Clause 11.5 of the Agreement, Invesmart agreed, as of the Agreement's execution, to deliver to Union Banka an irrevocable first demand Bank Guarantee issued by a reputable bank for the amount of CZK 300 million valid through 15 December 2002. This was to secure payment of a penalty in the event that Invesmart did not take over the CF loan portfolio after being so requested by the bank.

538. Invesmart did not issue the bank guarantee on 13 August 2002 or at any time thereafter. Mr Catalfamo conceded that although the Agreement required Invesmart to issue the guarantee, it did not so do:

A. Yes, this is very much connected to the Česká Finanční transactions, and actually the value of 1.2 billion was exactly the same value that had been negotiated at the time with CF. And we decided to take this major step because we wanted to show the commitment of Invesmart to the auditors that we really believed that the Česká Finanční will be concluded and the bank will continue as a going concern.

Q. Paragraph 5, you were supposed to deliver as of this day an irrevocable first demand bank guarantee issued by reputable bank for the amount of 300 million Czech crowns, valid through 15th December. That is right, isn't it?

A. Yes.

Q. You didn't do that, did you?

A. No, we didn't.<sup>386</sup>

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2002 from the CNB to Invesmart; Exhibit R-72, letter dated 7 October 2002 from Minister Sobotka to the CNB; Exhibit R-74, letter dated 11 October 2002 from the CNB to Minister Sobotka.

<sup>384</sup> Exhibit R-71, CNB decision, dated 4 October 2002.

<sup>385</sup> Exhibit R-52, letter dated 12 August 2002 from Invesmart to the CNB; Exhibit R-49, Receivables Assignment Agreement entered into between Union Banka and Invesmart, dated 13 August 2002.

<sup>386</sup> Transcript, Day 2, , p. 40, lines 8-22.

539. Thus, although the Receivables Assignment Agreement cleaned up the bank's finances enough to secure the issuance of the auditor's report, a key obligation undertaken by Invesmart in mid-August 2002 was not performed.<sup>387</sup>

540. Moreover, when the 1 December 2002 deadline for the contemplated assignment of the loan portfolio to CF passed and Invesmart became liable under the Receivables Assignment Agreement to pay the CZK 1.2 billion it had agreed to pay, it did not do so.

541. was also cross examined on this point:

Q. Why didn't you pay in December?

A. As I said, because we believed that a conclusion of what was the Česká Finanční transaction then – the government changing into another restructuring plan, was very, very close, and there was no need.

Q. This was a private law obligation to Union banka, which was in serious trouble in December. Why didn't you pay?

A. Because we felt it wasn't needed, because without the State support there would be --

Q. No UB?

A. There would be no UB, as we said.<sup>388</sup>

#### **A number of wealthy shareholders withdrew from Invesmart**

542. From the outset, Invesmart was held out as an investment company whose shareholders comprised a number of wealthy and prominent Italian individuals and families. Invesmart repeatedly adverted to the shareholders' substantial financial capacity in its dealings with the Czech authorities.<sup>389</sup>

543. One of the representatives of those families, a Mr Ajello (an Invesmart shareholder through C.G.I., S.r.l and also a representative of the interests of the Barilla and Ricci families<sup>390</sup>) joined and Mr Rienmüller in meeting with CNB representatives on 12 September 2002. At this meeting, CNB officials continued to press for further details on the documentation for proof of the source of the funds that was to be submitted with the second application. They noted that the end of the three month approval period was nearing and if the

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<sup>387</sup> Exhibit C-31, audit report for Union banka issued by Deloitte & Touche on 16 August 2002 which noted, at p.2, that Union Banka might not be able to continue as a going concern absent Invesmart's capital entry into the bank.

<sup>388</sup> Transcript, Day 2, Catalfamo, p. 41, lines 19–25, p. 42, lines 1–4.

<sup>389</sup> Exhibit R-66, letter dated 16 September 2002 from to the CNB; Exhibit R-18, Third Restructuring Plan submitted by Union Banka to the Ministry of Finance on 12 February 2003, p. 4. Mr. Vávra agreed that when was negotiating the CNB's approval he represented that there were serious companies supporting Invesmart as shareholders: Transcript, Day 2, Vávra, p. 210, lines 24–25, p. 211, lines 1–3.

documents were not provided, the administrative proceeding would likely be terminated with a negative decision. The minutes record the CNB observing that:

... proving financial capacity of Invesmart B.V. to realize the transaction and to remove problems of Union banka (particularly paying loans granted to shareholders and persons related to Union Group) is a key feature for CNB to assess the application.<sup>391</sup>

544. The minutes further record Invesmart's position that it did not expect that "the investors would deposit funds with a foreign bank and prove thereby the origin of funds and their actual amount until the final decision is made with respect to the transaction realization". Invesmart's priority was to decide whether to continue with the transaction, but it would "assess another possible method to prove the financial capacity".<sup>392</sup>

545. testified that:

[t]he reason why Mr. Ajello was there and participated in the meeting was for them to understand better what was the status of the Union banka transactions ... [and] we met some of the representatives of the supervisory departments. The reception was not very good, and Mr. Ajello was a little bit surprised that -- not to find the same kind of attitude that I had represented, which was that we were working entirely with the governments.<sup>393</sup>

546. The meeting's significance lies in the fact that the shareholders represented by Mr Ajello decided not to participate further in Invesmart. Indeed, at the very meeting at which Invesmart's shareholders approved the capital increase, some of its shareholders (such as the Barilla family) either abstained from voting on the increase or were unrepresented at the meeting and moreover had decided to sell their shares to \_\_\_\_\_ and thus withdraw from the company.<sup>394</sup>

547. The 12 September 2002 meeting led to an exchange of letters between \_\_\_\_\_ and the CNB. By letter dated 16 September 2002, \_\_\_\_\_ informed the CNB that Invesmart had

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<sup>390</sup> Transcript, Day 2, \_\_\_\_\_, p. 16, lines 22-24.

<sup>391</sup> Exhibit R-61, minutes of a meeting held on 12 September 2002 between the CNB and Invesmart.

<sup>392</sup> *Id.*, pp. 1-2.

<sup>393</sup> Transcript, Day 2, \_\_\_\_\_, p. 17, lines 4-14.

<sup>394</sup> Exhibit R-469, minutes of a meeting held on 4 November 2002 of shareholders of Invesmart B.V.. At this meeting, in addition to ratifying the capital contribution approved at the 16 October 2002 shareholders meeting (which decision had been taken at a meeting that had not been convened in accordance with the company's bylaws and therefore had to be ratified at a duly convened meeting), the shareholders approved the sale of shares from Sabina International S.A. to \_\_\_\_\_ and authorised the sale of shares from Fin.Ba, S.p.A., C.G.I., S.r.l, Selfid S.p.A. and Cititrust S.p.A. to \_\_\_\_\_

decided to complete the acquisition of up to 95 percent of Union Group subject to the resolution of certain matters such as the conclusion of a satisfactory transaction with CF.<sup>395</sup>

548. He noted further that the complexity and “inreliability” (sic) of the project made it impossible for Invesmart to obtain third party financing and that therefore the Union Group acquisition “will be therefore entirely covered by Invesmart with its own asset.” Board and shareholders’ meetings had been called (he attached the notices convening the two meetings on Invesmart letterhead) for 24 September 2002 and 16 October 2002, respectively, “to increase the capital of the company of additional €90 million”.<sup>396</sup>
549. The letter went on to describe some of Invesmart’s shareholders, which described as having “a strong and solid financial weight and reputation”. They included the previously mentioned Barilla and Ricci families and others.<sup>397</sup>
550. Invesmart’s 16 September 2002 letter evidently did not provide sufficient comfort to the CNB as to the source of the funds and consequently on 4 October 2002, for the second time, the CNB denied Invesmart’s application to acquire control of Union Banka.<sup>398</sup> This set the stage for Invesmart’s third application, filed on 22 October 2002 and leading up to that, the holding of the shareholders meeting on 16 October 2002 at which the €90 million capital increase was approved.
551. At the 16 October 2002 shareholders’ meeting administered by Meespierson in Rotterdam, the only shareholders voting in favour of the resolution to increase the share capital of the company by €90 million by way of share premium were [redacted] and de Sury (the holder of a very small interest). Apparently unbeknownst to the CNB (which had been advised in a previous communication that he owned 21 percent of Invesmart’s shares<sup>399</sup>) [redacted] now owned 56 percent of Invesmart’s shares after some shareholders, such as the Barilla family, had decided to exit the company. At Invesmart’s 4 November 2002 extraordinary general meeting convened to ratify the 16 October 2002 resolution and to take certain other decisions, resolutions were passed to either approve the sale or permit the sale of their shares to [redacted].<sup>400</sup>

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<sup>395</sup> Exhibit R-66, letter dated 16 September 2002 from [redacted] to Zdeněk Tůma, Pavel Racochoa, Vladimír Krejča, Petr Jiříček, and Renate Vernerova, p. 2.

<sup>396</sup> *Id.*

<sup>397</sup> *Id.*

<sup>398</sup> Exhibit R-71, CNB Decision, dated 4 October 2002.

<sup>399</sup> Exhibit R-469, minutes of a meeting held on 4 November 2002 of shareholders of Invesmart B.V., proposals 3 and 4.

<sup>400</sup> Exhibit R-469, minutes of the meeting held on 4 November 2002 of shareholders of Invesmart B.V.

**capacity to raise the majority of the €90 million capital increase was  
doubtful**

552. The exit of wealthy investors who decided not to participate in Invesmart suggests that experienced investors did not see the upside potential of the Union Banka deal being pursued by . The timing of their decision also warrants note: global financial markets declined after the events of 11 September 2001 and Invesmart's other investment funds were destined to be wound up. In fact, the decision to do so was also taken at the 4 November 2002 shareholders' meeting.<sup>401</sup>

553. There is no documentary evidence to show how the remaining investors, in particular , could have paid for their shares of the €90 million capital increase. testified that he had his own means to make a contribution, but that he was also counting on his family to come up with the necessary funds.<sup>402</sup> Other than testimony there is no record evidence that shows that his family was prepared to contribute the significant funds owed to Union Banka pursuant to the debt assumption and share purchase agreements.

554. While there is no doubt as to enthusiasm for the acquisition and profitable onward sale of Union Banka, having regard to all of the circumstances (particularly Invesmart's failure to issue the CZK 300 million bank guarantee on 13 August 2002 which had led the bank's auditors to issue the audited financial statements for the year ending 31 December 2001), the Tribunal does not consider his hope of familial financial support to be sufficient proof of his ability to finance his majority share of the €90 million needed to complete the deal. There is no indication that at any time after 4 November 2002 any shareholder made its respective contributions so as to enable the company to pay off the RPLs.

555. It also warrants noting that no claim for costs thrown away in the pursuit of the Union Banka acquisition was advanced in this proceeding. Indeed, such evidence as has been adduced shows that Invesmart used its control of the bank to authorise payment to it of the costs of its due diligence in acquiring control of the bank and that at least CZK 35 million of the CZK 65 million authorised by Union Banka's shareholders after Invesmart acquired control was paid out to it.<sup>403</sup> No evidence was adduced of the costs incurred in pursuing the investment,

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<sup>401</sup> *Id.*, proposals 7 and 8. The shareholders resolved *inter alia* to liquidate the Pleiades I-fund, Zodiac Hedge Fund Ltd. and Investar S.A.

<sup>402</sup> Transcript, Day 2, , p. 90, lines 10–25, p. 91, lines 1–13.

<sup>403</sup> Exhibit R-125, letter dated 2 June 2003 submitted by Union banka "in liquidation" to Silvie Goldscheirová and Jiří Majer of the CNB. At a meeting between : and the CNB held on 22 January 2003 the latter advised that the CZK 65 million payment could be a "possible contradiction" of the Banking Act (Exhibit R-137, minutes of a meeting held on 22 January 2003 between and Messrs Racoča, Štěpánek, and Krejča). A legal opinion rendered on 30 April 2003 stated that the payment was unlawful and the liquidator sought its repayment from Invesmart. No repayment was made.



although in closing submissions, counsel for the Claimant noted that Invesmart had spent close to two years trying to effect the transaction.<sup>404</sup>

556. The Tribunal views from Invesmart's: (i) lax due diligence; (ii) uncertain financial means; (iii) reliance upon the means of wealthy Italian shareholders who were about to sell their shares to<sup>405</sup>; (iv) failure to ensure that the various legal agreements it signed accorded with the conditions that it says governed its acquisition of control of the bank; and (v) failure to either issue the bank guarantee on 13 August 2002 or to pay the consideration for the Receivables Assignment Agreement when it came due in December 2002, collectively to be indicative of the Claimant's approach to the investment opportunity. This was, in the Tribunal's view, to take a "flyer" at gaining ownership of the bank with the assistance of state aid and then sell it at a quick profit.

557. It likewise appears to the Tribunal that recognising that Union Banka was in serious peril, the CNB erred in agreeing to treat with Invesmart. The CNB knew that Invesmart was a new company with no experience in running a bank. In response to the Chairman's question as to why the CNB approved the acquisition in such circumstances, Governor Tůma testified that:

... in the end we believed they would be able to deliver that money. They committed themselves. It means -- generally speaking, it's not an easy decision to close the bank. So that you look for chances how to avoid that. You look for potential mergers and so on.<sup>406</sup>

558. The evidence is that no Western bank would touch Union Banka in its current condition and the testimony was that Invesmart was the bank's only chance. Governor Tůma testified that "in the end we decided to try it. So it was a chance and we didn't want to kill it". He stated further that this was a mistake.<sup>407</sup> The Tribunal agrees.

559. The CNB's willingness to treat with Invesmart goes however to the issue of an award of costs. It is the Tribunal's view that although the claims have been rejected, the CNB bears some responsibility for the bringing of this international proceeding.

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<sup>404</sup> Transcript, Day 7, Smith, p. 122, lines 24–25, p. 123, lines 1–8.

<sup>405</sup> Even after the Barilla family sold their interests to (effective December 2002) their involvement in Invesmart was being represented to the Czech Ministry of Finance. The Third Restructuring Plan, submitted on 12 February 2003, continued to emphasise the wealth of various families that were no longer involved in Invesmart. acknowledged this to be a mistake (Transcript, Day 2, , p. 24, line 23). Other investors were still involved but were withdrawing.

<sup>406</sup> Transcript, Day 4, Tůma, p. 186, lines 14–18.

<sup>407</sup> *Id.*, p. 186, line 21.

## **Tribunal's determination on costs**

### **Costs of arbitration**

560. Article 38 of the UNCITRAL Arbitration Rules requires the Arbitral Tribunal to fix the costs of the arbitration in the award. The Claimant's costs (which include its share of the Tribunal's fees and disbursements) amount to €5,899,846. The Respondent's costs (including its share of the Tribunal's fees and disbursements) total €4,116,712.

561. Accordingly the costs of the arbitration amount to €10,016,558.

### **Allocation of costs**

562. Article 40(1) of the UNCITRAL Arbitration Rules provides, subject to paragraph 2, that the costs of arbitration shall in principle be borne by the unsuccessful party. However the Arbitral Tribunal may apportion such costs between the parties if it determines that apportionment is reasonable, taking into account the circumstances of the case.

563. With respect to the costs of legal representation and assistance, Article 40(2) provides that the Arbitral Tribunal, taking into account the circumstances of the case, shall be free to determine which party shall bear such costs or may apportion such costs between the parties if it determines that apportionment is reasonable.

564. Thus the general rule under the UNCITRAL Rules that the unsuccessful party shall bear the costs of arbitration does not apply with respect to that portion of the costs of arbitration which comprise the costs of legal representation and assistance. In both instances, however, the Tribunal possesses a discretion. With respect to the costs of arbitration (excluding costs of legal representation and assistance) the unsuccessful party bears the costs but subject to the Tribunal's discretion to apportion such costs taking into account the circumstances of the case. With respect to the costs of legal representation and assistance the Tribunal decides which party shall bear such costs or whether the costs should be apportioned.

### **Parties' submissions**

565. The Respondent submits that the general rule as to the costs of arbitration (excluding costs of legal representation and assistance) referred to in Article 40(1) should apply. Hence it says that the prevailing party should be reimbursed for all non-legal costs. The Respondent further states that this rule has been widely followed by arbitral tribunals in recent investment arbitrations conducted under the UNCITRAL Arbitration Rules and is consistent with Czech practice.

566. As to the costs of legal representation and assistance, the Respondent says that the success of a party in the dispute is a determining factor as recent decisions in investment treaty arbitrations have confirmed.
567. The Claimant also submits that the successful party should be awarded costs including costs of legal representation and assistance.

### **Determination**

568. The Tribunal has already referred to Article 40(1) and (2) of the UNCITRAL Arbitration Rules. The general rule as to the costs of arbitration (excluding costs of legal representation and assistance) is that they shall be borne by the unsuccessful party. While no general rule is stated with respect to the costs of legal representation and assistance the Tribunal agrees with the parties' submissions that such costs are also often awarded to the successful party and are therefore borne by the unsuccessful party.
569. However it is abundantly clear that under Article 40 the Tribunal possesses a discretion as to the awarding of costs and their allocation. The concluding words of Article 40(1) require the Tribunal to take into account "the circumstances of the case". Thus decisions of other tribunals in previous cases concerning the awarding of costs are not determinative and do not establish a precedent. They are merely illustrative of the application of Article 40 to the case at hand. In this case the successful party is the Respondent. However upon careful reflection, the Tribunal has concluded that there are special circumstances which make it inappropriate to award the Respondent costs.
570. In the first place the Respondent applied for an order for security for costs which was unsuccessful. This is a relevant factor although the Tribunal acknowledges that the costs incurred in connection with the application comprise only a small percentage of the total costs of arbitration.
571. A much more significant factor concerns the facts established by the Tribunal.
572. The Claimant is a company with extremely limited financial resources and little or no experience or expertise in banking. It was a most unlikely and perhaps inappropriate entity to acquire and manage what had been, at one time, a significant bank within the Czech Republic. And yet it received permission from the CNB to acquire the shares in Union Banka. It is true that the Claimant intended to on-sell Union Banka, after restructuring it, but even an acquisition for a limited time or purpose appears inappropriate, having regard to the financial resources and expertise of the Claimant.
573. At the hearing Mr Tůma, who was the Chairman of the CNB at the time the share acquisition was approved, was called to give evidence. Claimant's counsel asked Mr Tůma what he meant

when he said in his witness statement that Invesmart was not a substantial company. Mr Tůma answered:

I think that I already mentioned that today. It means Invesmart was not any Deutsche Bank or Société Générale or other well-known bank, so it was, let's say, no name in the banking sector, having no expertise in running the bank, and no experience in that respect. That is why, as I explained already, the procedure and the procedure for providing licence is -- would differ probably from looking at Deutsche or some other bank. So it is not -- that is one point.

Secondly, it wasn't a wealthy investor. So that I can imagine there are financial investors, so this was some kind of a financial investor, but it wasn't -- we didn't see at that time, at the beginning, enough money behind it. So that is why it was very -- it was one of the crucial issues during that licence procedure.<sup>408</sup>

574. The Chairman of the Tribunal then asked Mr Tůma why he had approved the acquisition to which he responded:

Because in the end we believed they would be able to deliver that money. They committed themselves. It means -- generally speaking, it's not an easy decision to close the bank. So that you look for chances how to avoid that. You look for potential mergers and so on. So there was an investor, and I believed at that time, I trust, that was a fair and honest person. Unfortunately it was my biggest mistake, probably and -- but in the end we believed that that commitment by the shareholders meeting was fair and that Invesmart would be able to deliver the money. So -- but we are speaking about that wasn't a substantial company, so explaining that at the time this was -- I am just saying this was a crucial issue, but in the end we decided to try it. So it was a chance and we didn't want to kill it.<sup>409</sup>

575. Having acquired Union Banka, the Claimant pressed its application for state assistance and argued in this arbitration that the CNB's approval of the share acquisition led it to believe that state aid would be granted.

576. Although this Tribunal has held that there was no breach of the BIT, the actions of the Czech authorities, and in particular the CNB in approving the share acquisition, were perhaps unfortunate or unwise.

577. In these circumstances the Tribunal, although unable to find that there was a breach of the BIT, considers that the Respondent should not recover any of the costs of arbitration which it has incurred and that the costs of arbitration should be allocated between the parties in accordance with the amounts they have paid or the costs incurred.

578. Accordingly the Tribunal makes no order concerning the costs of arbitration.

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<sup>408</sup> Transcript, Day 4, Tůma, p. 185, lines 23-25 and p. 186, lines 1-12.

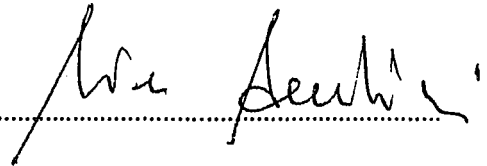
<sup>409</sup> Transcript, Day 4, Tůma, p. 186, lines 14-24.

## AWARD AND ORDER

1. The Tribunal finds that the Respondent did not breach its obligations to the Claimant under the BIT.
2. The Claims of the Claimant are dismissed.
3. Each party is to bear its own costs.

This award is made this        26        day of        June        2009

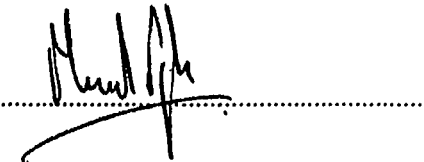
Signed by co-arbitrator  
PIERO BERNARDINI

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Signed by co-arbitrator  
CHRISTOPHER THOMAS QC

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Signed by chairman  
MICHAEL PRYLES

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## INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES

IN THE MATTER OF THE ARBITRATION BETWEEN

ALASDAIR ROSS ANDERSON *ET AL*  
(CLAIMANTS)

v.

REPUBLIC OF COSTA RICA  
(RESPONDENT)

ICSID CASE No. ARB(AF)/07/3

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AWARD

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MEMBERS OF THE TRIBUNAL

Dr. Sandra Morelli Rico, President  
Prof. Jeswald W. Salacuse, Arbitrator  
Prof. Raúl E. Vinuesa, ArbitratorSECRETARY OF THE TRIBUNAL  
Natalí Sequeira

REPRESENTING THE CLAIMANTS:	REPRESENTING THE RESPONDENT:
<p>Mr. François G. Tremblay Ms. Natacha Leclerc Cain Lamarre Casgrain Wells, s.e.n.c.r.l. 255, rue Racine Est, bureau 600, case postale 5420 Chicoutimi (Québec) G7H 6J6 Canada</p> <p>Mr. Robert Wisner Mr. W. Brad Hanna McMillan LLP Brookfield Place, 181 Bay Street, Suite 4400 Toronto, Ontario M5J 2T3 Canada</p>	<p>Mr. Esteban Agüero Guier Ms. Mónica C. Fernández Fonseca Mr. Luis Adolfo Fernández López Costa Rican Ministry of Foreign Trade</p> <p>Mr. Stanimir A. Alexandrov Ms. Marinn Carlson Mr. Patricio Grané * Sidley Austin LLP 1501 K Street N.W. Washington, D.C. 20005</p> <p><i>* until August 7, 2009</i></p>

Date of Dispatch to the Parties: May 19, 2010

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## I. PROCEDURAL BACKGROUND

1. The procedural background of this proceeding has been long and somewhat convoluted and therefore will only be summarized in its essence.
2. On May 10, 2004, a large number of individuals and companies from several different nationalities submitted a single Request for Arbitration (the “Request”) to the International Centre for Settlement of Investment Disputes (“ICSID” or “the Centre”) against the Republic of Costa Rica (“the Respondent” or “Costa Rica”), alleging violations of their rights under at least ten different bilateral investment treaties. The Request included an application for approval by the ICSID Secretary-General of access to the Additional Facility (AF) under Article 4 of the ICSID Additional Facility Rules. Upon receipt of the Request, the Centre requested additional information and sought clarifications regarding a series of errors and defects contained in the Request for Arbitration.
3. Ultimately, on March 27, 2007, after significant revisions, the Secretary-General of ICSID registered the Request for Arbitration, as amended and supplemented<sup>1</sup>, by one hundred thirty seven (137) individual nationals of Canada (hereinafter “the Claimants,” as listed in Appendix A to the present Award) against the Republic of Costa Rica, pursuant to Article 4(2) of the ICSID Arbitration (Additional Facility) Rules (the “Arbitration (AF) Rules”). On the same day, the Secretary-General dispatched the Notice of Registration to the parties and transmitted a copy of the Request for Arbitration and its supplemental letters to the Republic of Costa Rica. The Centre invited the Claimants to submit additional copies of the Request for Arbitration, reflecting the amendments and clarifications made subsequent to May 10, 2004. The case was registered as ICSID Case No. ARB(AF)/07/3 with the formal heading of *Alasdair Ross Anderson et al. v. Republic of Costa Rica*.

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<sup>1</sup> By Claimants’ letters of May 11, June 4, July 9, July 23, December 3 and December 23, 2004; January 13, January 26, February 16, March 18, April 18, July 26, August 5, September 13, September 30, October 20, 2005; and January 16, February 22, November 29 and December 18, 2006.



4. Pursuant to Article 5(e) of the Arbitration (AF) Rules, the Secretary-General invited the parties to proceed as soon as possible to constitute the Arbitral Tribunal. The Claimants appointed Professor Jeswald W. Salacuse, an American national, as arbitrator, and the Respondent appointed Professor Professor Raúl E. Vinuesa, a national of Argentina, as arbitrator. Pursuant to Articles 6 and 10 of the Arbitration (AF) Rules, the Chairman of the ICSID Administrative Council appointed Dr. Sandra Morelli Rico, a Colombian national, as President of the Tribunal.
5. By letter of May 2, 2008, the Acting Secretary-General of ICSID notified the parties that all three arbitrators had accepted their appointments and that, in accordance with Article 13(1) of the Arbitration (AF) Rules, the Tribunal was deemed to have been constituted and the proceeding to have begun on that date. On the same date, the parties were also informed that Ms. Natalí Sequeira would serve as Secretary of the Arbitral Tribunal. A first session was subsequently scheduled between the Tribunal and the parties to discuss preliminary procedural matters.
6. In response to the Secretary-General's request dated March 27, 2007, the Claimants filed on May 14, 2008 a Revised Request for Arbitration reflecting the amendments and clarifications to their original Request for Arbitration, along with various supporting documents.
7. On June 27, 2008, the Tribunal held its first session with the parties at the seat of the Centre in Washington, D.C. During the session, the parties confirmed their agreement that the Tribunal had been properly constituted in accordance with Articles 6 and 13 of the Arbitration (AF) Rules and that they did not have any objections in this respect. During the session the parties also agreed on a number of procedural matters reflected in written minutes signed by the President and the Secretary of the Tribunal. In particular, these matters concerned: i) the applicable arbitration rules for the proceeding; ii) the representation of the parties; iii) the apportionment of the procedural costs and the advance payments to the Centre; iv) the fees and expenses of the members of the Tribunal; v) the place of arbitration; vi) the procedural languages; vii) the records of the hearings; viii) the means of communication and copies of the

- instruments; ix) the presence and quorum for meetings of the Tribunal; x) the decisions of the Tribunal by correspondence or any other form of communication; xi) the delegation of power to set time limits and sign procedural orders on behalf of the Tribunal; xii) the phases of the proceeding (written and oral); xiii) number, sequence and schedule of written pleadings; xiv) the production of evidence and witnesses' testimony (written and oral); xv) dates and nature of subsequent sessions; and xvi) publication of the award and the decisions related to the proceeding.
8. During the first session, the parties agreed that since the Respondent intended to raise jurisdictional objections, the Tribunal would deal with the question of jurisdiction as a preliminary matter. The schedule of pleadings on jurisdictional objections was agreed as follows: Respondent's Memorial on Jurisdiction: September 26, 2008; Claimants' Counter-Memorial on Jurisdiction: December 23, 2008; Respondent's Reply on Jurisdiction: February 27, 2009; Claimants' Rejoinder on Jurisdiction: April 27, 2009. In addition, the parties proposed that the Hearing on Jurisdiction be held between August 3 and 7, 2009.
  9. During the course of the first session, the counsel for the Respondent, Dr. Stanimir A. Alexandrov, expressed the Respondent's intention to submit a request for provisional measures on costs. On this point, the President stated that in the event such request was formally submitted it would be dealt with pursuant to Article 46 of the Arbitration (AF) Rules and it would determine the schedule for the other party to submit observations. On July 8, 2008 the Respondent filed a Request for Provisional measures whereby it requested that: i) the Tribunal order the Claimants to post a bank guarantee (or an escrow account deposit administered by ICSID) equivalent to the ICSID administrative fees that the Respondent might incur during the course of the proceedings on jurisdiction; and ii) that the Tribunal order Claimants to represent that they agree to be held jointly and severally liable for any amounts that the Tribunal may award to cover Respondent's legal fees and expenses. The Claimants' submitted their observations on the Request for Provisional Measures on August 6, 2008. The Tribunal issued a Decision on Provisional Measures on November 5, 2008. The

Tribunal concluded that i) the facts presented by the Respondent did not constitute an urgent situation that risked irreparable harm to the Respondent's rights; ii) the Respondent had only a mere expectation and not a right with respect to an eventual award of costs; iii) the request to order the Claimants to be held joint and severally liable for the payment of any costs eventually awarded to the Respondent is not in the nature of a provisional measure to preserve existing rights; and iv) a Tribunal's decision in this respect might constitute a prejudgment on the responsibility of individual parties. Therefore, pursuant to Article 46 of the Arbitration (AF) Rules, the Tribunal denied Respondent's Request for Provisional Measures.

10. As agreed during the first session, the Respondent filed a Memorial on Objections to Jurisdiction and Admissibility on September 26, 2008. By letter of December 18, 2008, the parties agreed to an extension for the filing of the Claimants Counter-Memorial on Jurisdiction and Admissibility. According to the revised schedule, the subsequent jurisdictional pleadings were submitted as follows: Claimants Counter-Memorial on Jurisdiction and Admissibility, on January 13, 2009; Respondent's Reply on Jurisdiction and Admissibility, on April 10, 2009, and the Claimants' Rejoinder on Jurisdiction and Admissibility on June 10, 2009. By letters of June 8, 2009 the parties agreed to a five day extension for the presentation of the Claimants' Rejoinder on Jurisdiction and Admissibility, which was submitted on June 15, 2009.
11. The hearing on jurisdiction was held as scheduled, from August 3 through August 6, 2009, at the seat of the Centre in Washington D.C. Messrs. Robert Wisner and W. Brad Hanna of the law firm McMillan LLP and Natacha Leclerc of the law firm Cain Lamarre Casgrain Wells s.e.n.c.r.l., were present at the hearing on behalf of the Claimants. Messrs. Stanimir Alexandrov, Patricio Grané, Marinn F. Carlson, and Joshua Robbins of Sidley Austin LLP; Messrs. Esteban Agüero Guier, Mónica Fernández Fonseca, Luis Adolfo Fernández and José Carlos Quirce of the Costa Rican Government as well as Mr. Alan Thompson Chacón, Respondent's legal expert, were present at the hearing on behalf of the Respondent. During the hearing the Tribunal heard the oral examination of the following Claimants' witnesses:

Messrs. Patricia Lucie Fleming, Maurice Wilfrid Laframboise, Norman Albert Barr, and Charles Bergeron, all of whom were also Claimants in this proceeding. The following Respondent's witnesses were also examined: Messrs. Sandra Castro Mora, Walter Espinoza, Elizabeth Flores Calvo and Marietta Herrera Cantillo, all of whom were officials of different Costa Rican state agencies and powers.

12. The Respondent objected to the presence in the hearing room of those Claimants who were to appear also as witnesses prior to providing their oral testimony, on the grounds that Article 39(2)<sup>2</sup> of the Arbitration (AF) Rules referred to the attendance of witnesses only during their testimony, unless otherwise agreed by the parties<sup>3</sup>. The Claimants' counsel strongly objected to the exclusion of any Claimant from the hearing room. They argued that Article 39(2) Arbitration (AF) Rules explicitly gives parties the right to attend the hearing and that a party does not lose its rights simply by being a witness. Moreover, the Claimants argued that to deny a party the right to be present at a hearing in which his or her rights were at stake and to assist counsel in presenting that party's case would constitute a denial of due process.
13. On that point, the Tribunal decided by majority to allow those Claimants who were to testify as witnesses to attend the entire hearing on jurisdiction. Thereafter, the parties informed the Tribunal that they had agreed that the four Claimants scheduled to testify as witnesses would remain in the hearing room until Respondent's witnesses had offered their testimony. When the time came for the four Claimants to testify,

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<sup>2</sup> Article 39(2) of the Arbitration (AF) Rules provides: "(2) Unless either party objects, the Tribunal, after consultation with the Secretary-General, may allow other persons, besides the parties, their agents, counsel and advocates, witnesses and experts during their *testimony*, and officers of the Tribunal, to attend or observe all or part of the hearings, subject to appropriate logistical arrangements. The Tribunal shall for such cases establish procedures for the protection of proprietary or privileged information." [emphasis added]

<sup>3</sup>The Respondent had initially raised this objection by letter of July 29, 2009 addressed to the Tribunal, in which it stated that the presence in the hearing room of the Claimants who were also witnesses, would allow them to listen to the testimony of any preceding Respondent's witnesses with the result of possibly influencing their own testimony. That circumstance would give the Claimants an unfair advantage with respect to the Respondent whose witnesses would not have a similar opportunity. Thus, according to the Respondent, to allow the Claimant-witnesses to be present in the hearing prior to their testimony would be contrary to the principles of due process and equality of treatment of the parties. The Respondent had no objection to the presence at the hearing of the other Claimants, who would not be called as witnesses. By letter of July 30, 2009 the Claimants stated that it would be a fundamental violation of Claimants' rights to due process denying them the right to be present, since it is a widely accepted principle in arbitration that an arbitral tribunal may not exclude a party who wishes to be present from any hearing. In the Claimants' view, Article 39(1) of the Arbitration (AF) Rules grants the party an absolute right to be present at the hearing, while Article 39(2) only addresses the need for both parties to consent before the hearing is opened to non-parties. Finally, according to the Claimants, the Respondent's concerns about inequality are not substantiated as Respondent would also have representatives present throughout the hearing to instruct counsel. Therefore Claimants requested the Tribunal to deny Respondent's request.

they were to leave the hearing room, and each testifying Claimant would then be permitted to stay in the hearing room only after that Claimant had testified<sup>4</sup>.

14. The hearing on jurisdiction proceeded to its conclusion on the basis of this agreement. Costa Rica's witnesses namely, Ms. Marietta Cantillo, Mr. Walter Espinosa and Ms. Sandra Castro Mora testified and were cross-examined. Thereafter Claimants Wilfrid Laframboise, Patricia Lucie Fleming, Maurice Norman Albert Barr, and Charles Bergeron testified and were cross-examined.

## II. THE FACTS OF THIS CASE

15. This dispute concerns the situation in which the Claimants, 137 individual nationals of Canada, assert separate and distinct claims against Costa Rica for injuries to their alleged individual investments as a result of various breaches of domestic and international law, in particular the Agreement between the Government of the Republic of Costa Rica and the Government of Canada for the Protection and Promotion of Investment, signed on March 18, 1998, in force since September 29, 1999 (hereinafter referred to as "the BIT" or "the Canada-Costa Rica BIT"). Costa Rica is a Contracting Party to the Convention on the Settlement of Investment Disputes between States and Nationals of Other States, signed in Washington in 1965 (the "ICSID Convention"). As Canada is not a Party to the ICSID Convention, Schedule C of the Rules Governing the Additional Facility for the Administration of Proceedings (hereinafter referred to as "Additional Facility,") shall apply as provided by Article XII 4(b) of the BIT.<sup>5</sup>
16. In particular, Claimants alleged that Costa Rica, by failing to provide proper vigilance and governmental regulatory supervision over the national financial system, had injured their investments in violation of the BIT provisions regarding full protection and security, fair and equitable treatment, due process of law, and protection against expropriation.

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<sup>4</sup> Hearing on Jurisdiction Transcript, August 4, 2009, pp. 371-72.

<sup>5</sup> Article XII(4) provides that "*The dispute may be submitted to arbitration under ... (b) the Additional Facility Rules of ICSID, if either the disputing Contracting Party or the Contracting Party of the investor, but not both, is a Party to the ICSID Convention;...*"

17. Luis Enrique Villalobos Camacho and his brother Osvaldo Villalobos Camacho (hereinafter the “Villalobos brothers” or the “brothers”) at the time of the incidents giving rise to this case were Costa Rican nationals engaged in various business activities in Costa Rica. In particular, they owned and operated a currency exchange, known first as Casa de Cambio Hermanos Villalobos (“the Villalobos Brothers Money Exchange”) and later renamed Casa de Cambio Ofinter S.A. (“Ofinter”). From at least 1998 until Ofinter’s collapse in 2002, the *Superintendencia General de Entidades Financieras* (SUGEF), the Costa Rican governmental financial regulatory agency under the supervision of the Central Bank of Costa Rica, had licensed Ofinter to engage in the money exchange business and regularly included it in the list of authorized money exchanges, which it published periodically for purposes of informing the public. Ofinter had offices in downtown San Jose, the capital city of Costa Rica, and in the San Pedro Mall.
18. Sometime prior to 1996, the Villalobos brothers developed and instituted a scheme whereby individuals and companies would place funds with the brothers in return for a high interest rate on their deposits, as well as the repayment of the principal amount under stipulated conditions. The office in which these transactions were carried out was located in the San Pedro Mall, adjacent to Ofinter’s money exchange business, with a separate entrance from the money exchange business. The Villalobos brothers did not openly undertake a public solicitation of funds, nor did they explain to their clients how they would use the funds raised. Instead, they conducted this part of their business on a highly confidential basis and would accept contributions only from persons introduced to them through recommendations from acquaintances.
19. Individuals or companies placing funds in the scheme were required to make an initial minimum payment of US\$10,000. The minimum period of deposit for amounts up to US\$99,000 was six months and twelve months for deposits of more than US\$100,000. Interest was credited monthly to depositors’ accounts and they were entitled to withdraw interest on a monthly basis. In order to withdraw three or more months’ worth of interest, a depositor had to provide the brothers at least a two-week

written notice. All withdrawals of principal required at least one month's written notice. The Villalobos brothers promised to pay those depositing funds with them a minimum of 3% per month or a total of 36% interest per year. Some persons withdrew their interest regularly when paid and others left the interest to accumulate in their accounts with the brothers. Depositors who were willing to forego monthly withdrawals were promised a rate of 2.8% per month, compounded, which was equivalent to an annual interest rate of 39.29%.

20. Although Claimants argued that the deposits made with the Villalobos constituted a form of participation in an enterprise according to Article I(g)ii of the BIT, evidence on the record shows that deposits with the Villalobos brothers under the above scheme were structured as personal loans to Luis Enrique Villalobos<sup>6</sup>. After filling out a deposit form, depositors made payments of their deposits in one of three ways: 1) in cash delivered to a Villalobos brother or a Villalobos employee at the office in the San Pedro Mall; 2) by check, usually made out to Luis Enrique Villalobos, to Ofinter, to their brokerage account, or to another of their related entities; or 3) by wire transfer to one of their bank accounts in Costa Rica, the United States, or another country.
21. In return, as evidence of the transaction and as a receipt of the depositors' funds, the Villalobos brothers or an employee delivered to each depositor what some Claimants referred to as a "guarantee check" drawn on an account in the name of Luis Enrique Villalobos at the *Banco Nacional de Costa Rica* in the amount of the deposit made with the brothers. The checks were undated and the deposit form filled out by the depositors explained that the check was issued by Luis Enrique Villalobos, a physical person, responsible for the amount shown on the check. At same time, the Villalobos employee receiving the deposit made clear that the checks were not to be cashed and that the account on which they were drawn did not have sufficient funds to pay the amount indicated on the check. In fact, the account on which they were drawn

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<sup>6</sup> Claimants' Counter-Memorial on Jurisdiction and Admissibility, para. 36: "*Claimants do not dispute that the guarantee cheques and the documents accompanying the Beneficiary Statement establish that Enrique Villalobos was personally liable for payment of the principal advanced along with the interest set out on the cheque. In this sense, the investments were personal loans evidenced by a promissory note or debenture issued by the principal shareholder of Ofinter and its related companies.*"

- remained inactive after 1997 and never had more than US\$5,000. Often on the back of the check, a Villalobos employee would write information concerning the interest to be paid on the deposit. If a depositor wished to withdraw principal, he or she would present the guarantee check when requesting payment and surrender it upon payment.
22. Drawn by the high interest rates and the confidential nature of the scheme, more than 6,200 persons deposited a total of approximately US\$405 million with the Villalobos brothers over the years of the scheme's operation. Many of the depositors, like the Claimants in this case, were foreign nationals. They often deposited significant sums of money with what appears to be relatively little investigation and research, relying instead on the recommendations of friends and acquaintances who had previously deposited funds with the brothers and attested to the fact that the Villalobos brothers had regularly paid them the high interest rates promised. The Villalobos brothers provided minimal documentation to the persons depositing funds with them, and thereafter issued no periodic reports on the status of the funds received or the enterprises in which the funds were purportedly invested. Moreover, the Villalobos brothers made no reports to the tax or other governmental authorities of Costa Rica or any other government on their operations or on the income earned by depositors in the scheme.
23. It appears that agencies of the Costa Rican government inspected the Villalobos currency exchange operation from time to time. It also appears that such agencies came to suspect that the Villalobos brothers were conducting other unauthorized activities in connection with the currency exchange. Although the authorities pursued such leads, they were unable to gather sufficient evidence to prove wrongdoing. One of the problems they encountered was that the depositors themselves refused to cooperate by revealing to the authorities the nature of their business transactions with the Villalobos brothers.
24. On June 5, 2002, the Costa Rican judicial authorities received a request for cooperation and legal assistance from the Department of Justice of Canada, which



suspected that a criminal organization in Canada was using the Villalobos brothers scheme to launder money obtained from criminal activities. Pursuant to this request, Costa Rican law enforcement officials, having obtained a search warrant, raided the Villalobos offices and seized various documents and other items on July 4 and 5, 2002. The operation in the San Pedro Mall was closed as a result, but the Villalobos brothers moved their deposit business to another location in the same shopping mall, where despite public knowledge of the raid, certain persons, including the Claimant Norman Barr, continued to deposit funds with the brothers. After the raid, the Villalobos brothers issued other types of instruments to depositors instead of the so-called “guarantee checks” previously provided.

25. The Costa Rican government’s investigation after the raid revealed that the Villalobos brothers had been engaged in illegal financial intermediation and had operated a fraudulent Ponzi scheme whereby persons were induced to invest in the scheme by promises of a high return. Interest payments were financed not from the investment of such funds but from subsequent deposits by other persons. On November 27, 2002, the Costa Rican authorities ordered the arrest of the brothers, closed Ofinter, and seized the assets and accounts of the Villalobos brothers and their affiliated enterprises. On December 18, 2002, the Central Bank of Costa Rica formally cancelled Ofinter’s authorization to operate a currency exchange.
26. Although Osvaldo Villalobos Camacho was arrested and prosecuted for fraud and illegal financial intermediation, his brother Enrique Villalobos managed to escape capture and still remains a fugitive from justice at this time. Ultimately after a lengthy trial involving many witnesses and voluminous documentation, on May 16, 2007 the Trial Court of the First Circuit of San José found Osvaldo Villalobos Camacho guilty of aggravated fraud and illegal financial intermediation for his participation in operating the brothers’ financial scheme. The Trial Court sentenced him to eighteen years imprisonment for his criminal conduct.<sup>7</sup> In their lengthy decision, the judges of the Trial Court concluded that the Villalobos brothers had put in place and operated a

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<sup>7</sup> Decision of the Trial Court of the First Circuit of San José No. 435-07, May 16, 2007 (Respondent’s Exhibit R-8).

Ponzi scheme in which they had used funds received from depositors to pay other depositors and themselves, rather than to invest the funds so as to secure a return for use in paying investors. The judges noted that the brothers' scheme was cloaked in secrecy and was designed to avoid notice by the public or detection by the governmental authorities. On June 2, 2008, a decision of the Supreme Court of Costa Rica upheld the conviction and prison sentence of Osvaldo Villalobos.<sup>8</sup>

27. Since the clients who had provided funds to the brothers were considered victims of fraud, they were permitted under Costa Rican law to file a civil complaint for compensation in connection with the criminal case against Osvaldo Villalobos. At the Hearing on Jurisdiction in the present arbitration proceeding, the auxiliary attorney general of Costa Rica, who was the prosecutor in charge of the criminal prosecution against Osvaldo Villalobos, testified that only 300 persons chose to avail themselves of this procedure.<sup>9</sup> It is not clear whether the reason for this limited participation was the desire of most depositors to avoid the scrutiny of governmental and tax authorities or their belief that such participation would be futile in terms of actually securing a repayment of the funds that they had deposited with the brothers. As with the collapse of any Ponzi scheme, relatively few assets remained under the control of the court to satisfy even this relatively small number of claimants who participated in the criminal proceeding.
28. The Claimants, considering that they have lost their deposits with the Villalobos brothers, commenced this arbitration against the Costa Rican government for compensation for their loss on the grounds that such loss had been caused by various actions or omissions of the government of Costa Rica in violation of the Canada-Costa Rica BIT.

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<sup>8</sup> Decision of the Third Chamber of the Supreme Court of Justice of Costa Rica, June 2, 2008 (Respondent's Exhibit R-84).

<sup>9</sup> Testimony of Walter Espinoza, Hearing Transcript, August 4, 2009, at page 382 line 3.

### **III. RESPONDENT’S OBJECTIONS TO JURISDICTION AND ADMISSIBILITY**

29. In response to the Claimants’ Request for Arbitration, the Respondent contends that ICSID and this Tribunal lack jurisdiction to hear this dispute. In support of its position, the Respondent advances five distinct jurisdictional objections, as well as an admissibility objection to Claimants’ claim on expropriation.
30. The Respondent’s first jurisdictional objection is that none of the deposits made by the Claimants with the Villalobos brothers constitute an “investment”, as that term is defined in Article I of the BIT. Therefore, the Claimants are not entitled to seek the protection of the BIT for the funds that they have allegedly lost as a result of their participation in the Villalobos scheme since a tribunal under Article XII of the BIT only has jurisdiction to hear disputes concerning “investments.”
31. The Respondent’s second jurisdictional objection is that certain of the Claimants are not “investors” for purposes of Article I(h) of the BIT, which grants standing to bring a claim against a BIT contracting state only to persons who are investors.
32. The Respondent’s third jurisdictional objection is that the Claimants’ claims arising out of the search and seizure of Villalobos assets by Costa Rica, which Claimants allege constituted an unlawful expropriation and denial of due process, are barred by Article XII(3)(d) of the BIT which provides that a Canadian investor may submit a claim against Costa Rica only if “no judgment has been rendered by a Costa Rican court regarding the measure that is alleged to be a breach of this agreement.” Respondent contends that Costa Rican Courts have authorized and subsequently ratified the seizure of the Villalobos assets by the authorities of that country.
33. The Respondent’s fourth jurisdictional objection is that the majority of the claims in this case are untimely and therefore barred by either Article XII(3)(c) or Article XV of the BIT.
34. The Respondent’s fifth and final jurisdictional objection is that any claims of the Claimants based on alleged violations of international agreements other than the BIT

or of Costa Rican law are not covered by the BIT and its dispute settlement provisions.

35. The Respondent also alleges that the Claimants' claims of expropriation are inadmissible and premature since the necessary procedural requirements have not been fulfilled.

#### IV. CLAIMANTS' OPPOSITION TO OBJECTIONS TO JURISDICTION AND ADMISSIBILITY

36. Claimants argue that the Tribunal has jurisdiction to entertain the present case on the basis that jurisdiction has to be determined on a *prima facie* standard and issues of admissibility should not be decided as a preliminary matter.
37. Claimants reject Respondent's main objections to the jurisdiction of the Tribunal, arguing: (i) that they made an investment under Article I (g) of the BIT; (ii) that they are "investors" under Article I(h) of the BIT; (iii) that all claims are timely and complied with any necessary procedures under the BIT and (iv) that their claims are not barred by the procedural requirement of Article XII (3)(d) of the BIT.<sup>10</sup>
38. According to the Claimants, the funds provided to the Villalobos brothers are "investments" as they fall within the examples listed in Article I (g)(i)(vi) of the BIT and they meet the general definition of "investments" provided by that same Article I. They also argue that the said funds are not within the exceptions listed in Article I(g). They affirm that their investments were made in accordance with Costa Rican law and within the territory of Costa Rica.
39. In reference to objections *ratione personae*, Claimants argue that all Claimants are Canadian nationals, some of whom invested in Costa Rica indirectly through non-Canadian holding companies owned and controlled by them. They also maintain that Canadian successors of deceased investors have standing as investors under the BIT, and they assert no claims on behalf of prospective investors.

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<sup>10</sup> Article XII(3) of the BIT provides that "An investor may submit a dispute as referred to in paragraph (1) to arbitration in accordance with paragraph (4) only if: ... (d) in cases where Costa Rica is a party to the dispute, no judgment has been rendered by a Costa Rican court regarding the measure that is alleged to be in breach of this Agreement...".

40. Concerning objections *ratione temporis*, Claimants considered that none of their claims are barred by Article XV which provides that “This Agreement shall apply to any investment made by an investor of one contracting Party in the territory of the other Contracting Party before or after the entry into force of this Agreement...”.
41. They also maintain that all of their claims were submitted within the limitation period provided by Article XII(3) and that all Claimants filed the notices required under Article XII(2) of the BIT. Claimants also argued that Article XII(2) is procedural in nature and not jurisdictional. They assert that obligations under Article XII (2) and Article XII (3) are independent.
42. Finally, Claimants argue that their expropriation claims are admissible on the basis that at the time of submitting their Counter-Memorial on Jurisdiction and Admissibility, six and a half years had elapsed since Costa Rican authorities seized the assets of the Villalobos brothers without making these assets available to satisfy the claims of their creditors, including those of the Claimants. Claimants who participated in criminal proceedings against Osvaldo Villalobos have been unable to collect any of the seized assets. Thus, Claimants argue that the exhaustion of Costa Rican legal proceedings by those Claimants who did not participate in such criminal proceedings would be futile.

## **V. THE TRIBUNAL’S ANALYSIS AND CONCLUSIONS**

43. At the outset, it should be noted that each of the five jurisdictional objections advanced by the Respondent would, if established, have differing potential effects on this case. A finding by the Tribunal in support of the first jurisdictional objection would constitute a complete bar to the entire case advanced by all 137 Claimants, since each of them must establish that they have an “investment”, as that term is defined by the BIT, in order to bring an arbitration against Costa Rica. On the other hand, a finding by this Tribunal in support of any or all of the other four jurisdictional objections would have the result that this Tribunal would lack jurisdiction only with respect to certain Claimants or certain issues that they advance. In view of the

importance and all-encompassing nature of the Respondent's first jurisdictional objection, the Tribunal will address that objection first.

44. For the Tribunal to have jurisdiction in this case, each of the Claimants, under Article XII(2) has the burden to demonstrate, *inter alia* that he or she is "an investor" as defined in Article I(h) of the BIT. An "investor" under Article I(h) of the BIT means:

" (i) any natural person possessing the citizenship of one Contracting Party who is not also a citizen or the other Contracting Party; or

(ii) any enterprise as defined by paragraph (b) of this Article, incorporated or duly constituted in accordance with the applicable laws of one Contracting Party;

who owns or controls an investment made in the territory of the other Contracting Party."

45. Thus, in addition to their nationality, the Canadian Claimants must demonstrate that they own or control an "investment," as that term is defined in the BIT, in the territory of Costa Rica.

46. Article I(g) of the Canada-Costa Rica BIT states: " 'investment' means any kind of asset owned or controlled either directly, or indirectly through an enterprise or natural person of a third State, by an investor of one Contracting Party in the territory of the other Contracting Party in accordance with the latter's laws..." It then provides that "investment" includes, "*though not exclusively*", six listed categories of assets, including (i) movable and immovable property and related property rights; (ii) shares, stocks, bonds and debentures or any other form of participation in an enterprise; (iii) money, claims to money, and claims to performance under contract having a financial value; (iv) goodwill; (v) intellectual property rights; and (vi) rights conferred by law or under contract, to undertake any economic and commercial activity, including any rights to search for, cultivate, extract, or exploit natural resources. Article I(g) also stipulates that certain types of assets are not included within the meaning of investment. These include "real estate or other property not acquired in the

expectation or used for the purpose of economic benefit or other business purposes” and “claims to money that arise solely from: (i) commercial contracts for the sale of goods or services ... ; or (ii) the extension of credit in connection with a commercial transaction...”<sup>11</sup>

47. Thus, in order for this Tribunal to have jurisdiction over this dispute, the Claimants must, at a minimum, establish that their deposits and resulting legal relationship with the Villalobos brothers constituted “investments” as the term is defined by the Canada-Costa Rica BIT. To do that, they must show that their deposits had three characteristics: 1) that the deposits constituted “assets” under the BIT; 2) that the Claimants owned or controlled those assets in the territory of Costa Rica in accordance with Costa Rica law; and 3) that if the deposits satisfied these two characteristics they did not fall within those categories of assets that the BIT expressly excludes from the definition of investment. Thus, in order to find that the Claimants’ deposits and resulting relationships with the Villalobos brothers constituted an investment, the Tribunal at the outset must answer two basic questions in the affirmative: A) Did the Claimants’ deposits and resulting legal relationships with one or both of the Villalobos brothers constitute “assets” within the meaning of

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<sup>11</sup> The full text of Article I (g) of the Canada-Costa Rica BIT is as follows:

“(g) “investment” means any kind of asset owned or controlled either directly, or indirectly through an enterprise or natural person of a third State, by an investor of one Contracting Party in the territory of the other Contracting Party in accordance with the latter’s laws and, in particular, though not exclusively, includes:

- i. movable and immovable property and any related property rights, such as mortgages, liens or pledges;
- ii. shares, stock, bonds and debentures or any other form of participation in an enterprise;
- iii. money, claims to money, and claims to performance under contract having a financial value;
- iv. goodwill;
- v. intellectual property rights;
- vi. rights, conferred by law or under contract, to undertake any economic and commercial activity, including any rights to search for, cultivate, extract or exploit natural resources;

but does not mean real estate or other property, tangible or intangible, not acquired in the expectation or used for the purpose of economic benefit or other business purposes.

For further certainty, investment does not mean, claims to money that arise solely from:

- i. commercial contracts for the sale of goods or services by a national or enterprise in the territory of one Contracting Party to a national or an enterprise in the territory of the other Contracting Party; or
- ii. the extension of credit in connection with a commercial transaction, such as trade financing, where the original maturity of the loan is less than three years.

Without prejudice to subparagraph (ii) immediately above, a loan to an enterprise where the enterprise is an affiliate of the investor shall be considered an investment.

For purposes of this Agreement, an investor shall be considered to control an investment if the investor has the power to name a majority of the board of directors or otherwise to legally direct the actions of the enterprise which owns the investment.

Any change in the form of an investment does not affect its character as an investment.

For greater clarity, returns shall be considered a component of investment. For the purpose of this Agreement, “returns” means all amounts yielded by an investment, as defined above, covered by this Agreement and in particular, though not exclusively, includes profits, interest, capital gains, dividends, royalties, fees or other current income.”

the BIT?; and B) If so, did the Claimants own or control those assets “in accordance with the laws of...” Costa Rica?

**A) Did the Claimants’ Deposits and Resulting Legal Relationships with either or both of the Villalobos brothers constitute “assets” under the BIT?**

48. The Canada-Costa Rica BIT does not define the meaning of the word “asset.” The French version of the BIT refers to “*les avoirs de toute nature*” and the official Spanish version refers to “*cualquier tipo de activo*.” The French word “*avoirs*” is usually translated into English as “asset” and the Spanish word “*activo*” is also translated in English as asset. In English, the ordinary meaning of the word “asset” is “anything of value” or a “valuable item that is owned.”<sup>12</sup> The Oxford English Dictionary defines “asset” as “an item of value owned” and Webster’s Deluxe Unabridged Dictionary (2<sup>nd</sup> ed.) defines asset as “anything owned that has exchange value” or a “valuable or desirable thing to have.”<sup>13</sup>
49. On the basis of these definitions, one can say that a Claimant’s deposit of funds resulting in an obligation of Enrique Villalobos to pay interest and principal was an asset since it constituted a thing of value owned by that Claimant. As a result of transferring their funds to Villalobos, the Claimants obtained a promise from Enrique Villalobos to repay the principal amount under certain conditions and further to pay the Claimants a specific amount of interest each month. That asset, embodied in an agreement with Villalobos, promised them a specific return each month according to a pre-determined interest rate and the right to the repayment of their principal deposit upon stated conditions including notice. In fact, many of the Claimants received and withdrew periodic payments of funds from their accounts with the Villalobos brothers.

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<sup>12</sup> The American Heritage Dictionary (2<sup>nd</sup> ed). *Note by the Tribunal*: in the Spanish version of the Award, the definition of the Spanish word “*activo*” is provided from the *Diccionario de la Real Academia Española 22<sup>nd</sup> ed*).

<sup>13</sup> *Note by the Tribunal*: in the Spanish version of the Award, the equivalent definitions are provided from the *Pequeño Larousse Ilustrado (2010)*.



50. That being so, it is clear to the Tribunal that the obligations of Enrique Villalobos to the Claimants as a result of their deposit of funds constituted “assets” owned by the Claimants within the meaning of the Canada-Costa Rica BIT.

**B) Did the Claimants Own and Control Their Assets In Accordance with the Laws of Costa Rica?**

51. Under the BIT, not only must the Claimants demonstrate that they own the assets which they assert constitutes an investment, but they must also demonstrate that they own or control those assets in accordance with the laws of Costa Rica. The French text of the BIT requires that the investments be owned “*en conformité avec les lois*” and the Spanish version specifies that the asset must be owned “*de acuerdo con la legislación.*”
52. In interpreting the phrases “owned or controlled” and “in accordance with the ...laws...,” it should first be emphasized that the BIT states this requirement in objective and categorical terms. Each Claimant must meet this requirement, regardless of his or her knowledge of the law or his or her intention to follow the law. Thus, the Claimants’ statements that they intended to follow the law or that they did not know the law are irrelevant to a determination of whether they actually owned or controlled their investments in accordance with the laws of Costa Rica.
53. Not all BITs contain a requirement that investments subject to treaty protection be “made” or “owned” in accordance with the law of the host country. The fact that the Contracting Parties to the Canada-Costa Rica BIT specifically included such a provision is a clear indication of the importance that they attached to the legality of investments made by investors of the other Party and their intention that their laws with respect to investments be strictly followed. The assurance of legality with respect to investment has important, indeed crucial, consequences for the public welfare and economic well-being of any country.

54. In order to prevent economic hardship to individual citizens and reduce the risk of financial crises, governments ordinarily seek to protect the savings of the public from fraud and other harms that can do significant injury not only to individuals but to the economy as a whole. They therefore seek to achieve this objective by regulating the actions of individuals and companies who would raise capital from the public or otherwise seek to serve as financial intermediaries.<sup>14</sup> One means employed by Costa Rica to protect the public savings is the Organic Law of the Central Bank of Costa Rica,<sup>15</sup> one of whose objectives, according to Article 2(d), is “to promote a stable, efficient, and competitive system of financial intermediation.” Toward this end, Article 116 of the Law provides that the only entities that may engage in financial intermediation in the country are those that are expressly authorized to do so by law. Furthermore, Article 157 makes it a crime to engage in financial intermediation without authorization.
55. By actively seeking and accepting deposits from the Claimants and several thousand other persons, the Villalobos brothers were engaged in financial intermediation without authorization by the Central Bank or any other government body as required by law. The courts of Costa Rica after a lengthy and extensive legal process determined that Osvaldo Villalobos, because of his involvement in the scheme, committed aggravated fraud and illegal financial intermediation. In securing investments from the Claimants, the Villalobos brothers were thus clearly not acting in accordance with the laws of Costa Rica. The entire transaction between the Villalobos brothers and each Claimant was illegal because it violated the Organic Law of the Central Bank. If the transaction by which the Villalobos acquired the deposit was illegal, it follows that the acquisition by each Claimant of the asset resulting from that transaction was also not in accordance with the law of Costa Rica. Although the Claimants may not have committed a crime by entering into a transaction with the Villalobos,<sup>16</sup> the fact that they gained ownership of the asset in

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<sup>14</sup> See for example the United States Securities Act of 1933 which regulates the sale to the public of a “security,” which includes a wide range of financial instruments.

<sup>15</sup> *Ley Orgánica del Banco Central de Costa Rica No. 7558* (Respondent’s Exhibit R-40).

<sup>16</sup> Costa Rica has not prosecuted the Claimants for their participation in the Villalobos scheme. At the Jurisdictional Hearing, the auxiliary

violation of the Organic Law of the Central Bank means that their ownership was not in accordance with the laws of Costa Rica and that therefore each of their deposits and resulting relationships with Villalobos did not constitute an “investment” under the BIT.

56. Claimants’ counsel argued that in judging whether the Claimants’ deposits were owned in accordance with the laws of Costa Rica, this Tribunal should look only to whether the Claimants ownership rights in their claim to be paid the agreed-upon interest and principal were legal obligations under Costa Rican law. By accepting the deposits under the conditions outlined earlier in this decision, Enrique Villalobos clearly became subject to that legal obligation. However, this Tribunal believes that the approach suggested by Claimants’ counsel is too narrow and not a correct interpretation of the treaty language “owned ... in accordance with the law” of Costa Rica.
57. The ordinary dictionary meaning of the verb “own” is “to have or hold a property”<sup>17</sup> or “to have or possess a property.”<sup>18</sup> In order to determine whether the ownership of a property is in accordance with the law of a particular country, one must of necessity examine how the possession or ownership of that property was acquired and in particular whether the process by which that possession or ownership was acquired complied with all of the prevailing laws. In the present case, it is clear that that the transaction by which the Claimants obtained ownership of their assets (*i.e.* their claim to be paid interest and principal by Enrique Villalobos) did not comply with the requirements of the Organic Law of the Central Bank of Costa Rica and that therefore the Claimants did not own their investment in accordance with the laws of Costa Rica. That being the case, the obligations of the Villalobos brother held by the Claimants do not constitute “investments” under the Canada-Costa Rica BIT and

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attorney general of Costa Rica, Walter Espinoza, stated; “From our point of view, they [the Claimants] did not violate criminal law.” Transcript, Hearing on Jurisdiction, Tuesday, August 4, 2009, p. 430.

<sup>17</sup> Webster’s Third New International Dictionary. *Note by the Tribunal:* in the Spanish version of the Award, the definition of the Spanish word “poseer” is provided from the *Diccionario de la Real Academia Española* (22<sup>nd</sup> ed.).

<sup>18</sup> The American Heritage Dictionary of the English Language (2<sup>nd</sup> ed.). *Note by the Tribunal:* in the Spanish version of the Award, the definition of the Spanish word “poseer” is provided from the *Pequeño Larousse Ilustrado* (2010).

- therefore this Tribunal lacks jurisdiction to hear the Claimants' claims against Costa Rica under the BIT.
58. The Tribunal's interpretation of the words "owned in accordance with the laws" of Costa Rica reflects both sound public policy and sound investment practice. Costa Rica, indeed any country, has a fundamental interest in securing respect for its law. It clearly sought to secure that interest by requiring investments under the BIT to be owned and controlled according to law. At the same time, prudent investment practice requires that any investor exercise due diligence before committing funds to any particular investment proposal. An important element of such due diligence is for investors to assure themselves that their investments comply with the law. Such due diligence obligation is neither overly onerous nor unreasonable. Based on the evidence presented to the Tribunal, it is clear that the Claimants did not exercise the kind of due diligence that reasonable investors would have undertaken to assure themselves that their deposits with the Villalobos scheme were in accordance with the laws of Costa Rica.
59. On the basis of the foregoing analysis, the Tribunal concludes that the Respondent's objection to jurisdiction on the ground that the Claimants did not own or control investments in accordance with the law of Costa Rica is established and that this Tribunal is therefore without jurisdiction to hear and decide the Claimants' claims.
60. In view of the fact that the Tribunal's decision on the Respondent's first objection to jurisdiction is established and justifies a complete dismissal of the Claimants' case, the Tribunal does not consider it necessary or appropriate to consider and decide upon the other objections to jurisdiction and admissibility raised by the Respondent.
61. For the reasons presented and pursuant to Article 45 of the Arbitration (AF) Rules, the Tribunal decides to accept the first objection to jurisdiction raised by the Respondent, and it therefore dismisses the Claimants' Request for Arbitration on the ground that the Tribunal lacks jurisdiction "*ratione materiae*" to hear the dispute

which it presents. Therefore and pursuant to Article 44 of the Arbitration (AF) Rules, the Tribunal declares the proceedings closed.

## VI. COSTS

62. Article 58(1) of the Arbitration (AF) Rules provides: “Unless parties otherwise agree, the Tribunal shall decide how and by whom the fees and expenses of the members of the Tribunal, the expenses and charges of the Secretariat and the expenses incurred by the parties in connection with the proceeding shall be borne.” The Tribunal thus has discretion to determine the apportionment of costs between the parties. The Tribunal notes that in reference to the allocation of costs, the practice of ICSID investment arbitration differs from commercial arbitration, which tends to award costs to the successful party.<sup>19</sup> Most ICSID tribunals have determined that each party should bear its own costs.<sup>20</sup> In a few recent investment arbitration cases the principle that “costs follow the event” has been followed by tribunals, which have determined that the losing party should bear all or part of the costs of the proceeding and counsel fees.<sup>21</sup> Such departures from the established previous trend have been justified by tribunals in light of the existence of special reasons or circumstances.

63. In the present case, the Tribunal, in concluding that Claimants’ claims lacked jurisdiction *ratione materiae*, based its reasoning on a strict interpretation and application of the BIT to the facts alleged by the Claimants. In evaluating the facts presented, the Tribunal has found no evidence for concluding that special circumstances exist, such as procedural misconduct, the existence of a frivolous claim, or an abuse of the BIT process or of the international investment protection regime.

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<sup>19</sup> *EDF (Services) Limited v. Romania* (ICSID Case No. ARB/05/13), Award of October 8, 2009, para. 322. See also Article 40(1) of the UNCITRAL Arbitration Rules which provides: “...the costs of arbitration shall in principle be borne by the unsuccessful party. However, the arbitral tribunal may apportion each of such costs between the parties if it determines that apportionment is reasonable, taking into account the circumstances of the case.”

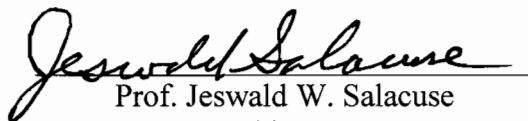
<sup>20</sup> See *i.e. Metalclad Corporation v. The United Mexican States* (ICSID Case No. ARB(AF)/97/1), Award of August 30, 2000; *Tradex Hellas S.A. (Greece) v. Albania* (ICSID Case No. ARB/94/2), Award of April 29, 1999; *ADF Group v. United States of America* (ICSID Case No. ARB(AF)/00/1), Award of January 9, 2003; *Biwater Gauff (Tanzania) Limited v. United Republic of Tanzania* (ICSID Case No. ARB/05/22), Award of July 24, 2008.

<sup>21</sup> *Phoenix Action Ltd v. the Czech Republic* (ICSID Case No. ARB/06/05), Award of April 15, 2009.

64. In consequence of the above, the Tribunal, in the application of its discretionary powers conferred by Article 58(1) of the ICSID (AF) Rules concludes that there are no special circumstances that justify a departure from the accepted and rational practice that each party shall bear its own legal costs and expenses and share equally in the costs and charges of the Tribunal and the ICSID Secretariat.

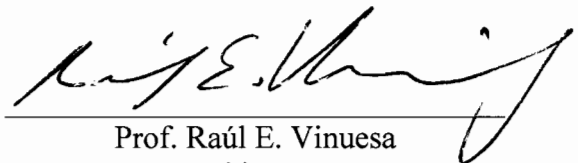
## VII. DECISION OF THE TRIBUNAL

65. For reasons stated in the foregoing paragraphs and pursuant to Article 45 of the Arbitration (AF) Rules, the Tribunal decides with unanimity that:
- a) the Respondent's preliminary objection *ratione materiae* to the Tribunal's jurisdiction must be accepted on grounds that the deposits made by the Claimants with the Villalobos brothers did not constitute an "investment" as that term is defined in Article I of the Canada-Costa Rica BIT;
  - b) the Tribunal is accordingly without jurisdiction to entertain the dispute submitted to it either in part or in whole; and
  - c) the Claimants' Request for Arbitration is therefore dismissed in its entirety.
66. The Tribunal further decides that:
- (a) The costs of the proceedings including the fees and expenses of the Arbitrators and the Secretariat shall be shared by the Parties in equal portion; and that
  - (b) Each Party shall bear its own costs and expenses in respect of legal fees for their counsel and their respective costs for the preparation of the written and the oral proceedings.



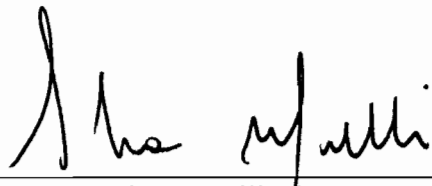
Prof. Jeswald W. Salacuse  
Arbitrator

Date: *April 29, 2010*



Prof. Raúl E. Vinuesa  
Arbitrator

Date: *May 10, 2010*



Dr. Sandra Morelli Rico  
President of the Tribunal

Date: *May 4, 2010*

## **VIII. ANNEX A**

List of one hundred and thirty seven (137) original Claimants attached to the letter sent by the ICSID Secretary-General on March 27, 2007, accompanying the Notice of Registration, by which ICSID approved access to the Additional Facility in this case and registered the Request for Arbitration.



## LIST OF CLAIMANTS

1. Alasdair Ross Anderson
2. Jeannine Anderson
3. Letty Anderson
4. Jean-Claude Barbu
5. Albert Barkhordarian
6. Norman A. Barr
7. Claude Beauchamp
8. Warren Becker
9. Michel Jean Bellefeuille
10. Lance Llewellyn Ralph
11. Bennett Lance
12. Charles Bergeron
13. Claudette Bernard
14. Susan Frances Berrezueta
15. Martin Eberhart Borner
16. Tessa Osbourne Borner
17. Andrew Leon Bowers
18. Robert M. Browne
19. Brian Roy Brownridge
20. Andrew (Wynne) Burns
21. Jackie (Jacqueline) Burns
22. Leonard B. Campbell
23. Carol Ann Christensen
24. Robert William Church
25. William Stewart Clark
26. Marcel Cloutier
27. Bruno Collet
28. Camille D'Amour
29. Gilles Delamirande
30. Elmer Freeman Dow
31. Gladys Irene Dow
32. Kimberly Karmen Dow
33. William Eugene Draper
34. James Elmaleh
35. Neil Emerson
36. Janet L. Empey
37. Arnold Eric Flather
38. Patricia Lucie Fleming
39. Daniel Fontaine
40. Hazel Vaughan Forte
41. Raynald Paul Forte
42. Diane – Alexis Fournier
43. Diane Fraser
44. Patricia Glennie
45. Peter Jeffrey Glennie
46. Georges-Aimé Gouin
47. Serge Guay
48. Louise Hamel
49. Andre Hebert
50. Francois Hebert
51. Pierre Hebert
52. Serge Hebert
53. Diane Hebert-Barbu
54. Richard Norman Herring
55. Lee Hineson
56. Edward J. Horvath
57. Gerald Walter Hunter
58. Shirley Hupp
59. Paul Hutt
60. Michael William Imbery
61. Gordon Jerry Jantzi
62. Marcel Jette
63. Shell Axel Johanson
64. Desiree Kantrim
65. Franz Kargl
66. Amy Teresa Khoo
67. Peter G. Kinzie
68. Dale Bruce Laverne Klassen
69. Rosemarie Elaine Klassen
70. Kathleen Beverly Knorr
71. Reinhold Knorr
72. Howard Lewis Krangle
73. Dennis Wayne Kurek
74. Rita Kurek
75. Stanley Kurek
76. Maurice Wilfrid Laframboise
77. Carole Lagace
78. Rejean Lagace
79. Marie-France Lamarche
80. Gisele Laurin Lavoie
81. Louise Lebeau
82. Dollard LeBlanc
83. Madeleine LeBlanc
84. Richard Lecavalier
85. Daniel Lefebvre
86. Robert Legault
87. Timothe Levesque
88. Jeffrey H. Macleod
89. Paul Mainville
90. Pierre Maltais
91. Michel A. Messier
92. David Elliott Milgram
93. Stanley Mracek
94. Patrick Murphy
95. Milton Daniel Oliver
96. Roger Ouellette
97. Robert Palmer
98. Jean Paquette
99. Pierrette Paquette
100. Marthe Paquin
101. Jamie Norman Payton
102. Beverly Joyce Penner
103. J. Heinrich Penner
104. Donna Potuzak
105. Robert Potuzak
106. Patrick Racicot
107. Luis Ramirez
108. Earl Reinboldt
109. Joyce Marie Renouf Fertig
110. Marie Ange Rice
111. Eric William Robinson
112. Daniel Stacey Roussel
113. Roger Allen Sanderson
114. Bradley Paul Sanson
115. Pierre Savignac
116. Edward William Saville
117. Jean Adonai Sicotte
118. Arthur Splett
119. Rick Splett
120. Gregory W. Spottiswood
121. Alfred Stopp
122. Luc Tessier
123. William B. Thorkelson
124. Alain Truchon
125. Anthony Adrian Van Leest
126. Margaret Van Leest
127. Herman Tjalke Vandonselaar
128. Gregory Gordon Warrian
129. Sheila Rae Warrian
130. Michael John Williams
131. Alan Reid Wilson
132. Albert Ross Wilson
133. Graham Wilson
134. James P. Wilson
135. Joan Frances Wilson
136. Sheila Wilson
137. Keith Woolford

TECHNISCHE UNIVERSITÄT MÜNCHEN

**JUDGMENT OF THE COURT**

21 November 1991 \*

In Case C-269/90,

REFERENCE to the Court under Article 177 of the EEC Treaty by the Bundesfinanzhof (Federal Finance Court) for a preliminary ruling in the proceedings pending before that court between

**Hauptzollamt München-Mitte**

and

**Technische Universität München**

on the validity of Commission Decision 83/348/EEC of 5 July 1983 establishing that the apparatus described as 'Jeol-Scanning Electron Microscope, model JSM-35 C' may not be imported free of Common Customs Tariff duties (Official Journal 1983 L 188, p. 22),

THE COURT,

composed of: O. Due, President, Sir Gordon Slynn, R. Joliet, F. A. Schockweiler and F. Grévisse (Presidents of Chambers), G. F. Mancini, C. N. Kakouris, J. C. Moitinho de Almeida, G. C. Rodríguez Iglesias, M. Díez de Velasco and M. Zuleeg, Judges,

Advocate General: F. G. Jacobs,  
Registrar: H. A. Rühl, Principal Administrator,

\* Language of the case: German.

after considering the written observations submitted on behalf of:

- Technische Universität München, by Mr Wachinger, Leitender Regierungsdirektor,
- Commission of the European Communities, by J. Sack, Legal Adviser, acting as Agent,

having regard to the Report for the Hearing,

after hearing the oral observations of the Commission at the hearing on 11 June 1991,

after hearing the Opinion of the Advocate General at the sitting on 11 July 1991,  
gives the following

### Judgment

- 1 By order of 17 July 1990, which was received at the Court on 6 September 1990, the Bundesfinanzhof (Federal Finance Court) referred to the Court for a preliminary ruling under Article 177 of the EEC Treaty a question on the validity of Commission Decision 83/348/EEC of 5 July 1983 establishing that the apparatus described as 'Jeol-Scanning Electron Microscope, Model JSM-35 C' may not be imported free of Common Customs Tariff duties (Official Journal 1983 L 188, p. 22).
- 2 The question was raised in the course of proceedings between the Technische Universität München and the Hauptzollamt München-Mitte.
- 3 The proceedings concern the grant of customs exemption, for a scientific instrument imported into the Community, under Article 3(1)(b) of Council Regu-

lation (EEC) No 1798/75 of 10 July 1975 on the importation free of Common Customs Tariff duties of educational, scientific and cultural materials (Official Journal 1975 L 184, p. 1), as amended by Council Regulation (EEC) No 1027/79 of 8 May 1979 (Official Journal 1979 L 134, p. 1) in force since 1 January 1980.

- 4 Between 1 June 1979 and 23 March 1981 the Technische Universität München brought into free circulation a scanning electron microscope, model JSM-35 C, manufactured by Japan Elektron Optics Laboratory Ltd of Tokyo. The instrument was intended to be used in research work in its chemistry, biology and geology departments. It was to be used in investigating electro-chemical processes, geological, mineralogical and food chemistry problems, and research into plastics, photochemical emulsions and biological systems.
- 5 The Hauptzollamt initially admitted it free of customs duty. However, by notices of 14 and 15 April and 22 June 1982 it then demanded customs duties of DM 31 110 plus import turnover tax of DM 3 746.
- 6 Following the objection procedure commenced by the Technische Universität, the Hauptzollamt requested the intervention of the Commission pursuant to Article 7(2) of Commission Regulation (EEC) No 2784/79 of 12 December 1979 laying down provisions for the implementation of Council Regulation (EEC) No 1798/75 (Official Journal 1979 L 318, p. 32).
- 7 On 5 July 1983, the Commission adopted Decision 83/348, referred to above, according to which the electron microscope in question could not be imported free of Common Customs Tariff duties because apparatus of equivalent scientific value, capable of being used for the same purposes, was being manufactured in the Community, in particular, the PSEM 500 X instrument produced by Philips Nederland BV.

- 8 Following this decision by the Commission, the Hauptzollamt rejected the application for duty-free admission. The Technische Universität then began an action.
- 9 The Bundesfinanzhof, to which the case came at last instance, considers that it raises a question of the validity of Commission Decision 83/348, cited above. In its view, the Court of Justice has always held that it has only a limited power of review in relation to disputes concerning the duty-free importation of scientific apparatus. According to its case-law, given the technical nature of the questions which arise, the Court may only declare a decision of the Commission invalid where there has been a manifest error of appraisal or a misuse of power. The Bundesfinanzhof doubts whether that view can be maintained.
- 10 The Bundesfinanzhof considers that the fact-finding and the application of the legal criteria governing the grant of duty-free admission cannot escape judicial review. That requirement for legal protection is not affected by the fact that the comparative examination of the equivalence of scientific apparatus carried out by the competent customs authorities is mainly technical.
- 11 The Bundesfinanzhof therefore asks the Court whether Commission Decision 83/348 is valid.
- 12 Reference is made to the Report for the Hearing for a fuller account of the facts of the case, the procedure and the written and oral observations submitted to the Court, which are mentioned or discussed hereinafter only in so far as is necessary for the reasoning of the Court.

- 13 It must be stated first of all that, since an administrative procedure entailing complex technical evaluations is involved, the Commission must have a power of appraisal in order to be able to fulfil its tasks.
- 14 However, where the Community institutions have such a power of appraisal, respect for the rights guaranteed by the Community legal order in administrative procedures is of even more fundamental importance. Those guarantees include, in particular, the duty of the competent institution to examine carefully and impartially all the relevant aspects of the individual case, the right of the person concerned to make his views known and to have an adequately reasoned decision. Only in this way can the Court verify whether the factual and legal elements upon which the exercise of the power of appraisal depends were present.
- 15 The Court must therefore examine whether the disputed decision was adopted in accordance with the principles mentioned above.
- 16 With regard to the first point, it should be borne in mind that Regulation No 1798/75, cited above, implemented in the Community the Florence Agreement of 22 November 1950 (see Official Journal 1979 L 134, p. 14) in which the Contracting States undertake not to apply customs duties and import duties on scientific apparatus intended for educational or research purposes, provided that no apparatus of equivalent scientific value is manufactured in the country of importation.
- 17 According to the first recital of the preamble to Regulation No 1798/75, it is necessary to allow, by all possible means, the admission free of Common Customs Tariff duties of educational, scientific and cultural materials in order to facilitate the free exchange of ideas as well as the exercise of cultural activities and scientific research within the Community.

- 18 Article 3(1) of the regulation provides that scientific instruments and apparatus imported exclusively for non-commercial purposes are to be admitted free of Common Customs Tariff duties if no instruments or apparatus of equivalent scientific value are being manufactured in the Community.
- 19 The grant of customs exemption for scientific apparatus imported into the Community can therefore only be refused, on the grounds that apparatus of equivalent scientific value exists in the Community, if the investigation carried out by the authorities responsible for applying Regulation No 1798/75 has established that fact for certain.
- 20 In the procedure laid down by Regulation No 2784/79 the Commission consults the Member States and, if necessary, a group of experts. If this group's examination shows that an equivalent apparatus is manufactured in the Community, the Commission adopts a decision establishing that the conditions for duty-free importation of the apparatus are not met.
- 21 The Commission has admitted that it has always followed the opinions of the group of experts because it has no other sources of information concerning the apparatus being considered.
- 22 In those circumstances, the group of experts cannot properly carry out its task unless it is composed of persons possessing the necessary technical knowledge in the various fields in which the scientific instruments concerned are used or the members of that group are advised by experts having that knowledge. Neither the minutes of the meeting of the group of experts nor the oral proceedings before the Court have shown that the members of the group themselves possessed the necessary knowledge in the fields of chemistry, biology and geographical sciences or that they sought advice from experts in those fields in order to be able to

address the technical problems raised by the examination of the equivalence of the scientific instruments in question. Consequently, the Commission has infringed its obligation to examine carefully and impartially all the relevant aspects of the case in point.

- 23 Secondly, it must be stated that Regulation No 2784/79 does not provide any opportunity for the person concerned, the importer of scientific apparatus, to explain his position to the group of experts or to comment on the information before the group or to take a position on the group's recommendation.
- 24 However, it is the importing institution which is best aware of the technical characteristics which the scientific apparatus must have in view of the work for which it is intended. The comparison between the imported apparatus and the instruments originating in the Community must, consequently, be made according to the information about the intended research projects and the actual intended use of the apparatus provided by the person concerned.
- 25 The right to be heard in such an administrative procedure requires that the person concerned should be able, during the actual procedure before the Commission, to put his own case and properly make his views known on the relevant circumstances and, where necessary, on the documents taken into account by the Community institution. This requirement was not met when the disputed decision was adopted.
- 26 Thirdly, and finally, with regard to the statement of reasons required by Article 190 of the Treaty, the Court has consistently held (see, in particular, its judgment in Case 205/85 *Nicolet Instrument v Hauptzollamt Frankfurt am Main-Flughafen* [1986] ECR 2049) that the statement of reasons must disclose in a clear and unequivocal fashion the reasoning followed by the Community authority which adopted the measure in question in such a way as to make the persons concerned



aware of the reasons for the measure and thus enable them to defend their rights and to enable the Court to exercise its supervisory jurisdiction.

- 27 In the instant case, it must be stated that the Commission's decision does not contain a sufficient statement of the scientific reasons capable of justifying the conclusion that the instrument manufactured in the Community is equivalent to the imported instrument. The disputed decision merely reproduces the wording of one of the Commission's previous decisions, Decision 82/86/EEC of 23 December 1981 (Official Journal 1982 L 41, p. 53). It is therefore impossible for the person concerned to ascertain whether the decision is vitiated by an error of appraisal. The decision does not therefore satisfy the requirements laid down by Article 190 of the Treaty.
- 28 It follows from all the considerations set out above that the decision in question was adopted pursuant to an administrative procedure in which the obligation of the competent institution to examine carefully and impartially all the relevant aspects of the individual case before it, the right to be heard and the obligation to provide an adequate statement of reasons for the decision subsequently adopted were infringed.
- 29 Accordingly, the answer to be given to the national court is that Commission Decision 83/348 of 5 July 1983 establishing that the apparatus described as 'Jeol-Scanning Electron Microscope, model JSM-35 C' may not be imported free of Common Customs Tariff duties is invalid.

### Costs

- 30 The costs incurred by the Commission of the European Communities, which have submitted observations to the Court, are not recoverable. Since these proceedings are, in so far as the parties to the main proceedings are concerned, in the nature of a step in the action pending before the national court, the decision on costs is a matter for that court.

On those grounds,

THE COURT,

in answer to the question submitted to it by the Bundesfinanzhof, by order of 17 July 1990, hereby rules:

**Commission Decision 83/348/EEC of 5 July 1983 establishing that the apparatus described as 'Jeol-Scanning Electron Microscope, model JSM-35 C' may not be imported free of Common Customs Tariff duties is invalid.**

Due	Slynn	Joliet	Schockweiler	Grévisse
Mancini	Kakouris	Moitinho de Almeida		
Rodríguez Iglesias	Díez de Velasco	Zuleeg		

Delivered in open court in Luxembourg on 21 November 1991.

J.-G. Giraud  
Registrar

O. Due  
President

NÖLLE

**JUDGMENT OF THE COURT (Fifth Chamber)**

22 October 1991 \*

In Case C-16/90,

REFERENCE to the Court under Article 177 of the EEC Treaty by the Finanzgericht Bremen (Second Chamber) for a preliminary ruling in the proceedings pending before that court between

**Detlef Nölle, trading as 'Eugen Nölle'**

and

**Hauptzollamt Bremen-Freihafen**

on the validity of Council Regulation (EEC) No 725/89 of 20 March 1989 imposing a definitive anti-dumping duty on imports of paint, distemper, varnish and similar brushes originating in the People's Republic of China and definitively collecting the provisional anti-dumping duty on such imports (Official Journal 1989 L 79, p. 24),

**THE COURT (Fifth Chamber),**

composed of: Sir Gordon Slynn, President of Chamber, acting as President of the Fifth Chamber, F. Grévisse, J. C. Moitinho de Almeida, G. C. Rodríguez Iglesias and M. Zuleeg, Judges,

Advocate General: W. Van Gerven,  
Registrar: D. Louterman, Principal Administrator,

\* Language of the case: German.

after considering the written observations submitted on behalf of:

- Detlef Nölle, trading as 'Eugen Nölle', the plaintiff in the main proceedings, by Frank Montag, Rechtsanwalt, Cologne,
- the Council of the European Communities by Erik Stein, Legal Adviser, acting as Agent,
- the Commission of the European Communities by Eric White, a member of the Legal Service, acting as Agent, assisted by Reinhard Wagner, a German Judge seconded to the Commission within the framework of the exchange scheme for national officials,

having regard to the Report for the Hearing,

after hearing the oral observations of Detlef Nölle, the Council and the Commission, represented by Eric White, Legal Adviser, and Claus-Michael Happe, a German official seconded to the Commission in the framework of the exchange scheme for national officials, at the hearing on 16 January 1991,

after hearing the Opinion of the Advocate General at the sitting on 4 June 1991,

gives the following

### **Judgment**

- 1 By order of 12 December 1989, which was received at the Court on 22 January 1990, the Finanzgericht Bremen (Second Chamber), referred to the Court for a preliminary ruling under Article 177 of the EEC Treaty a question on the validity of Council Regulation (EEC) No 725/89 of 20 March 1989 imposing a definitive anti-dumping duty on imports of paint, distemper, varnish and similar brushes originating in the People's Republic of China and definitively collecting the provisional anti-dumping duty on such imports (Official Journal 1989 L 79, p. 24).

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- 2 The question was raised in proceedings between Detlef Nölle, trading as 'Eugen Nölle' (hereinafter referred to as 'Nölle') and the Hauptzollamt Bremen-Freihafen (hereinafter referred to as 'the Hauptzollamt') concerning the definitive anti-dumping duties imposed by the latter on Nölle's imports of paint brushes from China.
  
- 3 On 21 November 1988 and 8 and 14 February 1989, Nölle applied to the Hauptzollamt for entry for free circulation of three consignments of cleaning and paint brushes falling under Combined Nomenclature code 9603 40 10 originating in the People's Republic of China. The Hauptzollamt first demanded, pursuant to Article 1 of Commission Regulation (EEC) No 3052/88 imposing a provisional anti-dumping duty on imports of paint, distemper, varnish and similar brushes originating in the People's Republic of China (Official Journal 1988 L 272, p. 16), payment of a provisional anti-dumping duty in respect of which Nölle, in pursuance of Article 1(4) of the said regulation, lodged a security in the form of a directly enforceable bank guarantee in the amounts of DM 31 000, DM 17 000 and DM 4 400, a total of DM 52 400 for the three consignments.
  
- 4 In three notices dated 14 April 1989, the Hauptzollamt requested Nölle to pay DM 29 937.04, DM 16 972.57 and DM 4 307.79, a total of DM 51 217.40, in definitive anti-dumping duty, corresponding, in accordance with Article 1 of the said Regulation No 725/89 (hereinafter referred to as 'the contested regulation'), to 69% of the net price per brush, free-at-Community-frontier, not cleared through customs.
  
- 5 On 3 May 1989, Nölle lodged an objection with the Hauptzollamt, claiming that the notices of 14 April were illegal on the ground that the contested regulation, on which they were based, was in several respects in breach of higher-ranking Community rules. The objection was dismissed and Nölle then brought an action before the Finanzgericht Bremen for the cancellation of the three notices.

- 6 In those circumstances the national court referred the following question to the Court for a preliminary ruling:

‘Is Council Regulation (EEC) No 725/89 of 20 March 1989 invalid?’

- 7 Reference is made to the Report for the Hearing for a fuller account of the facts of the case, the procedure and the written observations submitted to the Court, which are mentioned or discussed hereinafter only in so far as is necessary for the reasoning of the Court.

- 8 The national court bases its doubts as to the validity of the contested regulation on the grounds pleaded by the plaintiff in the main proceedings, namely infringement of Article 2(5)(a) of Council Regulation (EEC) No 2423/88 of 11 July 1988 on protection against dumped or subsidized imports from countries not members of the European Economic Community (Official Journal 1988 L 209, p. 1) (hereinafter referred to as ‘the basic regulation’).

- 9 That article provides that:

‘In the case of imports from non-market economy countries . . . normal value shall be determined in an appropriate and not unreasonable manner on the basis of one of the following criteria:

- (a) the price at which the like product of a market economy third country is actually sold:

(i) for consumption on the domestic market of that country; or

(ii) to other countries, including the Community;

...’

- 10 First of all it should be stressed that the aim of Article 2(5) of the basic regulation is to prevent account being taken of prices and costs in non-market-economy countries, that is to say, which are not the normal result of market forces (see the judgment in *Joined Cases C-305/86 and C-160/87 Neotype Techmashexport v Commission and Council* [1990] ECR I-2945).
- 11 It should also be remembered that the choice of reference country is a matter falling within the discretion enjoyed by the institutions in analysing complex economic situations.
- 12 However, the exercise of that discretion is not excluded from review by the Court. The Court has consistently held that in the context of such a review it will verify whether the relevant procedural rules have been complied with, whether the facts on which the choice is based have been accurately stated and whether there has been a manifest error of appraisal or a misuse of powers (judgments in *Case 240/84 NTN Toyo Bearing Company Limited and Others v Council* [1987] ECR 1809 and *Case 258/84 Nippon Seiko KK v Council* [1987] ECR 1923).
- 13 As regards in particular the choice of reference country it is desirable to verify whether the institutions neglected to take account of essential factors for the purpose of establishing the appropriate nature of the country chosen and whether the information contained in the documents in the case were considered with all the care required for the view to be taken that the normal value was determined in an appropriate and not unreasonable manner.
- 14 Nölle claims that the normal value was not determined in such a manner since Sri Lanka, the country chosen as the reference country, satisfied none of the conditions of which the Commission, according to its usual practice, has hitherto taken account, namely the existence in the country concerned of a like product of like volume and production methods, of conditions of access to raw materials comparable to those of the exporting country concerned and of prices resulting from the operation of the rules of the market economy.

- 15 In this respect Nölle claims first that China produces round, flat and radiator paint brushes, whereas Sri Lanka produces only flat brushes as well as other brushes not affected by the anti-dumping duty at issue.
- 16 The Commission thinks, however, that the Sri Lankan brushes are similar to the Chinese brushes because they are essentially manufactured from animal hair and have wooden handles of similar thickness, a ferrule and a quantity and weight of hair and bristle similar to those of the Chinese brushes. It is therefore in the Commission's view irrelevant that Sri Lanka produces only flat brushes.
- 17 It should be noted that neither the documents sent by the national court nor the documents and explanations produced during the hearing before the Court show conclusively whether or not the products in question are similar. It is therefore not established that in this respect the institutions made a manifestly incorrect appraisal.
- 18 Nölle claims in the second place that production volumes are not comparable, because in Sri Lanka there are only two major producers, one of whom manufactures practically none of the products in question, whereas in China there are at least 150 small and medium-sized businesses and the production volume there is accordingly at least 200 times as great as that in Sri Lanka.
- 19 According to the Commission the fact that production volume in the People's Republic of China is higher than in Sri Lanka is not relevant since the decisive criterion for calculating the normal value is the production costs of individual firms. In both these countries the firms are small or medium-sized with labour-intensive production in small-scale units with low wage rates.



- 20 It should be recalled that according in particular to paragraph 31 of the judgment in Joined Cases C-305/86 and C-160/87 *Neotype*, cited above, the size of the domestic market is not in principle a factor capable of being taken into consideration in the choice of a reference country under Article 2(5) of the basic regulation in so far as, during the period of the investigation, there is a sufficient number of transactions to ensure the representative nature of the market in relation to the exports in question. In this respect it should be borne in mind that in paragraphs 12 and 13 of the judgment in Case 250/85 *Brother Industries v Council* [1988] ECR 5683, the Court rejected a challenge to the institutions' practice of fixing the minimum level of representativity of the domestic market, for the purpose of calculating the normal value, at 5% of the exports in question.
- 21 At the hearing Nölle and the Commission agreed that the volume of exports of Chinese paint brushes to the Community was some 60 million brushes, whereas Sri Lanka's total production was of the order of 750 000 brushes a year, representing 1.25% of the volume of the exports in question.
- 22 It should be emphasized that although the sole fact that the production volume of the reference country is below the minimum level of 5% does not necessarily signify that the choice of that country cannot be regarded as appropriate and not unreasonable, a figure of 1.25% nevertheless amounts to an indication that the market considered is not very representative.
- 23 It must also be noted that the Commission and the Council did not produce during either the written or the oral procedure any figures or details capable of showing that, as they stated, production methods in Sri Lanka consisted in labour-intensive production in small-scale units with low wage rates, so that they were comparable to production methods in China.

- 24 Nölle states in the third place that the Sri Lankan industry is obliged to import pig bristle, wood for the handles, and the ferrules, whilst China has practically 85% of the world market in pig bristle.
- 25 The Commission contends that the alleged advantage resulting from access to raw materials cannot be satisfactorily quantified in a non-market-economy country and that in any event such an advantage may be offset by other competitive advantages existing in a market-economy country. Moreover it claims that, as regards the raw materials imported for paint-brush manufacture, adjustments were made (see recital 20 in the preamble to the contested regulation) and that the Commission deducted 25% of the already adjusted price to take account of quality differences.
- 26 This argument put forward by the Commission cannot be accepted. In the first place it follows from the Community institutions' established practice that the comparability of access to raw materials must be taken into consideration for the choice of reference country (see, for example Council Regulation (EEC) No 407/80 of 18 February 1980 imposing a definitive anti-dumping duty on certain sodium carbonate originating in the Soviet Union, Official Journal 1980 L 48, p. 1). Secondly the advantages resulting from access to raw materials cannot be excluded simply because there is no market economy in the exporting country. Since Article 2(5) of the basic regulation is actually applied only in the case of imports from non-market-economy countries, that argument would be tantamount to making impossible any comparison between the production costs of countries with different market conditions.
- 27 Nölle claims finally that the prices charged in Sri Lanka are not the result of the rules of a market economy since there is no natural competition there. It stresses in this respect that the two producers share roughly 90% of the domestic market and that the one of them who manufactures products comparable to those imported from China is a subsidiary of a Community producer who took a leading part in the anti-dumping proceeding set in motion by the European producers.

- 28 The Commission contends that that does not imply the existence of an agreement, decision or concerted practice on prices or the absence of sufficient competition.
- 29 In this respect it must be emphasized that, although the sole fact that there are only two producers in the reference country does not, of itself, prevent prices from being the result of real competition, Nölle, without any objection from the Commission, drew price comparisons during the written procedure and at the hearing from which it is clear that the Sri Lankan producers charged prices higher than those of two representative Community producers. In addition, Nölle produced two documents from the Sri Lankan firms in question, showing that they could supply the Community only to a very limited extent as the production of brushes is adapted to the needs of the domestic market and that there is no price advantage in comparison with the prices which the parent company is able to offer in Europe.
- 30 It appears from the foregoing that Nölle has produced sufficient factors, already known to the Commission and the Council during the anti-dumping proceeding, to raise doubts as to whether the choice of Sri Lanka as a reference country was appropriate and not unreasonable.
- 31 However, the institutions came to the conclusion that Sri Lanka represented an appropriate and not unreasonable choice and did not therefore consider Taiwan, which had been suggested by the plaintiff.
- 32 It should be pointed out in this connection that although the institutions are not required to consider every reference country suggested by the parties during an anti-dumping proceeding, the doubts which arose in this case with regard to the choice of Sri Lanka ought to have led the Commission to examine the proposal made by the plaintiff in greater depth.

- 33 It may be seen from the preamble to the contested regulation that Taiwan was considered as a possible reference country but that the institutions did not pursue that possibility on the ground that the physical characteristics and the production costs of the products were different and that the Taiwanese producers who were approached refused to cooperate (recitals 16 and 17 in the preamble to the contested regulation).
- 34 These statements were not supported by any details and no facts were produced. As regards, in particular, the Taiwanese producers' alleged refusal to cooperate, it should be noted that the letter addressed to the two main producers in Taiwan, produced by the Commission during the hearing, cannot be regarded as a sufficient attempt to obtain information, regard being had to its wording and the extremely short period allowed for reply, which made it practically impossible for the producers in question to cooperate.
- 35 In view of all the circumstances set out above it appears, on the one hand, that various factors known to the institutions were in any event such as to raise doubts as to the appropriateness of Sri Lanka as a reference country and, on the other hand, that the institutions did not make a serious or sufficient attempt to determine whether Taiwan could be considered as an appropriate reference country.
- 36 In these circumstances it must be considered that the normal value was not determined 'in an appropriate and not unreasonable manner' within the meaning of Article 2(5)(a) of the basic regulation.
- 37 As the anti-dumping duty was therefore imposed in contravention of that provision, the contested regulation must be declared invalid and there is no need to consider the other grounds for invalidity put forward by the national court.

- 38 The answer to the question raised must therefore be that Regulation No 725/89 is invalid.

### Costs

- 39 The costs incurred by the Commission and the Council of the European Communities, which have submitted observations to the Court, are not recoverable. Since these proceedings are, for the parties to the main proceedings, a step in the action pending before the national court, the decision on costs is a matter for that court.

On those grounds,

THE COURT (Fifth Chamber),

in answer to the question submitted to it by the Finanzgericht Bremen (Second Chamber), by order of 12 December 1989, hereby rules:

**Council Regulation (EEC) No 725/89 of the Council of 20 March 1989 imposing a definitive anti-dumping duty on imports of paint, distemper, varnish and similar brushes originating in the People's Republic of China and definitively collecting the provisional anti-dumping duty in such imports is invalid.**

Slynn

Grévisse

Moitinho de Almeida

Rodríguez Iglesias

Zuleeg

Delivered in open court in Luxembourg on 22 October 1991.

J.-G. Giraud  
Registrar

Gordon Slynn  
President of Chamber acting as  
President of the Fifth Chamber

**Draft articles on  
Prevention of Transboundary Harm from Hazardous Activities,  
with commentaries  
2001**

Text adopted by the International Law Commission at its fifty-third session, in 2001, and submitted to the General Assembly as a part of the Commission's report covering the work of that session (A/56/10). The report, which also contains commentaries on the draft articles, appears in the *Yearbook of the International Law Commission, 2001*, vol. II, Part Two.



dispute shall, at the request of any of them, have recourse to the establishment of an impartial fact-finding commission.

3. The Fact-finding Commission shall be composed of one member nominated by each party to the dispute and in addition a member not having the nationality of any of the parties to the dispute chosen by the nominated members who shall serve as Chairperson.

4. If more than one State is involved on one side of the dispute and those States do not agree on a common member of the Commission and each of them nominates a member, the other party to the dispute has the right to nominate an equal number of members of the Commission.

5. If the members nominated by the parties to the dispute are unable to agree on a Chairperson within three months of the request for the establishment of the Commission, any party to the dispute may request the Secretary-General of the United Nations to appoint the Chairperson who shall not have the nationality of any of the parties to the dispute. If one of the parties to the dispute fails to nominate a member within three months of the initial request pursuant to paragraph 2, any other party to the dispute may request the Secretary-General of the United Nations to appoint a person who shall not have the nationality of any of the parties to the dispute. The person so appointed shall constitute a single-member Commission.

6. The Commission shall adopt its report by a majority vote, unless it is a single-member Commission, and shall submit that report to the parties to the dispute setting forth its findings and recommendations, which the parties to the dispute shall consider in good faith.

## 2. TEXT OF THE DRAFT ARTICLES WITH COMMENTARIES THERETO

98. The text of the draft articles adopted by the Commission at its fifty-third session with commentaries thereto is reproduced below.

### PREVENTION OF TRANSBOUNDARY HARM FROM HAZARDOUS ACTIVITIES

#### *General commentary*

(1) The articles deal with the concept of prevention in the context of authorization and regulation of hazardous activities which pose a significant risk of transboundary harm. Prevention in this sense, as a procedure or as a duty, deals with the phase prior to the situation where significant harm or damage might actually occur, requiring States concerned to invoke remedial or compensatory measures, which often involve issues concerning liability.

(2) The concept of prevention has assumed great significance and topicality. The emphasis upon the duty to prevent as opposed to the obligation to repair, remedy or compensate has several important aspects. Prevention should be a preferred policy because compensation in case of harm often cannot restore the situation prevailing prior to the event or accident. Discharge of the duty of prevention or due diligence is all the more required as knowledge regarding the operation of hazardous activities, materials used and the process of managing them and the risks involved is steadily growing. From a legal point of view, the enhanced ability to trace the chain of causation, i.e. the physical link between the cause (activity) and the effect (harm), and even the several intermediate links

in such a chain of causation, makes it also imperative for operators of hazardous activities to take all steps necessary to prevent harm. In any event, prevention as a policy is better than cure.

(3) Prevention of transboundary harm arising from hazardous activities is an objective well emphasized by principle 2 of the Rio Declaration on Environment and Development (Rio Declaration)<sup>857</sup> and confirmed by ICJ in its advisory opinion on the *Legality of the Threat or Use of Nuclear Weapons*<sup>858</sup> as now forming part of the corpus of international law.

(4) The issue of prevention, therefore, has rightly been stressed by the Experts Group on Environmental Law of the World Commission on Environment and Development (Brundtland Commission). Article 10 recommended by the Group in respect of transboundary natural resources and environmental interferences thus reads: "States shall, without prejudice to the principles laid down in articles 11 and 12, prevent or abate any transboundary environmental interference or a significant risk thereof which causes substantial harm—i.e. harm which is not minor or insignificant."<sup>859</sup> It must be further noted that the well-established principle of prevention was highlighted in the arbitral award in the *Trail Smelter case*<sup>860</sup> and was reiterated not only in principle 21 of the Declaration of the United Nations Conference on the Human Environment (Stockholm Declaration)<sup>861</sup> and principle 2 of the Rio Declaration, but also in General Assembly resolution 2995 (XXVII) of 15 December 1972 on cooperation between States in the field of the environment. This principle is also reflected in principle 3 of the Principles of conduct in the field of the environment for the guidance of States in the conservation and harmonious utilization of natural resources shared by two or more States, adopted by the Governing Council of UNEP in 1978, which provided that States must:

avoid to the maximum extent possible and ... reduce to the minimum extent possible the adverse environmental effects beyond its jurisdiction of the utilization of a shared natural resource so as to protect the environment, in particular when such utilization might:

- (a) cause damage to the environment which could have repercussions on the utilization of the resource by another sharing State;
- (b) threaten the conservation of a shared renewable resource;
- (c) endanger the health of the population of another State.<sup>862</sup>

<sup>857</sup> *Report of the United Nations Conference on Environment and Development, Rio de Janeiro, 3–14 June 1992* (United Nations publication, Sales No. E.93.I.8 and corrigenda), vol. I: *Resolutions adopted by the Conference*, resolution 1, annex I.

<sup>858</sup> *Legality of the Threat or Use of Nuclear Weapons* (see footnote 54 above), pp. 241–242, para. 29; see also A/51/218, annex.

<sup>859</sup> *Environmental Protection and Sustainable Development: Legal Principles and Recommendations* (London, Graham and Trotman/Martinus Nijhoff, 1987), p. 75, adopted by the Experts Group. It was also noted that the duty not to cause substantial harm could be deduced from the non-treaty-based practice of States, and from the statements made by States individually and/or collectively. See J. G. Lammers, *Pollution of International Watercourses* (The Hague, Martinus Nijhoff, 1984), pp. 346–347 and 374–376.

<sup>860</sup> *Trail Smelter* (see footnote 253 above), pp. 1905 et seq.

<sup>861</sup> *Report of the United Nations Conference on the Human Environment, Stockholm, 5–16 June 1972* (United Nations publication, Sales No. E.73.II.A.14 and corrigendum), part one, chap. I.

<sup>862</sup> UNEP, *Environmental Law: Guidelines and Principles*, No. 2, *Shared Natural Resources* (Nairobi, 1978), p. 2. The principles are re-



(5) Prevention of transboundary harm to the environment, persons and property has been accepted as an important principle in many multilateral treaties concerning protection of the environment, nuclear accidents, space objects, international watercourses, management of hazardous wastes and prevention of marine pollution.<sup>863</sup>

### *Preamble*

#### *The States Parties,*

**Having in mind Article 13, paragraph 1 (a), of the Charter of the United Nations, which provides that the General Assembly shall initiate studies and make recommendations for the purpose of encouraging the progressive development of international law and its codification,**

**Bearing in mind the principle of permanent sovereignty of States over the natural resources within their territory or otherwise under their jurisdiction or control,**

**Bearing also in mind that the freedom of States to carry on or permit activities in their territory or otherwise under their jurisdiction or control is not unlimited,**

**Recalling the Rio Declaration on Environment and Development of 13 June 1992,**

**Recognizing the importance of promoting international cooperation,**

**Have agreed as follows:**

### *Commentary*

(1) The preamble sets out the general context in which the topic of prevention is elaborated, keeping in view the mandate given to the Commission to codify and develop international law. Activities covered under the present topic of prevention require States to engage in cooperation and accommodation in their mutual interest. States

produced in ILM, vol. 17, No. 5 (September 1978), p. 1098. See also decision 6/14 of 19 May 1978 of the Governing Council of UNEP, *Official Records of the General Assembly, Thirty-third Session, Supplement No. 25 (A/33/25)*, annex I. For a mention of other sources where the principle of prevention is reflected, see *Environmental Protection and Sustainable Development ...* (footnote 859 above), pp. 75–80.

<sup>863</sup> For a collection of treaties arranged according to the area or sector of the environment covered and protection offered against particular threats, see E. Brown Weiss, D. B. Magraw and P. C. Szasz, *International Environmental Law: Basic Instruments and References* (Dobbs Ferry, N.Y., Transnational, 1992); P. Sands, *Principles of International Environmental Law*, vol. 1: *Frameworks, Standards and Implementation* (Manchester University Press, 1995); L. Boisson de Chazournes, R. Desgagné and C. Romano, *Protection internationale de l'environnement: recueil d'instruments juridiques* (Paris, Pedone, 1998); C. Dommen and P. Cullet, eds., *Droit international de l'environnement. Textes de base et références* (London, Kluwer, 1998); M. Prieur and S. Doumbé-Billé, eds., *Recueil francophone des textes internationaux en droit de l'environnement* (Brussels, Bruylant, 1998); A. E. Boyle and D. Freestone, eds., *International Law and Sustainable Development: Past Achievements and Future Challenges* (Oxford University Press, 1999); F. L. Morrison and R. Wolfrum, eds., *International, Regional and National Environmental Law* (The Hague, Kluwer, 2000); and P. W. Birnie and A. E. Boyle, *International Law and the Environment*, 2nd ed. (Oxford University Press, 2002) (forthcoming).

are free to formulate necessary policies to develop their natural resources and to carry out or authorize activities in response to the needs of their populations. In so doing, however, States have to ensure that such activities are carried out taking into account the interests of other States and therefore the freedom they have within their own jurisdiction is not unlimited.

(2) The prevention of transboundary harm from hazardous activities should also be seen in the context of the general principles incorporated in the Rio Declaration and other considerations that emphasize the close interrelationship between issues of environment and development. A general reference in the fourth preambular paragraph to the Rio Declaration indicates the importance of the interactive nature of all the principles contained therein. This is without prejudice to highlighting specific principles of the Rio Declaration, as appropriate, in the commentaries to follow on particular articles.

### *Article 1. Scope*

**The present articles apply to activities not prohibited by international law which involve a risk of causing significant transboundary harm through their physical consequences.**

### *Commentary*

(1) Article 1 limits the scope of the articles to activities not prohibited by international law and which involve a risk of causing significant transboundary harm through their physical consequences. Subparagraph (d) of article 2 further limits the scope of the articles to those activities carried out in the territory or otherwise under the jurisdiction or control of a State.

(2) Any activity which involves the risk of causing significant transboundary harm through the physical consequences is within the scope of the articles. Different types of activities could be envisaged under this category. As the title of the proposed articles indicates, any hazardous and by inference any ultrahazardous activity which involves a risk of significant transboundary harm is covered. An ultrahazardous activity is perceived to be an activity with a danger that is rarely expected to materialize but might assume, on that rare occasion, grave (more than significant, serious or substantial) proportions.

(3) Suggestions have been made at different stages of the evolution of the present articles to specify a list of activities in an annex to the present articles with an option to make additions or deletions to such a list in the future as appropriate. States could also be given the option to add to or delete from the list items which they may include in any national legislation aimed at implementing the obligations of prevention.

(4) It is, however, felt that specification of a list of activities in an annex to the articles is not without problems and functionally not essential. Any such list of activities is likely to be under inclusion and could become quickly

dated from time to time in the light of fast evolving technology. Further, except for certain ultrahazardous activities which are mostly the subject of special regulation, e.g. in the nuclear field or in the context of activities in outer space, the risk that flows from an activity is primarily a function of the particular application, the specific context and the manner of operation. It is felt that a generic list could not capture these elements.

(5) It may be further noted that it is always open to States to specify activities coming within the scope of the articles in any regional or bilateral agreements or to do so in their national legislation regulating such activities and implementing obligations of prevention.<sup>864</sup> In any case, the scope of the articles is clarified by the four different criteria noted in the article.

(6) The *first criterion* to define the scope of the articles refers to “activities not prohibited by international law”. This approach has been adopted in order to separate the topic of international liability from the topic of State responsibility.<sup>865</sup> The employment of this criterion is also intended to allow a State likely to be affected by an activity involving the risk of causing significant transboundary harm to demand from the State of origin compliance with obligations of prevention although the activity itself is not prohibited. In addition, an invocation of these articles by a State likely to be affected is not a bar to a later claim by that State that the activity in question is a prohibited activity. Equally, it is to be understood that non-fulfilment of the duty of prevention at any event of the minimization of risk under the articles would not give rise to the implication that the activity itself is prohibited.<sup>866</sup> However, in such a case State responsibility could be engaged to implement the obligations, including any civil responsi-

<sup>864</sup> For example, various conventions deal with the type of activities which come under their scope: the Convention for the Prevention of Marine Pollution from Land-based Sources; the Protocol for the Protection of the Mediterranean Sea against Pollution from Land-based Sources; the Agreement for the Protection of the Rhine against Chemical Pollution; appendix I to the Convention on Environmental Impact Assessment in a Transboundary Context, where a number of activities such as the crude oil refineries, thermal power stations, installations to produce enriched nuclear fuels, etc., are identified as possibly dangerous to the environment and requiring environmental impact assessment under the Convention; the Convention on the Protection of the Marine Environment of the Baltic Sea Area; the Convention on the Transboundary Effects of Industrial Accidents; annex II to the Convention on Civil Liability for Damage Resulting from Activities Dangerous to the Environment, where activities such as the installations or sites for the partial or complete disposal of solid, liquid or gaseous wastes by incineration on land or at sea, installations or sites for thermal degradation of solid, gaseous or liquid wastes under reduced oxygen supply, etc., have been identified as dangerous activities; this Convention also has a list of dangerous substances in annex I.

<sup>865</sup> *Yearbook ... 1977*, vol. II (Part Two), p. 6, para. 17.

<sup>866</sup> See M. B. Akehurst “International liability for injurious consequences arising out of acts not prohibited by international law”, *NYIL*, 1985, vol. 16, pp. 3–16; A. E. Boyle, “State responsibility and international liability for injurious consequences of acts not prohibited by international law: a necessary distinction?”, *International and Comparative Law Quarterly*, vol. 39 (1990), pp. 1–26; K. Zemanek, “State responsibility and liability”, *Environmental Protection and International Law*; W. Lang, H. Neuhold and K. Zemanek, eds. (London, Graham and Trotman/Martinus Nijhoff, 1991), p. 197; and the second report on international liability for injurious consequences arising out of acts not prohibited by international law (prevention of transboundary damage from hazardous activities), by the Special Rapporteur, Pemmaraju Sreenivasa Rao, *Yearbook ... 1999*, vol. II (Part One), document A/CN.4/501, paras. 35–37.

ity or duty of the operator.<sup>867</sup> The articles are primarily concerned with the management of risk and emphasize the duty of cooperation and consultation among all States concerned. States likely to be affected are given the right of engagement with the State of origin in designing and, where appropriate, in the implementation of a system of management of risk commonly shared between or among them. The right thus envisaged in favour of the States likely to be affected however does not give them the right to veto the activity or project itself.<sup>868</sup>

(7) The *second criterion*, found in the definition of the State of origin in article 2, subparagraph (d), is that the activities to which preventive measures are applicable “are planned or are carried out” in the territory or otherwise under the jurisdiction or control of a State. Three concepts are used in this criterion: “territory”, “jurisdiction” and “control”. Even though the expression “jurisdiction or control of a State” is a more commonly used formula in some instruments,<sup>869</sup> the Commission finds it useful to mention also the concept of “territory” in order to emphasize the importance of the territorial link, when such a link exists, between activities under these articles and a State.

(8) For the purposes of these articles, *territorial jurisdiction* is the dominant criterion. Consequently, when an activity covered by the present articles occurs within the *territory* of a State, that State must comply with the *obligations of prevention*. “Territory” is, therefore, taken as conclusive evidence of jurisdiction. Consequently, in cases of competing jurisdictions over an activity covered by these articles, the territorially based jurisdiction prevails. The Commission, however, is mindful of situations where a State, under international law, has to accept limits to its territorial jurisdiction in favour of another State. The prime example of such a situation is innocent passage of a foreign ship through the territorial sea. In such situations, if the activity leading to significant transboundary harm

<sup>867</sup> See P.-M. Dupuy, *La responsabilité internationale des États pour les dommages d'origine technologique et industrielle* (Paris, Pedone, 1976); Brownlie, *System of the Law of Nations ...* (footnote 92 above); A. Rosas, “State responsibility and liability under civil liability regimes”, *Current International Law Issues: Nordic Perspectives (Essays in honour of Jerzy Sztucki)*, O. Bring and S. Mahmoudi, eds. (Dordrecht, Martinus Nijhoff, 1994), p. 161; and F. Bitar, *Les mouvements transfrontières de déchets dangereux selon la Convention de Bâle: Étude des régimes de responsabilité* (Paris, Pedone, 1997), pp. 79–138. However, different standards of liability, burden of proof and remedies apply to State responsibility and liability. See also P.-M. Dupuy, “Où en est le droit international de l'environnement à la fin du siècle?”, *RGDIP*, vol. 101, No. 4 (1997), pp. 873–903; T. A. Berwick, “Responsibility and liability for environmental damage: a roadmap for international environmental regimes”, *Georgetown International Environmental Law Review*, vol. 10, No. 2 (1998), pp. 257–267; and P.-M. Dupuy, “À propos des mésaventures de la responsabilité internationale des États dans ses rapports avec la protection internationale de l'environnement”, *Les hommes et l'environnement: quels droits pour le vingt-et-unième siècle? Études en hommage à Alexandre Kiss*, M. Prieur and C. Lambrechts, eds. (Paris, Frison-Roche, 1998), pp. 269–282.

<sup>868</sup> On the nature of the duty of engagement and the attainment of a balance of interests involved, see the first report on prevention of transboundary damage from hazardous activities, by the Special Rapporteur, Pemmaraju Sreenivasa Rao, *Yearbook ... 1998*, vol. II (Part One), document A/CN.4/487 and Add.1, paras. 43, 44, 54 and 55 (d).

<sup>869</sup> See, for example, principle 21 of the Stockholm Declaration (footnote 861 above); article 194, paragraph 2, of the United Nations Convention on the Law of the Sea; principle 2 of the Rio Declaration (footnote 857 above); and article 3 of the Convention on Biological Diversity.

emanates from the foreign ship, the flag State, and not the territorial State, must comply with the provisions of the present articles.

(9) The concept of “territory” for the purposes of these articles does not cover all cases where a State exercises “jurisdiction” or “control”. The expression “jurisdiction” of a State is intended to cover, in addition to the activities being undertaken within the territory of a State, activities over which, under international law, a State is authorized to exercise its competence and authority. The Commission is aware that questions involving the determination of jurisdiction are complex and sometimes constitute the core of a dispute. This article certainly does not presume to resolve all the questions of conflicts of jurisdiction.

(10) Sometimes, because of the location of the activity, there is no territorial link between a State and the activity such as, for example, activities taking place in outer space or on the high seas. The most common example is the jurisdiction of the flag State over a ship. The Geneva Conventions on the Law of the Sea and the United Nations Convention on the Law of the Sea have covered many jurisdictional capacities of the flag State.

(11) In cases of concurrent jurisdiction by more than one State over the activities covered by these articles, States shall individually and, when appropriate, jointly comply with the provisions of these articles.

(12) The function of the concept of “control” in international law is to attach certain legal consequences to a State whose jurisdiction over certain activities or events is not recognized by international law; it covers situations in which a State is exercising *de facto* jurisdiction, even though it lacks jurisdiction *de jure*, such as in cases of unlawful intervention, occupation and unlawful annexation. Reference may be made, in this respect, to the advisory opinion by ICJ in the *Namibia* case. In that advisory opinion, the Court, after holding South Africa responsible for having created and maintained a situation which the Court declared illegal and finding South Africa under an obligation to withdraw its administration from Namibia, nevertheless attached certain legal consequences to the *de facto* control of South Africa over Namibia. The Court held:

The fact that South Africa no longer has any title to administer the Territory does not release it from its obligations and responsibilities under international law towards other States in respect of the exercise of its powers in relation to this Territory. Physical control of a territory, and not sovereignty or legitimacy of title, is the basis of State liability for acts affecting other States.<sup>870</sup>

(13) The *third criterion* is that activities covered in these articles must involve a “risk of causing significant transboundary harm”. The term is defined in article 2 (see the commentary to article 2). The words “transboundary harm” are intended to exclude activities which cause harm only in the territory of the State within which the activity is undertaken without the possibility of any harm to any other State. For discussion of the term “significant”, see the commentary to article 2.

(14) As to the element of “risk”, this is by definition concerned with future possibilities, and thus implies some element of assessment or appreciation of risk. The mere fact that harm eventually results from an activity does not mean that the activity involved a risk, if no properly informed observer was or could have been aware of that risk at the time the activity was carried out. On the other hand, an activity may involve a risk of causing significant transboundary harm even though those responsible for carrying out the activity underestimated the risk or were even unaware of it. The notion of risk is thus to be taken objectively, as denoting an appreciation of possible harm resulting from an activity which a properly informed observer had or ought to have had.

(15) In this context, it should be stressed that these articles as a whole have a continuing operation and effect, i.e. unless otherwise stated, they apply to activities as carried out from time to time. Thus, it is possible that an activity which in its inception did not involve any risk (in the sense explained in paragraph (14)), might come to do so as a result of some event or development. For example, a perfectly safe reservoir may become dangerous as a result of an earthquake, in which case the continued operation of the reservoir would be an activity involving risk. Or developments in scientific knowledge might reveal an inherent weakness in a structure or materials which carry a risk of failure or collapse, in which case again the present articles might come to apply to the activity concerned in accordance with their terms.

(16) The *fourth criterion* is that the significant transboundary harm must have been caused by the “physical consequences” of such activities. It was agreed by the Commission that in order to bring this topic within a manageable scope, it should exclude transboundary harm which may be caused by State policies in monetary, socio-economic or similar fields. The Commission feels that the most effective way of limiting the scope of these articles is by requiring that these activities should have transboundary physical consequences which, in turn, result in significant harm.

(17) The physical link must connect the activity with its transboundary effects. This implies a connection of a very specific type—a consequence which does or may arise out of the very nature of the activity or situation in question. That implies that the activities covered in these articles must themselves have a physical quality, and the consequences must flow from that quality. Thus, the stockpiling of weapons does not entail the consequence that the weapons stockpiled will be put to a belligerent use. Yet, this stockpiling may be characterized as an activity which, because of the explosive or incendiary properties of the materials stored, entails an inherent risk of disastrous misadventure.

### *Article 2. Use of terms*

#### **For the purposes of the present articles:**

(a) “Risk of causing significant transboundary harm” includes risks taking the form of a high probability of causing significant transboundary harm and

<sup>870</sup> See footnote 176 above.

a low probability of causing disastrous transboundary harm;

(b) “Harm” means harm caused to persons, property or the environment;

(c) “Transboundary harm” means harm caused in the territory of or in other places under the jurisdiction or control of a State other than the State of origin, whether or not the States concerned share a common border;

(d) “State of origin” means the State in the territory or otherwise under the jurisdiction or control of which the activities referred to in article 1 are planned or are carried out;

(e) “State likely to be affected” means the State or States in the territory of which there is the risk of significant transboundary harm or which have jurisdiction or control over any other place where there is such a risk;

(f) “States concerned” means the State of origin and the State likely to be affected.

#### Commentary

(1) *Subparagraph* (a) defines the concept of “risk of causing significant transboundary harm” as encompassing a low probability of causing disastrous transboundary harm or a high probability of causing significant transboundary harm. The Commission feels that instead of defining separately the concept of “risk” and then “harm”, it is more appropriate to define the expression of “risk of causing significant transboundary harm” because of the interrelationship between “risk” and “harm” and the relationship between them and the adjective “significant”.

(2) For the purposes of these articles, “risk of causing significant transboundary harm” refers to the combined effect of the probability of occurrence of an accident and the magnitude of its injurious impact. It is, therefore, the combined effect of “risk” and “harm” which sets the threshold. In this respect inspiration is drawn from the Code of Conduct on Accidental Pollution of Transboundary Inland Waters,<sup>871</sup> adopted by ECE in 1990. Under section I, subparagraph (f), of the Code of Conduct, “‘risk’ means the combined effect of the probability of occurrence of an undesirable event and its magnitude”. A definition based on the combined effect of “risk” and “harm” is more appropriate for these articles, and *the combined effect should reach a level that is deemed significant*. The obligations of prevention imposed on States are thus not only reasonable but also sufficiently limited so as not to impose such obligations in respect of virtually any activity. The purpose is to strike a balance between the interests of the States concerned.

(3) The definition in the preceding paragraph allows for a spectrum of relationships between “risk” and “harm”, all of which would reach the level of “significant”.

<sup>871</sup> United Nations publication, Sales No. E.90.II.E.28. See also G. Handl, *Grenzüberschreitendes nukleares Risiko und völkerrechtlicher Schutzanspruch* (Berlin, Duncker und Humblot, 1992), pp. 15–20.

The definition refers to two types of activities under these articles. One is where there is a low probability of causing disastrous harm. This is normally the characteristic of ultrahazardous activities. The other one is where there is a high probability of causing significant harm. This includes activities which have a high probability of causing harm which, while not disastrous, is still significant. But it would exclude activities where there is a very low probability of causing significant transboundary harm. The word “includes” is intended to highlight the intention that the definition is providing a spectrum within which the activities under these articles will fall.

(4) The term “significant” is not without ambiguity and a determination has to be made in each specific case. It involves more factual considerations than legal determination. It is to be understood that “*significant*” is *something more than “detectable” but need not be at the level of “serious” or “substantial”*. The harm must lead to a real detrimental effect on matters such as, for example, human health, industry, property, environment or agriculture in other States. Such detrimental effects must be susceptible of being measured by factual and objective standards.

(5) The ecological unity of the planet does not correspond to political boundaries. In carrying out lawful activities within their own territories, States have impacts on each other. These mutual impacts, so long as they have not reached the level of “significant”, are considered tolerable.

(6) The idea of a threshold is reflected in the *Trail Smelter* award, which used the words “serious consequence[s]”,<sup>872</sup> as well as in the *Lake Lanoux* award, which relied on the concept “seriously” (*gravement*).<sup>873</sup> A number of conventions have also used “significant”, “serious” or “substantial” as the threshold.<sup>874</sup> “Significant” has also been used in other legal instruments and domestic law.<sup>875</sup>

<sup>872</sup> See footnote 253 above.

<sup>873</sup> *Lake Lanoux* case, UNRIAA, vol. XII (Sales No. 63.V.3), p. 281.

<sup>874</sup> See, for example, article 4, paragraph 2, of the Convention on the Regulation of Antarctic Mineral Resource Activities; articles 2, paragraphs 1 and 2, of the Convention on Environmental Impact Assessment in a Transboundary Context; section I, subparagraph (b), of the Code of Conduct on Accidental Pollution of Transboundary Inland Waters (footnote 871 above); and article 7 of the Convention on the Law of the Non-navigational Uses of International Watercourses.

<sup>875</sup> See, for example, article 5 of the draft convention on industrial and agricultural uses of international rivers and lakes, prepared by the Inter-American Juridical Committee in 1965 (OAS, *Ríos y lagos internacionales (utilización para fines agrícolas e industriales)*, 4th ed. rev. (OEA/Ser.I/VI, CIJ-75 Rev.2) (Washington, D.C., 1971), p. 132); article X of the Helsinki Rules on the Uses of the Waters of International Rivers (International Law Association, *Report of the Fifty-second Conference, Helsinki, 1966* (London, 1967), p. 496); paragraphs 1 and 2 of General Assembly resolution 2995 (XXVII) of 15 December 1972 concerning cooperation between States in the field of the environment; paragraph 6 of the annex to OECD Council recommendation C(74)224 of 14 November 1974 on Principles concerning transfrontier pollution (OECD, *OECD and the Environment* (Paris, 1986), p. 142, reprinted in ILM, vol. 14, No. 1 (January 1975), p. 246); the Memorandum of Intent Concerning Transboundary Air Pollution, between the Government of the United States and the Government of Canada, of 5 August 1980 (United Nations, *Treaty Series*, vol. 1274, No. 21009, p. 235) and article 7 of the Agreement between the United States of America and the United Mexican States on Cooperation for the Protection and

(7) The term “significant”, while determined by factual and objective criteria, also involves a value determination which depends on the circumstances of a particular case and the period in which such determination is made. For instance, a particular deprivation at a particular time might not be considered “significant” because at that specific time scientific knowledge or human appreciation for a particular resource had not reached a point at which much value was ascribed to that particular resource. But some time later that view might change and the same harm might then be considered “significant”.

(8) *Subparagraph* (b) is self-explanatory in that “harm” for the purpose of the present articles would cover harm caused to persons, property or the environment.

(9) *Subparagraph* (c) defines “transboundary harm” as meaning harm caused in the territory of or in other places under the jurisdiction or control of a State other than the State of origin, whether or not the States concerned share a common border. This definition includes, in addition to a typical scenario of an activity within a State with injurious effects on another State, activities conducted under the jurisdiction or control of a State, for example, on the high seas, with effects on the territory of another State or in places under its jurisdiction or control. It includes, for example, injurious impacts on ships or platforms of other States on the high seas as well. It will also include activities conducted in the territory of a State with injurious consequences on, for example, the ships or platforms of another State on the high seas. The Commission cannot forecast all the possible future forms of “transboundary harm”. However, it makes clear that the intention is to be able to draw a line and clearly distinguish a State under whose jurisdiction and control an activity covered by these articles is conducted from a State which has suffered the injurious impact.

(10) In *subparagraph* (d), the term “State of origin” is introduced to refer to the State in the territory or otherwise under the jurisdiction or control of which the activities referred to in article 1 are carried out.<sup>876</sup>

(11) In *subparagraph* (e), the term “State likely to be affected” is defined to mean the State on whose territory or in other places under whose jurisdiction or control there is the risk of significant transboundary harm. There may be more than one such State likely to be affected in relation to any given activity.

(12) In *subparagraph* (f), the term “States concerned” refers to both the State of origin and the State likely to be affected to which some of the articles refer together.

Improvement of the Environment in the Border Area, of 14 August 1983 (reprinted in ILM, vol. 22, No. 5 (September 1983), p. 1025). The United States has also used the word “significant” in its domestic law dealing with environmental issues; see *Restatement of the Law Third, Restatement of the Law, The Foreign Relations Law of the United States* (St. Paul, Minn., American Law Institute Publishers, 1987), vol. 2, pp. 111–112.

<sup>876</sup> See paragraphs (7) to (12) of the commentary to article 1.

### Article 3. Prevention

**The State of origin shall take all appropriate measures to prevent significant transboundary harm or at any event to minimize the risk thereof.**

#### Commentary

(1) Article 3 is based on the fundamental principle *sic utere tuo ut alienum non laedas*, which is reflected in principle 21 of the Stockholm Declaration,<sup>877</sup> reading:

States have, in accordance with the Charter of the United Nations and the principles of international law, the sovereign right to exploit their own natural resources pursuant to their own environmental policies, and the responsibility to ensure that activities within their jurisdiction or control do not cause damage to the environment of other States or of areas beyond the limits of national jurisdiction.

(2) However, the limitations on the freedom of States reflected in principle 21 are made more specific in article 3 and subsequent articles.

(3) This article, together with article 4, provides the basic foundation for the articles on prevention. The articles set out the more specific obligations of States to prevent significant transboundary harm or at any event to minimize the risk thereof. The article thus emphasizes the primary duty of the State of origin to prevent significant transboundary harm; and only in case this is not fully possible it should exert its best efforts to minimize the risk thereof. The phrase “at any event” is intended to express priority in favour of the duty of prevention. The word “minimize” should be understood in this context as meaning to pursue the aim of reducing to the lowest point the possibility of harm.

(4) The present article is in the nature of a statement of principle. It provides that States shall take all appropriate measures to prevent significant transboundary harm or at any event minimize the risk thereof. The phrase “all appropriate measures” refers to all those specific actions and steps that are specified in the articles on prevention and minimization of transboundary harm. Article 3 is complementary to articles 9 and 10 and together they constitute a harmonious ensemble. In addition, it imposes an obligation on the State of origin to adopt and implement national legislation incorporating accepted international standards. These standards would constitute a necessary reference point to determine whether measures adopted are suitable.

(5) As a general principle, the obligation in article 3 to prevent significant transboundary harm or minimize the risk thereof applies only to activities which involve a risk of causing significant transboundary harm, as those terms are defined in article 2. In general, in the context of prevention, a State of origin does not bear the risk of unforeseeable consequences to States likely to be affected by activities within the scope of these articles. On the other hand, the obligation to “take all appropriate measures” to prevent harm, or to minimize the risk thereof, cannot be

<sup>877</sup> See footnote 861 above. See also the Rio Declaration (footnote 857 above).

confined to activities which are already properly appreciated as involving such a risk. The obligation extends to taking appropriate measures to identify activities which involve such a risk, and this obligation is of a continuing character.

(6) This article, then, sets up the principle of prevention that concerns every State in relation to activities covered by article 1. The *modalities* whereby the State of origin may discharge the obligations of prevention which have been established include, for example, legislative, administrative or other action necessary for enforcing the laws, administrative decisions and policies which the State of origin has adopted.<sup>878</sup>

(7) The obligation of the State of origin to take preventive or minimization measures is one of due diligence. It is the conduct of the State of origin that will determine whether the State has complied with its obligation under the present articles. The duty of due diligence involved, however, is not intended to guarantee that significant harm be totally prevented, if it is not possible to do so. In that eventuality, the State of origin is required, as noted above, to exert its best possible efforts to minimize the risk. In this sense, it does not guarantee that the harm would not occur.<sup>879</sup>

(8) An obligation of due diligence as the standard basis for the protection of the environment from harm can be deduced from a number of international conventions<sup>880</sup> as well as from the resolutions and reports of international conferences and organizations.<sup>881</sup> The obligation of due diligence was discussed in a dispute which arose in 1986 between Germany and Switzerland relating to the pollution of the Rhine by Sandoz. The Swiss Government acknowledged responsibility for lack of due diligence in preventing the accident through adequate regulation of its pharmaceutical industries.<sup>882</sup>

<sup>878</sup> See article 5 and commentary.

<sup>879</sup> For a similar observation, see paragraph (4) of the commentary to article 7 of the draft articles on the law of the non-navigational uses of international watercourses adopted by the Commission on second reading, *Yearbook ... 1994*, vol. II (Part Two), p. 103. As to the lack of scientific information, see A. Epiney and M. Scheyli, *Strukturprinzipien des Umweltvölkerrechts* (Baden-Baden, Nomos-Verlagsgesellschaft, 1998), pp. 126–140.

<sup>880</sup> See, for example, article 194, paragraph 1, of the United Nations Convention on the Law of the Sea; articles I and II and article VII, paragraph 2, of the Convention on the Prevention of Marine Pollution by Dumping of Wastes and Other Matter; article 2 of the Vienna Convention for the Protection of the Ozone Layer; article 7, paragraph 5, of the Convention on the Regulation of Antarctic Mineral Resource Activities; article 2, paragraph 1, of the Convention on Environmental Impact Assessment in a Transboundary Context; and article 2, paragraph 1, of the Convention on the Protection and Use of Transboundary Watercourses and International Lakes.

<sup>881</sup> See principle 21 of the World Charter for Nature (General Assembly resolution 37/7 of 28 October 1982, annex); and principle VI of the draft principles of conduct for the guidance of States concerning weather modification, prepared by WMO and UNEP (M. L. Nash, *Digest of United States Practice in International Law* (Washington, D.C., United States Government Printing Office, 1978), p. 1205).

<sup>882</sup> See *The New York Times*, 11, 12 and 13 November 1986, pp. A1, A8 and A3, respectively. See also A. C. Kiss, “‘Tchernobâle’ ou la pollution accidentelle du Rhin par les produits chimiques”, *Annuaire français de droit international*, vol. 33 (1987), pp. 719–727.

(9) In the “*Alabama*” case, the tribunal examined two different definitions of due diligence submitted by the parties. The United States defined due diligence as:

[A] diligence proportioned to the magnitude of the subject and to the dignity and strength of the power which is to exercise it; a diligence which shall, by the use of active vigilance, and of all the other means in the power of the neutral, through all stages of the transaction, prevent its soil from being violated; a diligence that shall in like manner deter designing men from committing acts of war upon the soil of the neutral against its will.<sup>883</sup>

The United Kingdom defined due diligence as “such care as Governments ordinarily employ in their domestic concerns”.<sup>884</sup> The tribunal seemed to have been persuaded by the broader definition of the standard of due diligence presented by the United States and expressed concern about the “national standard” of due diligence presented by the United Kingdom. The tribunal stated that:

[the] British case seemed also to narrow the international duties of a Government to the exercise of the restraining powers conferred upon it by municipal law, and to overlook the obligation of the neutral to amend its laws when they were insufficient.<sup>885</sup>

(10) In the context of the present articles, due diligence is manifested in reasonable efforts by a State to inform itself of factual and legal components that relate foreseeably to a contemplated procedure and to take appropriate measures, in timely fashion, to address them. Thus, States are under an obligation to take unilateral measures to prevent significant transboundary harm or at any event to minimize the risk thereof arising out of activities within the scope of article 1. Such measures include, first, formulating policies designed to prevent significant transboundary harm or to minimize the risk thereof and, secondly, implementing those policies. Such policies are expressed in legislation and administrative regulations and implemented through various enforcement mechanisms.

(11) The standard of due diligence against which the conduct of the State of origin should be examined is that which is generally considered to be appropriate and proportional to the degree of risk of transboundary harm in the particular instance. For example, activities which may be considered ultrahazardous require a much higher standard of care in designing policies and a much higher degree of vigour on the part of the State to enforce them. Issues such as the size of the operation; its location, special climate conditions, materials used in the activity, and whether the conclusions drawn from the application of these factors in a specific case are reasonable, are among the factors to be considered in determining the due diligence requirement in each instance. What would be considered a reasonable standard of care or due diligence may change with time; what might be considered an appropriate and reasonable procedure, standard or rule at one point in time may not be considered as such at some point in the future. Hence, due diligence in ensuring safety requires a State to keep abreast of technological changes and scientific developments.

(12) It is also necessary in this connection to note principle 11 of the Rio Declaration, which states:

<sup>883</sup> “*Alabama*” (see footnote 87 above), pp. 572–573.

<sup>884</sup> *Ibid.*, p. 612.

<sup>885</sup> *Ibid.*, p. 613.

States shall enact effective environmental legislation. Environmental standards, management objectives and priorities should reflect the environmental and developmental context to which they apply. Standards applied by some countries may be inappropriate and of unwarranted economic and social cost to other countries, in particular developing countries.<sup>886</sup>

(13) Similar language is found in principle 23 of the Stockholm Declaration. That principle, however, specifies that such domestic standards are “[w]ithout prejudice to such criteria as may be agreed upon by the international community”.<sup>887</sup> The economic level of States is one of the factors to be taken into account in determining whether a State has complied with its obligation of due diligence. But a State’s economic level cannot be used to dispense the State from its obligation under the present articles.

(14) Article 3 imposes on the State a duty to take all necessary measures to prevent significant transboundary harm or at any event to minimize the risk thereof. This could involve, *inter alia*, taking such measures as are appropriate by way of abundant caution, even if full scientific certainty does not exist, to avoid or prevent serious or irreversible damage. This is well articulated in principle 15 of the Rio Declaration and is subject to the capacity of States concerned (see paragraphs (5) to (8) of the commentary to article 10). An efficient implementation of the duty of prevention may well require upgrading the input of technology in the activity as well as the allocation of adequate financial and manpower resources with necessary training for the management and monitoring of the activity.

(15) The operator of the activity is expected to bear the costs of prevention to the extent that he is responsible for the operation. The State of origin is also expected to undertake the necessary expenditure to put in place the administrative, financial and monitoring mechanisms referred to in article 5.

(16) States are engaged in continuously evolving mutually beneficial schemes in the areas of capacity-building, transfer of technology and financial resources. Such efforts are recognized to be in the common interest of all States in developing uniform international standards regulating and implementing the duty of prevention.

(17) The main elements of the obligation of due diligence involved in the duty of prevention could be thus stated: the degree of care in question is that expected of a good Government. It should possess a legal system and sufficient resources to maintain an adequate administrative apparatus to control and monitor the activities. It is, however, understood that the degree of care expected of a State with a well-developed economy and human and material resources and with highly evolved systems and structures of governance is different from States which are not so well placed.<sup>888</sup> Even in the latter case, vigi-

lance, employment of infrastructure and monitoring of hazardous activities in the territory of the State, which is a natural attribute of any Government, are expected.<sup>889</sup>

(18) The required degree of care is proportional to the degree of hazard involved. The degree of harm itself should be foreseeable and the State must know or should have known that the given activity has the risk of significant harm. The higher the degree of inadmissible harm, the greater would be the duty of care required to prevent it.

#### Article 4. Cooperation

**States concerned shall cooperate in good faith and, as necessary, seek the assistance of one or more competent international organizations in preventing significant transboundary harm or at any event in minimizing the risk thereof.**

#### Commentary

(1) The principle of cooperation between States is essential in designing and implementing effective policies to prevent significant transboundary harm or at any event to minimize the risk thereof. The requirement of cooperation of States extends to all phases of planning and of implementation. Principle 24 of the Stockholm Declaration and principle 7 of the Rio Declaration recognize cooperation as an essential element in any effective planning for the protection of the environment. More specific forms of cooperation are stipulated in subsequent articles. They envisage the participation of the State likely to be affected in any preventive action, which is indispensable to enhance the effectiveness of any such action. The latter State may know better than anybody else, for instance, which features of the activity in question may be more damaging to it, or which zones of its territory close to the border may be more affected by the transboundary effects of the activity, such as a specially vulnerable ecosystem.

(2) The article requires States concerned to cooperate in *good faith*. Paragraph 2 of Article 2 of the Charter of the United Nations provides that all Members “shall fulfil in good faith the obligations assumed by them in accordance with the present Charter”. The 1969 and 1978 Vienna Conventions declare in their preambles that the principle of good faith is universally recognized. In addition, article 26 and article 31, paragraph 1, of the 1969 Vienna Convention acknowledge the essential place of this principle in the law of treaties. The decision of ICJ in the *Nuclear Tests* case touches upon the scope of the application of good faith. In that case, the Court proclaimed that “[o]ne of the basic principles governing the creation and performance of legal obligations, whatever their source, is the principle of good faith”.<sup>890</sup> This dictum of the Court implies that good faith applies also to unilateral

<sup>886</sup> See footnote 857 above.

<sup>887</sup> See footnote 861 above.

<sup>888</sup> See A. C. Kiss and S. Doumbé-Billé, “La Conférence des Nations Unies sur l’environnement et le développement (Rio de Janeiro, 3–14 June 1992)”, *Annuaire français de droit international*, vol. 38 (1992), pp. 823–843; M. Kamto, “Les nouveaux principes du droit international de l’environnement”, *Revue juridique de l’environnement*, vol. 1 (1993),

pp. 11–21; and R. Lefeber, *Transboundary Environmental Interference and the Origin of State Liability* (The Hague, Kluwer, 1996), p. 65.

<sup>889</sup> See the observation of Max Huber in the *British Claims in the Spanish Zone of Morocco* case (footnote 44 above), p. 644.

<sup>890</sup> See footnote 196 above.

acts.<sup>891</sup> Indeed, the principle of good faith covers “the entire structure of international relations”.<sup>892</sup>

(3) The arbitration tribunal, established in 1985 between Canada and France in the *La Bretagne* case, held that the principle of good faith was among the elements that afforded a sufficient guarantee against any risk of a party exercising its rights abusively.<sup>893</sup>

(4) The words “States concerned” refer to the State of origin and the State or States likely to be affected. While other States in a position to contribute to the goals of these articles are encouraged to cooperate, no legal obligations are imposed upon them to do so.

(5) The article provides that States shall “as necessary” seek the assistance of one or more international organizations in performing their preventive obligations as set out in these articles. States shall do so only when it is deemed necessary. The words “as necessary” are intended to take account of a number of possibilities: First, assistance from international organizations may not be necessary in every case. For example, the State of origin or the States likely to be affected may, themselves, be technologically advanced and have the necessary technical capability. Secondly, the term “international organization” is intended to refer to organizations that are competent and in a position to assist in such matters. Thirdly, even if there are competent international organizations, they could extend necessary assistance only in accordance with their constitutions. In any case, the article does not purport to create any obligation for international organizations to respond to requests for assistance independent of its own constitutional requirements.

(6) Requests for assistance from international organizations may be made by one or more States concerned. The principle of cooperation means that it is preferable that such requests be made by all States concerned. The fact, however, that all States concerned do not seek necessary assistance does not free individual States from the obligation to seek assistance. Of course, the response and type of involvement of an international organization in cases in which the request has been lodged by only one State will depend, for instance, on the nature of the request, the type of assistance involved and the place where the international organization would have to perform such assistance.

### Article 5. Implementation

**States concerned shall take the necessary legislative, administrative or other action including the establishment of suitable monitoring mechanisms to implement the provisions of the present articles.**

<sup>891</sup> M. Virally, “Review essay: good faith in public international law”, *AJIL*, vol. 77, No. 1 (1983), p. 130.

<sup>892</sup> See R. Rosenstock, “The declaration of principles of international law concerning friendly relations: a survey”, *AJIL*, vol. 65 (1971), p. 734; see, more generally, R. Kolb, *La bonne foi en droit international public: contribution à l'étude des principes généraux de droit* (Paris, Presses Universitaires de France, 2000).

<sup>893</sup> *ILR*, vol. 82 (1990), p. 614.

### Commentary

(1) This article states what might be thought to be the obvious, viz. that under the present articles, States are required to take the necessary measures of implementation, whether of a legislative, administrative or other character. Implementation, going beyond formal application, involves the adoption of specific measures to ensure the effectiveness of the provisions of the present articles. Article 5 has been included here to emphasize the continuing character of the obligations, which require action to be taken from time to time to prevent transboundary harm or at any event to minimize the risk thereof arising from activities to which the articles apply.<sup>894</sup>

(2) The measures referred to in this article include, for example, the opportunity available to persons concerned to make representations and the establishment of quasi-judicial procedures. The use of the term “other action” is intended to cover the variety of ways and means by which States could implement the present articles. Article 5 mentions some measures expressly only in order to give guidance to States; it is left up to them to decide upon necessary and appropriate measures. Reference is made to “suitable monitoring mechanisms” in order to highlight the measures of inspection which States generally adopt in respect of hazardous activities.

(3) To say that States must take the necessary measures does not mean that they must themselves get involved in operational issues relating to the activities to which article 1 applies. Where these activities are conducted by private persons or enterprises, the obligation of the State is limited to establishing the appropriate regulatory framework and applying it in accordance with these articles. The application of that regulatory framework in the given case will then be a matter of ordinary administration or, in the case of disputes, for the relevant courts or tribunals, aided by the principle of non-discrimination contained in article 15.

(4) The action referred to in article 5 may appropriately be taken in advance. Thus, States may establish a suitable monitoring mechanism before the activity in question is approved or instituted.

### Article 6. Authorization

**1. The State of origin shall require its prior authorization for:**

**(a) any activity within the scope of the present articles carried out in its territory or otherwise under its jurisdiction or control;**

<sup>894</sup> This article is similar to article 2, paragraph 2, of the Convention on Environmental Impact Assessment in a Transboundary Context, which reads: “Each Party shall take the necessary legal, administrative or other measures to implement the provisions of this Convention, including, with respect to proposed activities listed in appendix I that are likely to cause significant adverse transboundary impact, the establishment of an environmental impact assessment procedure that permits public participation and preparation of the environmental impact assessment documentation described in appendix II.”



(b) any major change in an activity referred to in subparagraph (a);

(c) any plan to change an activity which may transform it into one falling within the scope of the present articles.

2. The requirement of authorization established by a State shall be made applicable in respect of all pre-existing activities within the scope of the present articles. Authorizations already issued by the State for pre-existing activities shall be reviewed in order to comply with the present articles.

3. In case of a failure to conform to the terms of the authorization, the State of origin shall take such actions as appropriate, including where necessary terminating the authorization.

#### Commentary

(1) This article sets forth the fundamental principle that the prior authorization of a State is required for activities which involve a risk of causing significant transboundary harm undertaken in its territory or otherwise under its jurisdiction or control. The word “authorization” means granting permission by governmental authorities to conduct an activity covered by these articles. States are free to choose the form of such authorization.

(2) The requirement of authorization noted in article 6, *paragraph 1* (a), obliges a State to ascertain whether activities with a possible risk of significant transboundary harm are taking place in its territory or otherwise under its jurisdiction or control and implies that the State should take the measures indicated in these articles. It also requires the State to take a responsible and active role in regulating such activities. The tribunal in the *Trail Smelter* arbitration held that Canada had “the duty ... to see to it that this conduct should be in conformity with the obligation of the Dominion under international law as herein determined”. The tribunal held that, in particular, “the Trail Smelter shall be required to refrain from causing any damage through fumes in the State of Washington”.<sup>895</sup> Article 6, *paragraph 1* (a), is compatible with this requirement.

(3) ICJ in the *Corfu Channel* case held that a State has an obligation “not to allow knowingly its territory to be used for acts contrary to the rights of other States”.<sup>896</sup>

(4) The words “in its territory or otherwise under its jurisdiction or control” are taken from article 2. The expression “any activity within the scope of the present articles” introduces all the requirements specified in article 1 for an activity to fall within the scope of these articles.

(5) Article 6, *paragraph 1* (b), makes the requirement of prior authorization applicable also for a major change planned in an activity already within the scope of article 1 where that change may increase the risk or alter the nature or the scope of the risk. Some examples of major changes are: building of additional production capacities, large-scale employment of new technology in an existing activ-

ity, re-routing of motorways, express roads or re-routing airport runways. Changing investment and production (volume and type), physical structure or emissions and changes bringing existing activities to levels higher than the allowed threshold could also be considered as part of a major change.<sup>897</sup> Similarly, article 6, *paragraph 1* (c), contemplates a situation where a change is proposed in the conduct of an activity that is otherwise innocuous, where the change would transform that activity into one which involves a risk of causing significant transboundary harm. The implementation of such a change would also require State authorization.

(6) *Paragraph 2* of article 6 emphasizes that the requirement of authorization should be made applicable to all the pre-existing activities falling within the scope of the present articles, once a State adopts these articles. It might be unreasonable to require States when they assume the obligations under these articles to apply them immediately in respect of existing activities. A suitable period of time might be needed in that case for the operator of the activity to comply with the authorization requirements. The decision as to whether the activity should be stopped pending authorization or should continue while the operator goes through the process of obtaining authorization is left to the State of origin. In case the authorization is denied by the State of origin, it is assumed that the State of origin will stop the activity.

(7) The adjustment envisaged in *paragraph 2* generally occurs whenever new legislative and administrative terms are put in place because of safety standards or new international standards or obligations which the State has accepted and needed to enforce.

(8) *Paragraph 3* of article 6 notes the consequences of the failure of an operator to comply with the requirement of authorization. The State of origin, which has the main responsibility to monitor these activities, is given the necessary flexibility to ensure that the operator complies with the requirements involved. As appropriate, the State of origin shall terminate the authorization and, where appropriate, prohibit the activity from taking place altogether.

#### Article 7. Assessment of risk

**Any decision in respect of the authorization of an activity within the scope of the present articles shall, in particular, be based on an assessment of the possible transboundary harm caused by that activity, including any environmental impact assessment.**

#### Commentary

(1) Under article 7, a State of origin, before granting authorization to operators to undertake activities referred to in article 1, should ensure that an assessment is undertaken of the risk of the activity causing significant transboundary harm. This assessment enables the State to determine the extent and the nature of the risk involved in an

<sup>895</sup> *Trail Smelter* (see footnote 253 above), pp. 1965–1966.

<sup>896</sup> *Corfu Channel* (see footnote 35 above), p. 22.

<sup>897</sup> See ECE, *Current Policies, Strategies and Aspects of Environmental Impact Assessment in a Transboundary Context* (United Nations publication, Sales No. E.96.II.E.11), p. 48.

activity and consequently the type of preventive measures it should take.

(2) Although the assessment of risk in the *Trail Smelter* case may not directly relate to liability for risk, it nevertheless emphasized the importance of an assessment of the consequences of an activity causing significant risk. The tribunal in that case indicated that the study undertaken by well-established and known scientists was “probably the most thorough [one] ever made of any area subject to atmospheric pollution by industrial smoke”.<sup>898</sup>

(3) The requirement of article 7 is fully consonant with principle 17 of the Rio Declaration, which provides also for assessment of risk of activities that are likely to have a significant adverse impact on the environment:

Environmental impact assessment, as a national instrument, shall be undertaken for proposed activities that are likely to have a significant adverse impact on the environment and are subject to a decision of a competent national authority.<sup>899</sup>

The requirement of assessment of adverse effects of activities has been incorporated in various forms in many international agreements.<sup>900</sup> The most notable is the Convention on Environmental Impact Assessment in a Transboundary Context.

(4) The practice of requiring an environmental impact assessment has become very prevalent in order to assess whether a particular activity has the potential of causing significant transboundary harm. The legal obligation to conduct an environmental impact assessment under national law was first developed in the United States of America in the 1970s. Later, Canada and Europe adopted the same approach and essentially regulated it by guidelines. In 1985, a European Community directive required member States to conform to a minimum requirement of environmental impact assessment. Since then, many other countries have also made environmental impact assessment a necessary condition under their national law for authorization to be granted for developmental but hazardous industrial activities.<sup>901</sup> According to one United

Nations study, the environmental impact assessment has already shown its value for implementing and strengthening sustainable development, as it combines the precautionary principle with the principle of preventing environmental damage and also allows for public participation.<sup>902</sup>

(5) The question of who should conduct the assessment is left to States. Such assessment is normally conducted by operators observing certain guidelines set by the States. These matters would have to be resolved by the States themselves through their domestic laws or as parties to international instruments. However, it is presumed that a State of origin will designate an authority, whether or not governmental, to evaluate the assessment on behalf of the Government and will accept responsibility for the conclusions reached by that authority.

(6) The article does not specify what the content of the risk assessment should be. Obviously, the assessment of risk of an activity can only be meaningfully prepared if it relates the risk to the possible harm to which the risk could lead. This corresponds to the basic duty contained in article 3. Most existing international conventions and legal instruments do not specify the content of assessment. There are exceptions, such as the Convention on Environmental Impact Assessment in a Transboundary Context, which provides in detail the content of such assessment.<sup>903</sup> The 1981 study of the legal aspects concerning the environment related to offshore mining and drilling within the limits of national jurisdiction, prepared by the Working Group of Experts on Environmental Law of UNEP,<sup>904</sup> also provides, in its conclusion No. 8, in detail the content of assessment for offshore mining and drilling.

(7) The specifics of what ought to be the content of assessment is left to the domestic laws of the State

1995), p. 259; and G. J. Martin “Le concept de risque et la protection de l’environnement: évolution parallèle ou fertilisation croisée?”, *Les hommes et l’environnement ...* (footnote 867 above), pp. 451–460.

<sup>902</sup> See footnote 897 above.

<sup>903</sup> Article 4 of the Convention provides that the environmental impact assessment of a State party should contain, as a minimum, the information described in appendix II to the Convention. Appendix II (Content of the environmental impact assessment documentation) lists nine items as follows:

“(a) A description of the proposed activity and its purpose;

“(b) A description, where appropriate, of reasonable alternatives (for example, location or technological) to the proposed activity and also the no-action alternative;

“(c) A description of the environment likely to be significantly affected by the proposed activity and its alternatives;

“(d) A description of the potential environmental impact of the proposed activity and its alternatives and an estimation of its significance;

“(e) A description of mitigation measures to keep adverse environmental impact to a minimum;

“(f) An explicit indication of predictive methods and underlying assumptions as well as the relevant environmental data used;

“(g) An identification of gaps in knowledge and uncertainties encountered in compiling the required information;

“(h) Where appropriate, an outline for monitoring and management programmes and any plans for post-project analysis; and

“(i) A non-technical summary including a visual presentation as appropriate (maps, graphs, etc.).”

<sup>904</sup> See UNEP/GC.9/5/Add.5, annex III.

<sup>898</sup> *Trail Smelter* (see footnote 253 above), pp. 1973–1974.

<sup>899</sup> See footnote 857 above.

<sup>900</sup> See, for example, article XI of the Kuwait Regional Convention for Cooperation on the Protection of the Marine Environment from Pollution; articles 205 and 206 of the United Nations Convention on the Law of the Sea; the Regional Convention for the Conservation of the Environment of the Red Sea and Gulf of Aden; article 14 of the ASEAN Agreement on the Conservation of Nature and Natural Resources; Convention for the Protection of the Natural Resources and Environment of the South Pacific Region; article 4 of the Convention on the Regulation of Antarctic Mineral Resource Activities; article 8 of the Protocol on Environmental Protection to the Antarctic Treaty; article 14, paragraphs 1 (a) and (b), of the Convention on Biological Diversity; and article 4 of the Convention on the Transboundary Effects of Industrial Accidents.

<sup>901</sup> For a survey of various North American and European legal and administrative systems of environmental impact assessment policies, plans and programmes, see ECE, *Application of Environmental Impact Assessment Principles to Policies, Plans and Programmes* (United Nations publication, Sales No. E.92.II.E.28), pp. 43 et seq.; approximately 70 developing countries have environmental impact assessment legislation of some kind. Other countries either are in the process of drafting new and additional environmental impact assessment legislation or are planning to do so; see M. Yeater and L. Kurukulasuriya, “Environmental impact assessment legislation in developing countries”, *UNEP’s New Way Forward: Environmental Law and Sustainable Development*, Sun Lin and L. Kurukulasuriya, eds. (UNEP,

conducting such assessment.<sup>905</sup> For the purposes of article 7, however, such an assessment should contain an evaluation of the possible transboundary harmful impact of the activity. In order for the States likely to be affected to evaluate the risk to which they might be exposed, they need to know what possible harmful effects that activity might have on them.

(8) The assessment should include the effects of the activity not only on persons and property, but also on the environment of other States. The importance of the protection of the environment, independently of any harm to individual human beings or property, is clearly recognized.

(9) This article does not oblige the State of origin to require risk assessment for any activity being undertaken within their territory or otherwise under their jurisdiction or control. Activities involving a risk of causing significant transboundary harm have some general characteristics which are identifiable and could provide some indication to States as to which activities might fall within the terms of these articles. For example, the type of the source of energy used in manufacturing, the location of the activity and its proximity to the border area, etc. could all give an indication of whether the activity might fall within the scope of these articles. There are certain substances that are listed in some conventions as dangerous or hazardous and their use in any activity may in itself be an indication that those activities might involve a risk of significant transboundary harm.<sup>906</sup> There are also certain conventions that list the activities that are presumed to be harmful and that might signal that those activities might fall within the scope of these articles.<sup>907</sup>

#### *Article 8. Notification and information*

**1. If the assessment referred to in article 7 indicates a risk of causing significant transboundary harm, the State of origin shall provide the State likely to be affected with timely notification of the risk and the assessment and shall transmit to it the available technical and all other relevant information on which the assessment is based.**

**2. The State of origin shall not take any decision on authorization of the activity pending the receipt, within a period not exceeding six months, of the response from the State likely to be affected.**

<sup>905</sup> For the format of environmental impact assessment adopted in most legislations, see M. Yeater and L. Kurukulasuriya, *loc. cit.* (footnote 901 above), p. 260.

<sup>906</sup> For example, the Convention for the Prevention of Marine Pollution from Land-based Sources provides in article 4 an obligation for the parties to eliminate or restrict the pollution of the environment by certain substances, and the list of those substances is annexed to the Convention. Similarly, the Convention on the Protection of the Marine Environment of the Baltic Sea Area provides a list of hazardous substances in annex I and of noxious substances and materials in annex II, deposits of which are either prohibited or strictly limited; see also the Protocol for the Protection of the Mediterranean Sea against Pollution from Land-based Sources; and the Agreement for the Protection of the Rhine against Chemical Pollution.

<sup>907</sup> See footnote 864 above.

#### *Commentary*

(1) Article 8 deals with a situation in which the assessment undertaken by a State of origin, in accordance with article 7, indicates that the activity planned does indeed pose a risk of causing significant transboundary harm. This article, together with articles 9, 11, 12 and 13, provides for a set of procedures essential to balancing the interests of all the States concerned by giving them a reasonable opportunity to find a way to undertake the activity with satisfactory and reasonable measures designed to prevent or minimize transboundary harm.

(2) Article 8 calls on the State of origin to notify States likely to be affected by the planned activity. The activities here include both those that are planned by the State itself and those planned by private entities. The requirement of notification is an indispensable part of any system designed to prevent transboundary harm or at any event to minimize the risk thereof.

(3) The obligation to notify other States of the risk of significant harm to which they are exposed is reflected in the *Corfu Channel* case, where ICJ characterized the duty to warn as based on "elementary considerations of humanity".<sup>908</sup> This principle is recognized in the context of the use of international watercourses and in that context is embodied in a number of international agreements, decisions of international courts and tribunals, declarations and resolutions adopted by intergovernmental organizations, conferences and meetings, and studies by intergovernmental and international non-governmental organizations.<sup>909</sup>

(4) In addition to the utilization of international watercourses, the principle of notification has also been recognized in respect of other activities with transboundary effects, for example, article 3 of the Convention on Environmental Impact Assessment in a Transboundary Context<sup>910</sup> and articles 3 and 10 of the Convention on the Transboundary Effects of Industrial Accidents. Principle 19 of the Rio Declaration speaks of timely notification:

States shall provide prior and timely notification and relevant information to potentially affected States on activities that may have a significant adverse transboundary environmental effect and shall consult with those States at an early stage and in good faith.<sup>911</sup>

<sup>908</sup> *Corfu Channel* (see footnote 35 above), p. 22.

<sup>909</sup> For treaties dealing with prior notification and exchange of information in respect of watercourses, see paragraph (6) of the commentary to article 12 (Notification concerning planned measures with possible adverse effects), of the draft articles on the law of the non-navigational uses of international watercourses (*Yearbook ... 1994*, vol. II (Part Two), pp. 119–120).

<sup>910</sup> Article 3, paragraph 2, of the Convention provides for a system of notification which reads:

"This notification shall contain, *inter alia*:

"(a) Information on the proposed activity, including any available information on its possible transboundary impact;

"(b) The nature of the possible decision; and

"(c) An indication of a reasonable time within which a response under paragraph 3 of this Article is required, taking into account the nature of the proposed activity;

"and may include the information set out in paragraph 5 of this Article."

<sup>911</sup> See footnote 857 above.

(5) The procedure for notification has been established by a number of OECD resolutions. For example, in respect of certain chemical substances, the annex to OECD resolution C(71)73 of 18 May 1971 stipulates that each member State is to receive notification prior to the proposed measures in each other member State regarding substances which have an adverse impact on man or the environment where such measures could have significant effects on the economies and trade of the other States.<sup>912</sup> The annex to OECD Council recommendation C(74)224 of 14 November 1974 on "Some principles concerning transfrontier pollution" in its "Principle of information and consultation" requires notification and consultation prior to undertaking an activity which may create a risk of significant transboundary pollution.<sup>913</sup> The principle of notification is well established in the case of environmental emergencies.<sup>914</sup>

(6) Where assessment reveals the risk of causing significant transboundary harm, in accordance with *paragraph 1*, the State which plans to undertake such activity has the obligation to notify the States which may be affected. The notification shall be accompanied by available technical information on which the assessment is based. The reference to "available" technical and other relevant information is intended to indicate that the obligation of the State of origin is limited to transmitting the technical and other information which was developed in relation to the activity. This information is generally revealed during the assessment of the activity in accordance with article 7. Paragraph 1 assumes that technical information resulting from the assessment includes not only what might be called raw data, namely fact sheets, statistics, etc., but also the analysis of the information which was used by the State of origin itself to make the determination regarding the risk of transboundary harm. The reference to the available data includes also other data which might become available later after transmitting the data which was initially available to the States likely to be affected.

(7) States are free to decide how they wish to inform the States that are likely to be affected. As a general rule, it is assumed that States will directly contact the other States through diplomatic channels.

(8) Paragraph 1 also addresses the situation where the State of origin, despite all its efforts and diligence, is unable to identify *all* the States which may be affected prior to authorizing the activity and gains that knowledge only after the activity is undertaken. In accordance with this paragraph, the State of origin, in such cases, is under an obligation to notify the other States likely to be affected as soon as the information comes to its knowledge and it has had an opportunity, within a reasonable time, to determine the States concerned.

(9) *Paragraph 2* addresses the need for the States likely to be affected to respond within a period not exceeding six months. It is generally a period of time that should

allow these States to evaluate the data involved and arrive at their own conclusion. This is a requirement that is conditioned by cooperation and good faith.

#### *Article 9. Consultations on preventive measures*

**1. The States concerned shall enter into consultations, at the request of any of them, with a view to achieving acceptable solutions regarding measures to be adopted in order to prevent significant transboundary harm or at any event to minimize the risk thereof. The States concerned shall agree, at the commencement of such consultations, on a reasonable time frame for the consultations.**

**2. The States concerned shall seek solutions based on an equitable balance of interests in the light of article 10.**

**3. If the consultations referred to in paragraph 1 fail to produce an agreed solution, the State of origin shall nevertheless take into account the interests of the State likely to be affected in case it decides to authorize the activity to be pursued, without prejudice to the rights of any State likely to be affected.**

#### *Commentary*

(1) Article 9 requires the States concerned, that is, the State of origin and the States that are likely to be affected, to enter into consultations in order to agree on the measures to prevent significant transboundary harm, or at any event to minimize the risk thereof. Depending upon the time at which article 9 is invoked, consultations may be prior to authorization and commencement of an activity or during its performance.

(2) There is a need to maintain a balance between two equally important considerations in this article. First, the article deals with activities that are not prohibited by international law and that, normally, are important to the economic development of the State of origin. Secondly, it would be unfair to other States to allow those activities to be conducted without consulting them and taking appropriate preventive measures. Therefore, the article does not provide a mere formality which the State of origin has to go through with no real intention of reaching a solution acceptable to the other States, nor does it provide a right of veto for the States that are likely to be affected. To maintain a balance, the article relies on the manner in which, and purpose for which, the parties enter into consultations. The parties must enter into consultations in good faith and must take into account each other's legitimate interests. The parties should consult each other with a view to arriving at an acceptable solution regarding the measures to be adopted to prevent significant transboundary harm, or at any event to minimize the risk thereof.

(3) The principle of good faith is an integral part of any requirement of consultations and negotiations. The obligation to consult and negotiate genuinely and in good faith was recognized in the *Lake Lanoux* award where the tribunal stated that:

<sup>912</sup> OECD, *OECD and the Environment* (see footnote 875 above), annex, p. 91, para. 1.

<sup>913</sup> *Ibid.*, p. 142.

<sup>914</sup> See paragraph (1) of the commentary to article 17.

Consultations and negotiations between the two States must be genuine, must comply with the rules of good faith and must not be mere formalities. The rules of reason and good faith are applicable to procedural rights and duties relative to the sharing of the use of international rivers.<sup>915</sup>

(4) With regard to this particular point about good faith, the judgment of ICJ in the *Fisheries Jurisdiction* case is also relevant. There the Court stated that “[t]he task [of the parties] will be to conduct their negotiations on the basis that each must in good faith pay reasonable regard to the legal rights of the other”.<sup>916</sup> In the *North Sea Continental Shelf* cases the Court held that:

(a) [T]he parties are under an obligation to enter into negotiations with a view to arriving at an agreement, and not merely to go through a formal process of negotiation as a sort of prior condition for the automatic application of a certain method of delimitation in the absence of agreement; they are under an obligation so to conduct themselves that the negotiations are meaningful, which will not be the case when either of them insists upon its own position without contemplating any modification of it.<sup>917</sup>

Even though the Court in this judgment speaks of “negotiations”, it is believed that the good-faith requirement in the conduct of the parties during the course of consultation or negotiations is the same.

(5) The purpose of consultations is for the parties to find acceptable solutions regarding measures to be adopted in order to prevent significant transboundary harm, or at any event to minimize the risk thereof. The words “acceptable solutions”, regarding the adoption of preventive measures, refer to those measures that are accepted by the parties within the guidelines specified in paragraph 2. Generally, the consent of the parties on measures of prevention will be expressed by means of some form of agreement.

(6) The parties should obviously aim, first, at selecting those measures which may avoid any risk of causing significant transboundary harm or, if that is not possible, which minimize the risk of such harm. Under the terms of article 4, the parties are required, moreover, to cooperate in the implementation of such measures. This requirement, again, stems from the assumption that the obligation of due diligence, the core base of the provisions intended to prevent significant transboundary harm, or at any event to minimize the risk thereof, is of a continuous nature affecting every stage related to the conduct of the activity.

(7) Article 9 may be invoked whenever there is a question about the need to take preventive measures. Such questions obviously may arise as a result of article 8, because a notification to other States has been made by the State of origin that an activity it intends to undertake may pose a risk of causing significant transboundary harm, or in the course of the exchange of information under article 12 or in the context of article 11 on procedures in the absence of notification.

(8) Article 9 has a broad scope of application. It is to apply to all issues related to preventive measures. For ex-

ample, when parties notify under article 8 or exchange information under article 12 and there are ambiguities in those communications, a request for consultations may be made simply in order to clarify those ambiguities.

(9) *Paragraph 2* provides guidance for States when consulting each other on preventive measures. The parties shall seek solutions based on an equitable balance of interests in the light of article 10. Neither paragraph 2 of this article nor article 10 precludes the parties from taking account of other factors which they perceive as relevant in achieving an equitable balance of interests.

(10) *Paragraph 3* deals with the possibility that, despite all efforts by the parties, they cannot reach an agreement on acceptable preventive measures. As explained in paragraph (3) above, the article maintains a balance between the two considerations, one of which is to deny the States likely to be affected a right of veto. In this context, the *Lake Lanoux* award may be recalled where the tribunal noted that, in certain situations, the party that was likely to be affected might, in violation of good faith, paralyse genuine negotiation efforts.<sup>918</sup> To take account of this possibility, the article provides that the State of origin is permitted to go ahead with the activity, for the absence of such an alternative would, in effect, create a right of veto for the States likely to be affected. The State of origin, while permitted to go ahead with the activity, is still obligated, as measure of self-regulation, to take into account the interests of the States likely to be affected. As a result of consultations, the State of origin is aware of the concerns of the States likely to be affected and is in a better position to seriously take them into account in carrying out the activity. The last part of paragraph 3 preserves the rights of States likely to be affected.

#### *Article 10. Factors involved in an equitable balance of interests*

**In order to achieve an equitable balance of interests as referred to in paragraph 2 of article 9, the States concerned shall take into account all relevant factors and circumstances, including:**

**(a) the degree of risk of significant transboundary harm and of the availability of means of preventing such harm, or minimizing the risk thereof or repairing the harm;**

**(b) the importance of the activity, taking into account its overall advantages of a social, economic and technical character for the State of origin in relation to the potential harm for the State likely to be affected;**

**(c) the risk of significant harm to the environment and the availability of means of preventing such harm, or minimizing the risk thereof or restoring the environment;**

**(d) the degree to which the State of origin and, as appropriate, the State likely to be affected are prepared to contribute to the costs of prevention;**

<sup>915</sup> See footnote 873 above.

<sup>916</sup> *Fisheries Jurisdiction (United Kingdom v. Iceland)*, Merits, Judgment, I.C.J. Reports 1974, p. 33, para. 78.

<sup>917</sup> *North Sea Continental Shelf* (see footnote 197 above), para. 85. See also paragraph 87.

<sup>918</sup> See footnote 873 above.

(e) the economic viability of the activity in relation to the costs of prevention and to the possibility of carrying out the activity elsewhere or by other means or replacing it with an alternative activity;

(f) the standards of prevention which the State likely to be affected applies to the same or comparable activities and the standards applied in comparable regional or international practice.

### Commentary

(1) The purpose of this article is to provide some guidance for States which are engaged in consultations seeking to achieve an equitable balance of interests. In reaching an equitable balance of interests, the facts have to be established and all the relevant factors and circumstances weighed. This article draws its inspiration from article 6 of the Convention on the Law of the Non-navigational Uses of International Watercourses.

(2) The main clause of the article provides that in order “to achieve an equitable balance of interests as referred to in paragraph 2 of article 9, the States concerned shall take into account all relevant factors and circumstances”. The article proceeds to set forth a non-exhaustive list of such factors and circumstances. The wide diversity of types of activities which is covered by these articles, and the different situations and circumstances in which they will be conducted, make it impossible to compile an exhaustive list of factors relevant to all individual cases. No priority or weight is assigned to the factors and circumstances listed, since some of them may be more important in certain cases while others may deserve to be accorded greater weight in other cases. In general, the factors and circumstances indicated will allow the parties to compare the costs and benefits which may be involved in a particular case.

(3) *Subparagraph (a)* compares the degree of risk of significant transboundary harm to the availability of means of preventing such harm or minimizing the risk thereof and the possibility of repairing the harm. For example, the degree of risk of harm may be high, but there may be measures that can prevent the harm or reduce that risk, or there may be possibilities for repairing the harm. The comparisons here are both quantitative and qualitative.

(4) *Subparagraph (b)* compares the importance of the activity in terms of its social, economic and technical advantages for the State of origin and the potential harm to the States likely to be affected. The Commission in this context recalls the decision in the *Donauversinkung* case where the court stated that:

The interests of the States in question must be weighed in an equitable manner one against another. One must consider not only the absolute injury caused to the neighbouring State, but also the relation of the advantage gained by the one to the injury caused to the other.<sup>919</sup>

<sup>919</sup> *Streitsache des Landes Württemberg und des Landes Preussen gegen das Land Baden (Württemberg and Prussia v. Baden), betreffend die Donauversinkung*, German Staatsgerichtshof, 18 June 1927, *Entscheidungen des Reichsgerichts in Zivilsachen* (Berlin), vol. 116, appendix, pp. 18 et seq.; see also A. McNair and H. Lauterpacht, eds., *Annual Digest of Public International Law Cases, 1927 and 1928* (London,

In more recent times, States have negotiated what might be seen as equitable solutions to transboundary disputes; agreements concerning French potassium emissions into the Rhine, pollution of United States–Mexican boundary waters, and North American and European acid rain all display elements of this kind.<sup>920</sup>

(5) *Subparagraph (c)* compares, in the same fashion as subparagraph (a), the risk of significant harm to the environment and the availability of means of preventing such harm, or minimizing the risk thereof and the possibility of restoring the environment. It is necessary to emphasize the particular importance of protection of the environment. Principle 15 of the Rio Declaration is relevant to this subparagraph. Requiring that the precautionary approach be widely applied to States according to their capabilities, principle 15 states:

Where there are threats of serious or irreversible damage, lack of full scientific certainty shall not be used as a reason for postponing cost-effective measures to prevent environmental degradation.<sup>921</sup>

(6) The precautionary principle was affirmed in the “pan-European” Bergen Ministerial Declaration on Sustainable Development in the ECE Region, adopted in May 1990 by the ECE member States. It stated that: “Environmental measures must anticipate, prevent and attack the causes of environmental degradation. Where there are threats of serious or irreversible damage, lack of full scientific certainty should not be used as a reason for postponing measures to prevent environmental degradation.”<sup>922</sup> The precautionary principle was recommended by the UNEP Governing Council in order to promote the prevention and elimination of marine pollution, which is increasingly becoming a threat to the marine environment and a cause of human suffering.<sup>923</sup> The precautionary principle has also been referred to or incorporated without any explicit reference in various other conventions.<sup>924</sup>

Longmans, 1931), vol. 4, p. 131; *Kansas v. Colorado, United States Reports*, vol. 206 (1921), p. 100 (1907); and *Washington v. Oregon, ibid.*, vol. 297 (1936), p. 517 (1936).

<sup>920</sup> See the Convention on the Protection of the Rhine against Pollution from Chlorides, with the Additional Protocol to the Convention on the Protection of the Rhine against Pollution from Chlorides; the Agreement on the Permanent and Definitive Solution to the International Problem of the Salinity of the Colorado River, ILM, vol. 12, No. 5 (September 1973), p. 1105; the Convention on Long-Range Transboundary Air Pollution; and the Agreement between the United States and Canada on Air Quality of 1991 (United Nations, *Treaty Series*, vol. 1852, No. 31532, p. 79, reprinted in ILM, vol. 30 (1991), p. 678). See also A. E. Boyle and D. Freestone, *op. cit.* (footnote 863 above), p. 80; and I. Romy, *Les pollutions transfrontières des eaux: l'exemple du Rhin* (Lausanne, Payot, 1990).

<sup>921</sup> See footnote 857 above.

<sup>922</sup> Report of the Economic Commission for Europe on the Bergen Conference (8–16 May 1990), A/CONF.151/PC/10, annex I, para. 7.

<sup>923</sup> Governing Council decision 15/27 (1989); see *Official Records of the General Assembly, Forty-fourth Session, Supplement No. 25 (A/44/25)*, annex I. See also P. Sands, *op. cit.* (footnote 863 above), p. 210.

<sup>924</sup> See article 4, paragraph 3, of the Bamako Convention on the Ban of the Import into Africa and the Control of Transboundary Movement and Management of Hazardous Wastes within Africa; article 3, paragraph 3, of the United Nations Framework Convention on Climate Change; article 174 (ex-article 130r) of the Treaty establishing the European Community as amended by the Treaty of Amsterdam; and article 2 of the Vienna Convention for the Protection of the Ozone Layer. It may be noted that previous treaties apply the precautionary principle in a very general sense without making any explicit reference to it.

(7) According to the Rio Declaration, the precautionary principle constitutes a very general rule of conduct of prudence. It implies the need for States to review their obligations of prevention in a continuous manner to keep abreast of the advances in scientific knowledge.<sup>925</sup> ICJ in its judgment in the *Gabčíkovo-Nagymaros Project* case invited the parties to “look afresh at the effects on the environment of the operation of the Gabčíkovo power plant”, built on the Danube pursuant to the Treaty on the Construction and Operation of the Gabčíkovo-Nagymaros Barrage System of 1977, in the light of the new requirements of environmental protection.<sup>926</sup>

(8) States should consider suitable means to restore, as far as possible, the situation existing prior to the occurrence of harm. It is considered that this should be highlighted as a factor to be taken into account by States concerned which should adopt environmentally friendly measures.

(9) *Subparagraph* (d) provides that one of the elements determining the choice of preventive measures is the willingness of the State of origin and States likely to be affected to contribute to the cost of prevention. For example, if the States likely to be affected are prepared to contribute to the expense of preventive measures, it may be reasonable, taking into account other factors, to expect the State of origin to take more costly but more effective preventive measures. This, however, should not underplay the measures the State of origin is obliged to take under these articles.

(10) These considerations are in line with the basic policy of the so-called polluter-pays principle. This principle was initiated first by the Council of OECD in 1972.<sup>927</sup> The polluter-pays principle was given cognizance at the global level when it was adopted as principle 16 of the Rio Declaration. It noted:

<sup>925</sup> On the principle of precaution generally, see H. Hohmann, *Präventive Rechtspflichten und -prinzipien des modernen Umweltvölkerrechts: Zum Stand des Umweltvölkerrechts zwischen Umweltnutzung und Umweltschutz* (Berlin, Duncker and Humblot, 1992), pp. 406–411; J. Cameron, “The status of the precautionary principle in international law”, *Interpreting the Precautionary Principle*, T. O’Riordan and J. Cameron, eds. (London, Earthscan, 1994), pp. 262–289; H. Hohmann, *Precautionary Legal Duties and Principles of Modern International Environmental Law: The Precautionary Principle — International Environmental Law between Exploitation and Protection* (London, Graham and Trotman/Martinus Nijhoff, 1994); D. Freestone and E. Hey, eds., *The Precautionary Principle and International Law: The Challenge of Implementation* (The Hague, Kluwer, 1996); A. Epiney and M. Scheyli, *op. cit.* (footnote 879 above), pp. 103–125; P. Martin-Bidou, “Le principe de précaution en droit international de l’environnement”, *RGDIP*, vol. 103, No. 3 (1999), pp. 631–666; and N. de Sadeleer, “Réflexions sur le statut juridique du principe de précaution”, *Le principe de précaution: significations et conséquences*, E. Zaccai and J.-N. Missa, eds. (Éditions de l’Université de Bruxelles, 2000), pp. 117–142.

<sup>926</sup> *Gabčíkovo-Nagymaros Project* (see footnote 27 above), pp. 77–78, para. 140. However, in this case the Court did not accept Hungary’s claim that it was entitled to terminate the Treaty on the grounds of “ecological state of necessity” arising from risks to the environment that had not been detected at the time of its conclusion. It stated that other means could be used to remedy the vague “peril”; see paragraphs 49 to 58 of the judgment, pp. 39–46.

<sup>927</sup> See OECD Council recommendation C(72)128 on Principles relative to transfrontier pollution (OECD, *Guiding Principles concerning International Economic Aspects of Environmental Policies*) and OECD environment directive on equal right of access and non-discrimination in relation to transfrontier pollution, mentioned in the “Survey of liability regimes ...” (footnote 846 above), paras. 102–130.

National authorities should endeavour to promote the internalization of environmental costs and the use of economic instruments, taking into account the approach that the polluter should, in principle, bear the cost of pollution, with due regard to the public interest and without distorting international trade and investment.<sup>928</sup>

This is conceived as the most efficient means of allocating the cost of pollution prevention and control measures so as to encourage the rational use of scarce resources. It also encourages internalization of the cost of publicly mandated technical measures in preference to inefficiencies and competitive distortions in governmental subsidies.<sup>929</sup> This principle is specifically referred to in article 174 (ex-article 130r) of the Treaty establishing the European Community as amended by the Treaty of Amsterdam.

(11) The expression “as appropriate” indicates that the State of origin and the States likely to be affected are not put on the same level as regards the contribution to the costs of prevention. States concerned frequently embark on negotiations concerning the distribution of costs for preventive measures. In so doing, they proceed from the basic principle derived from article 3 according to which these costs are to be assumed by the operator or the State of origin. These negotiations mostly occur in cases where there is no agreement on the amount of the preventive measures and where the affected State contributes to the costs of preventive measures in order to ensure a higher degree of protection that it desires over and above what is essential for the State of origin to ensure. This link between the distribution of costs and the amount of preventive measures is in particular reflected in *subparagraph* (d).

(12) *Subparagraph* (e) introduces a number of factors that must be compared and taken into account. The economic viability of the activity must be compared to the costs of prevention. The cost of the preventive measures should not be so high as to make the activity economically non-viable. The economic viability of the activity should also be assessed in terms of the possibility of changing the location, or conducting it by other means, or replacing it with an alternative activity. The words “carrying out the activity ... by other means” intend to take into account, for example, a situation in which one type of chemical substance used in the activity, which might be the source of transboundary harm, could be replaced by another chemical substance; or mechanical equipment in the plant or the factory could be replaced by different equipment. The words “replacing [the activity] with an alternative activity” are intended to take account of the possibility that the same or comparable results may be reached by another activity with no risk, or lower risk, of significant transboundary harm.

<sup>928</sup> See footnote 857 above.

<sup>929</sup> See G. Hafner, “Das Verursacherprinzip”, *Economy-Fachmagazin* No. 4/90 (1990), pp. F23–F29; S. E. Gaines, “The polluter-pays principle: from economic equity to environmental ethos”, *Texas International Law Journal*, vol. 26 (1991), p. 470; H. Smets, “The polluter-pays principle in the early 1990s”, *The Environment after Rio: International Law and Economics*, L. Campiglio et al., eds. (London, Graham and Trotman/Martinus Nijhoff, 1994), p. 134; “Survey of liability regimes ...” (footnote 846 above), para. 113; Rio Declaration on Environment and Development—application and implementation: report of the Secretary-General (E/CN.17/1997/8, paras. 87–90); and A. Epiney and M. Scheyli, *op. cit.* (see footnote 879 above), p. 152.

(13) According to *subparagraph* (f), States should also take into account the standards of prevention applied to the same or comparable activities in the State likely to be affected, other regions or, if they exist, the international standards of prevention applicable for similar activities. This is particularly relevant when, for example, the States concerned do not have any standard of prevention for such activities, or they wish to improve their existing standards.

#### *Article 11. Procedures in the absence of notification*

**1. If a State has reasonable grounds to believe that an activity planned or carried out in the State of origin may involve a risk of causing significant transboundary harm to it, it may request the State of origin to apply the provision of article 8. The request shall be accompanied by a documented explanation setting forth its grounds.**

**2. In the event that the State of origin nevertheless finds that it is not under an obligation to provide a notification under article 8, it shall so inform the requesting State within a reasonable time, providing a documented explanation setting forth the reasons for such finding. If this finding does not satisfy that State, at its request, the two States shall promptly enter into consultations in the manner indicated in article 9.**

**3. During the course of the consultations, the State of origin shall, if so requested by the other State, arrange to introduce appropriate and feasible measures to minimize the risk and, where appropriate, to suspend the activity in question for a reasonable period.**

#### *Commentary*

(1) Article 11 addresses the situation in which a State, although it has received no notification about an activity in accordance with article 8, becomes aware that an activity is being carried out in the State of origin, either by the State itself or by a private operator, and believes, on reasonable grounds, that the activity carries a risk of causing it significant harm.

(2) The expression “a State” is not intended to exclude the possibility that more than one State could entertain the belief that a planned activity could adversely affect them in a significant way. The words “apply the provision of article 8” should not be taken as suggesting that the State which intends to authorize or has authorized an activity has necessarily failed to comply with its obligations under article 8. In other words, the State of origin may have made an assessment of the potential of the planned activity for causing significant transboundary harm and concluded in good faith that no such effects would result therefrom. *Paragraph 1* allows a State to request that the State of origin take a “second look” at its assessment and conclusion, and does not prejudge the question whether the State of origin initially complied with its obligations under article 8.

(3) The State likely to be affected could make such a request, however, only upon satisfaction of two conditions. The first is that the requesting State must have “reasonable grounds to believe” that the activity in question may involve a risk of causing significant transboundary harm. The second is that the requesting State must provide a “documented explanation setting forth its grounds”. These conditions are intended to require that the requesting State have more than a vague and unsubstantiated apprehension. A serious and substantiated belief is necessary, particularly in view of the possibility that the State of origin may be required to suspend implementation of its plans under paragraph 3 of article 11.

(4) The first sentence of *paragraph 2* deals with the case in which the planning State concludes, after taking a “second look” as described in paragraph (2) of the present commentary, that it is not under an obligation to provide a notification under article 8. In such a situation, paragraph 2 seeks to maintain a fair balance between the interests of the States concerned by requiring the State of origin to provide the same kind of justification for its finding as was required of the requesting State under paragraph 1. The second sentence of paragraph 2 deals with the case in which the finding of the State of origin does not satisfy the requesting State. It requires that, in such a situation, the State of origin promptly enter into consultations with the other State (or States), at the request of the latter. The consultations are to be conducted in the manner indicated in paragraphs 1 and 2 of article 9. In other words, their purpose is to achieve “acceptable solutions” regarding measures to be adopted in order to prevent significant transboundary harm or at any event to minimize the risk thereof, and that the solutions to be sought should be “based on an equitable balance of interests”. These phrases are discussed in the commentary to article 9.

(5) *Paragraph 3* requires the State of origin to introduce appropriate and feasible measures to minimize the risk and, where appropriate, to suspend the activity in question for a reasonable period, if it is requested to do so by the other State during the course of consultations. States concerned could also agree otherwise.

(6) Similar provisions have been provided for in other legal instruments. Article 18 of the Convention on the Law of the Non-navigational Uses of International Watercourses, and article 3, paragraph 7, of the Convention on Environmental Impact Assessment in a Transboundary Context also contemplate a procedure whereby a State likely to be affected by an activity can initiate consultations with the State of origin.

#### *Article 12. Exchange of information*

**While the activity is being carried out, the States concerned shall exchange in a timely manner all available information concerning that activity relevant to preventing significant transboundary harm or at any event minimizing the risk thereof. Such an exchange of information shall continue until such time as the States concerned consider it appropriate even after the activity is terminated.**



*Commentary*

(1) Article 12 deals with steps to be taken after an activity has been undertaken. The purpose of all these steps is the same as previous articles, viz. to prevent significant transboundary harm or at any event to minimize the risk thereof.

(2) Article 12 requires the State of origin and the States likely to be affected to exchange information regarding the activity after it has been undertaken. The phrase “concerning that activity” after the words “all available information” is intended to emphasize the link between the information and the activity and not any information. The duty of prevention based on the concept of due diligence is not a one-time effort but requires continuous effort. This means that due diligence is not terminated after granting authorization for the activity and undertaking the activity; it continues in respect of monitoring the implementation of the activity as long as the activity continues.

(3) The information that is required to be exchanged, under article 12, is whatever would be useful, in the particular instance, for the purpose of prevention of risk of significant harm. Normally, such information comes to the knowledge of the State of origin. However, when the State that is likely to be affected has any information which might be useful for prevention purposes, it should make it available to the State of origin.

(4) The requirement of exchange of information is fairly common in conventions designed to prevent or reduce environmental and transboundary harm. These conventions provide for various ways of gathering and exchanging information, either between the parties or through providing the information to an international organization which makes it available to other States.<sup>930</sup> In the context of these articles, where the activities are most likely to involve a few States, the exchange of information is effected between the States directly concerned. Where the information might affect a large number of States, relevant information may be exchanged through other avenues, such as, for example, competent international organizations.

(5) Article 12 requires that such information should be exchanged in a *timely manner*. This means that when the State becomes aware of such information, it should inform the other States quickly so that there will be enough time for the States concerned to consult on appropriate preventive measures or the States likely to be affected will have sufficient time to take proper actions.

<sup>930</sup> For example, article 10 of the Convention for the Prevention of Marine Pollution from Land-based Sources, article 200 of the United Nations Convention on the Law of the Sea and article 4 of the Vienna Convention for the Protection of the Ozone Layer speak of individual or joint research by the States parties on prevention or reduction of pollution and of transmitting to each other directly or through a competent international organization the information so obtained. The Convention on Long-Range Transboundary Air Pollution provides for research and exchange of information regarding the impact of activities undertaken by the States parties. Examples are found in other instruments such as section VI, para. 1 (b) (iii), of the Code of Conduct on Accidental Pollution of Transboundary Inland Waters (see footnote 871 above), article 17 of the Convention on Biological Diversity and article 13 of the Convention on the Protection and Use of Transboundary Watercourses and International Lakes.

(6) There is no requirement in the article as to the frequency of exchange of information. The requirement of article 12 comes into operation only when States have any information which is relevant to preventing transboundary harm or at any rate to minimizing the risk thereof.

(7) The second sentence of article 12 is designed to ensure exchange of information under this provision not only while an activity is “carried out”, but even after it ceases to exist, if the activity leaves behind by-products or materials associated with the activity which require monitoring to avoid the risk of significant transboundary harm. An example in this regard is nuclear activity which leaves behind nuclear waste even after the activity is terminated. But it is a recognition of the fact that the consequences of certain activities even after they are terminated continue to pose a significant risk of transboundary harm. Under these circumstances, the obligations of the State of origin do not end with the termination of the activity.

*Article 13. Information to the public*

**States concerned shall, by such means as are appropriate, provide the public likely to be affected by an activity within the scope of the present articles with relevant information relating to that activity, the risk involved and the harm which might result and ascertain their views.**

*Commentary*

(1) Article 13 requires States, whenever possible and by such means as are appropriate, to provide the public likely to be affected, whether their own or that of other States, with information relating to the risk and harm that might result from an activity to ascertain their views thereon. The article therefore requires States (a) to provide information to the public regarding the activity and the risk and the harm it involves; and (b) to ascertain the views of the public. It is, of course, clear that the purpose of providing information to the public is to allow its members to inform themselves and then to ascertain their views. Without that second step, the purpose of the article would be defeated.

(2) The content of the information to be provided to the public includes information about the activity itself as well as the nature and the scope of risk and harm that it entails. Such information is contained in the documents accompanying the notification which is effected in accordance with article 8 or in the assessment which may be carried out by the requesting State under article 11.

(3) This article is inspired by new trends in international law, in general, and environmental law, in particular, of seeking to involve, in the decision-making processes, individuals whose lives, health, property and environment might be affected by providing them with a chance to present their views and be heard by those responsible for making the ultimate decisions.

(4) Principle 10 of the Rio Declaration provides for public involvement in decision-making processes as follows:

Environmental issues are best handled with the participation of all concerned citizens, at the relevant level. At the national level, each individual shall have appropriate access to information concerning the environment that is held by public authorities, including information on hazardous materials and activities in their communities, and the opportunity to participate in decision-making processes. States shall facilitate and encourage public awareness and participation by making information widely available. Effective access to judicial and administrative proceedings, including redress and remedy, shall be provided.<sup>931</sup>

(5) A number of other recent international instruments dealing with environmental issues have required States to provide the public with information and to give it an opportunity to participate in decision-making processes. Section VII, paragraphs 1 and 2, of the Code of Conduct on Accidental Pollution of Transboundary Inland Waters is relevant in that context:

1. In order to promote informed decision-making by central, regional or local authorities in proceedings concerning accidental pollution of transboundary inland waters, countries should facilitate participation of the public likely to be affected in hearings and preliminary inquiries and the making of objections in respect of proposed decisions, as well as recourse to and standing in administrative and judicial proceedings.

2. Countries of incident should take all appropriate measures to provide physical and legal persons exposed to a significant risk of accidental pollution of transboundary inland waters with sufficient information to enable them to exercise the rights accorded to them by national law in accordance with the objectives of this Code.<sup>932</sup>

Article 3, paragraph 8, of the Convention on Environmental Impact Assessment in a Transboundary Context; article 17 of the Convention on the Protection of the Marine Environment of the Baltic Sea Area; article 6 of the United Nations Framework Convention on Climate Change; the Convention on the Protection and Use of Transboundary Watercourses and International Lakes (art. 16); the Convention on the Transboundary Effects of Industrial Accidents (art. 9 and annex VIII); article 12 of the Convention on the Law of the Non-navigational Uses of International Watercourses; the Convention on Access to Information, Public Participation in Decision-making and Access to Justice in Environmental Matters; the European Council directives 90/313/EEC on the freedom of access to information on the environment<sup>933</sup> and 96/82/EC on the control of major-accident hazards involving dangerous substances;<sup>934</sup> and OECD Council recommendation C(74)224 on Principles concerning transfrontier pollution<sup>935</sup> all provide for information to the public.

(6) There are many modalities for participation in decision-making processes. Reviewing data and information on the basis of which decisions will be based and having an opportunity to confirm or challenge the accuracy of the facts, the analysis and the policy considerations either through administrative tribunals, courts, or groups of concerned citizens is one way of participation in decision-

making. This form of public involvement enhances the efforts to prevent transboundary and environmental harm.

(7) The obligation contained in article 13 is circumscribed by the phrase “by such means as are appropriate”, which is intended to leave the ways in which such information could be provided to the States, their domestic law requirements and the State policy as to, for example, whether such information should be provided through media, non-governmental organizations, public agencies and local authorities. In the case of the public beyond a State’s borders, information may be provided, as appropriate, through the good offices of the State concerned, if direct communication is not feasible or practical.

(8) Further, the State that might be affected, after receiving notification and information from the State of origin and before responding to the notification shall, by such means as are appropriate, inform those parts of its own public likely to be affected.

(9) “Public” includes individuals, interest groups (non-governmental organizations) and independent experts. General “public”, however, refers to individuals who are not organized into groups or affiliated to specific groups. Public participation could be encouraged by holding public meetings or hearings. The public should be given the opportunity for consultation and their participation should be facilitated by providing them with necessary information on the proposed policy, plan or programme under consideration. It must, however, be understood that requirements of confidentiality may affect the extent of public participation in the assessment process. It is also common that the public is not involved, or only minimally involved, in efforts to determine the scope of a policy, plan or programme. Public participation in the review of a draft document or environmental impact assessment would be useful in obtaining information regarding concerns related to the proposed action, additional alternatives and potential environmental impact.<sup>936</sup>

(10) Apart from the desirability of encouraging public participation in national decision-making on vital issues regarding development and the tolerance levels of harm in order to enhance the legitimacy of and compliance with the decisions taken, it is suggested that, given the development of human rights law, public participation could also be viewed as a growing right under national law as well as international law.<sup>937</sup>

#### *Article 14. National security and industrial secrets*

**Data and information vital to the national security of the State of origin or to the protection of industrial secrets or concerning intellectual property may**

<sup>936</sup> See ECE, *Application of Environmental Impact Assessment Principles ...* (footnote 901 above), pp. 4 and 8.

<sup>937</sup> See T. M. Franck, “Fairness in the international legal and institutional system: general course on public international law”, *Recueil des cours...*, 1993–III (Dordrecht, Martinus Nijhoff, 1994), vol. 240, p. 110. See also D. Craig and D. Ponce Nava, “Indigenous peoples’ rights and environmental law”, *UNEP’s New Way Forward ...* (footnote 901 above), pp. 115–146.

<sup>931</sup> See footnote 857 above.

<sup>932</sup> See footnote 871 above.

<sup>933</sup> *Official Journal of the European Communities*, No. L 158 of 23 June 1990, p. 56.

<sup>934</sup> *Ibid.*, No. L 10 of 14 January 1997, p. 13.

<sup>935</sup> See footnote 875 above.

**be withheld, but the State of origin shall cooperate in good faith with the State likely to be affected in providing as much information as possible under the circumstances.**

*Commentary*

(1) Article 14 is intended to create a narrow exception to the obligation of States to provide information in accordance with articles 8, 12 and 13. States are not obligated to disclose information that is vital to their national security. This type of clause is not unusual in treaties which require exchange of information. Article 31 of the Convention on the Law of the Non-navigational Uses of International Watercourses also provides for a similar exception to the requirement of disclosure of information vital to national defence or security.

(2) Article 14 includes industrial secrets and information protected by intellectual property in addition to national security. Although industrial secrets are a part of the intellectual property rights, both terms are used to give sufficient coverage to protected rights. In the context of these articles, it is highly probable that some of the activities which come within the scope of article 1 might involve the use of sophisticated technology involving certain types of information which are protected under the domestic law. Normally, domestic laws of States determine the information that is considered an industrial secret and provide protection for them. This type of safeguard clause is not unusual in legal instruments dealing with exchange of information relating to industrial activities. For example, article 8 of the Convention on the Protection and Use of Transboundary Watercourses and International Lakes and article 2, paragraph 8, of the Convention on Environmental Impact Assessment in a Transboundary Context provide for similar protection of industrial and commercial secrecy.

(3) Article 14 recognizes the need for balance between the legitimate interests of the State of origin and the States that are likely to be affected. It therefore requires the State of origin that is withholding information on the grounds of security or industrial secrecy to cooperate in good faith with the other States in providing as much information as possible under the circumstances. The words "as much information as possible" include, for example, the general description of the risk and the type and the extent of harm to which a State may be exposed. The words "under the circumstances" refer to the conditions invoked for withholding the information. Article 14 essentially encourages and relies on the good-faith cooperation of the parties.

*Article 15. Non-discrimination*

**Unless the States concerned have agreed otherwise for the protection of the interests of persons, natural or juridical, who may be or are exposed to the risk of significant transboundary harm as a result of an activity within the scope of the present articles, a State shall not discriminate on the basis of nationality or residence or place where the injury might occur, in**

**granting to such persons, in accordance with its legal system, access to judicial or other procedures to seek protection or other appropriate redress.**

*Commentary*

(1) This article sets out the basic principle that the State of origin is to grant access to its judicial and other procedures without discrimination on the basis of nationality, residence or the place where the injury might occur. The content of this article is based on article 32 of the Convention on the Law of the Non-navigational Uses of International Watercourses.

(2) Article 15 contains two basic elements, namely, non-discrimination on the basis of nationality or residence and non-discrimination on the basis of where the injury might occur. The rule set forth obliges States to ensure that any person, whatever his nationality or place of residence, who might suffer significant transboundary harm as a result of activities referred to in article 1 should, regardless of where the harm might occur, receive the same treatment as that afforded by the State of origin to its nationals in case of possible domestic harm. It is not intended that this obligation should affect the existing practice in some States of requiring that non-residents or aliens post a bond, as a condition of utilizing the court system, to cover court costs or other fees. Such a practice is not "discriminatory" under the article, and is taken into account by the phrase "in accordance with its legal system".

(3) Article 15 also provides that the State of origin may not discriminate on the basis of the place where the damage might occur. In other words, if significant harm may be caused in State A as a result of an activity referred to in article 1 in State B, State B may not bar an action on the grounds that the harm would occur outside its jurisdiction.

(4) This rule is residual, as indicated by the phrase "unless the States concerned have agreed otherwise". Accordingly, States concerned may agree on the best means of providing protection or redress to persons who may suffer a significant harm, for example through a bilateral agreement. States concerned are encouraged under the present articles to agree on a special regime dealing with activities with the risk of significant transboundary harm. In such arrangements, States may also provide for ways and means of protecting the interests of the persons concerned in case of significant transboundary harm. The phrase "for the protection of the interests of persons" has been used to make it clear that the article is not intended to suggest that States can decide by mutual agreement to discriminate in granting access to their judicial or other procedures or a right to compensation. The purpose of the inter-State agreement should always be the protection of the interests of the victims of the harm.

(5) Precedents for the obligation contained in this article may be found in international agreements and in recommendations of international organizations. For example, the Convention on the Protection of the Environment between Denmark, Finland, Norway and Sweden in its article 3 provides as follows:

Any person who is affected or may be affected by a nuisance caused by environmentally harmful activities in another contracting State shall have the right to bring before the appropriate Court or Administrative Authority of that State the question of the permissibility of such activities, including the question of measures to prevent damage, and to appeal against the decision of the Court or the Administrative Authority to the same extent and on the same terms as a legal entity of the State in which the activities are being carried out.

The provisions of the first paragraph of this article shall be equally applicable in the case of proceedings concerning compensation for damage caused by environmentally harmful activities. The question of compensation shall not be judged by rules which are less favourable to the injured Party than the rules of compensation of the State in which the activities are being carried out.<sup>938</sup>

(6) The OECD Council has adopted recommendation C(77)28(Final) on implementation of a regime of equal right of access and non-discrimination in relation to trans-frontier pollution. Paragraph 4, subparagraph (a), of the annex to that recommendation provides as follows:

Countries of origin should ensure that any person who has suffered transfrontier pollution damage or is exposed to a significant risk of transfrontier pollution shall at least receive equivalent treatment to that afforded in the Country of origin in cases of domestic pollution and in comparable circumstances, to persons of equivalent condition or status ...<sup>939</sup>

#### Article 16. Emergency preparedness

**The State of origin shall develop contingency plans for responding to emergencies, in cooperation, where appropriate, with the State likely to be affected and competent international organizations.**

#### Commentary

(1) This article contains an obligation that calls for anticipatory rather than responsive action. The text of article 16 is based on article 28, paragraph 4, of the Convention on the Law of the Non-navigational Uses of International Watercourses which reads:

When necessary, watercourse States shall jointly develop contingency plans for responding to emergencies, in cooperation, where appropriate, with other potentially affected States and competent international organizations.

The need for the development of contingency plans for responding to possible emergencies is well recognized.<sup>940</sup>

<sup>938</sup> Similar provisions may be found in article 2, paragraph 6, of the Convention on Environmental Impact Assessment in a Transboundary Context; the Guidelines on responsibility and liability regarding transboundary water pollution, part II.E.8, prepared by the ECE Task Force on responsibility and liability regarding transboundary water pollution (document ENVWA/R.45, annex); and paragraph 6 of the Draft ECE Charter on environmental rights and obligations, prepared at a meeting of experts on environmental law, 25 February to 1 March 1991 (document ENVWA/R.38, annex I).

<sup>939</sup> OECD, *OECD and the Environment* (see footnote 875 above), p. 150. This is also the main thrust of principle 14 of the Principles of conduct in the field of the environment for the guidance of States in the conservation and harmonious utilization of natural resources shared by two or more States (see footnote 862 above). A discussion of the principle of equal access may be found in S. van Hoogstraten, P.-M. Dupuy and H. Smets, "L'égalité d'accès: pollution transfrontière", *Environmental Policy and Law*, vol. 2, No. 2 (June 1976), p. 77.

<sup>940</sup> See E. Brown Weiss, "Environmental disasters in international law", *Anuario Jurídico Interamericano*, 1986 (OAS, Washington, D.C., 1987), pp. 141-169. Resolution No. 13 of 17 December 1983

It is suggested that the duty to prevent environmental disasters obligates States to enact safety measures and procedures to minimize the likelihood of major environmental accidents, such as nuclear reactor accidents, toxic chemical spills, oil spills or forest fires. Where necessary, specific safety or contingency measures are open to States to negotiate and agree in matters concerning management of risk of significant transboundary harm, such safety measures could include: (a) adoption of safety standards for the location and operation of industrial and nuclear plants and vehicles; (b) maintenance of equipment and facilities to ensure ongoing compliance with safety measures; (c) monitoring of facilities, vehicles or conditions to detect dangers; and (d) training of workers and monitoring of their performance to ensure compliance with safety standards. Such contingency plans should include establishment of early warning systems.

(2) While States of origin bear the primary responsibility for developing contingency plans, in many cases it will be appropriate to prepare them in cooperation with other States likely to be affected and competent international organizations. For example, the contingency plans may necessitate the involvement of other States likely to be affected, as well as international organizations with competence in the particular field.<sup>941</sup> In addition, the coordination of response efforts might be most effectively handled by a competent international organization of which the States concerned are members.

(3) Development of contingency plans are also better achieved through establishment of common or joint commissions composed of members representing all States concerned. National points of contact would also have to be established to review matters and employ the latest means of communication to suit early warnings.<sup>942</sup> Contingency plans to respond to marine pollution disasters are well known. Article 199 of the United Nations Convention on the Law of the Sea requires States to develop such plans. The obligation to develop contingency plans is also found in certain bilateral and multilateral agreements concerned with forest fires, nuclear accidents and other environmental catastrophes.<sup>943</sup> The Convention for the Protection of the Natural Resources and Environment of the South Pacific Region provides in article 15 that the "Parties shall develop and promote individual

of the European Council of Environmental Law concerning "Principles concerning international cooperation in environmental emergencies linked to technological development" expressly calls for limits on siting of all hazardous installations, for the adoption of safety standards to reduce risk of emergencies, and for monitoring and emergency planning; see *Environmental Policy and Law*, vol. 12, No. 3 (April 1984), p. 68. See also G. Handl, *op. cit.* (footnote 871 above), pp. 62-65.

<sup>941</sup> For a review of various contingency plans established by several international organizations and bodies such as UNEP, FAO, the United Nations Disaster Relief Coordinator, UNHCR, UNICEF, WHO, IAEA and ICRC, see B. G. Ramcharan, *The International Law and Practice of Early-Warning and Preventive Diplomacy: The Emerging Global Watch* (Dordrecht, Kluwer, 1991), chapter 7 (The Practice of Early-Warning: Environment, Basic Needs and Disaster-Preparedness), pp. 143-168.

<sup>942</sup> For establishment of joint commissions, see, for example, the Indus Waters Treaty, 1960 and the Agreement for the Protection of the Rhine against Chemical Pollution.

<sup>943</sup> For a mention of these agreements, see E. Brown Weiss, *loc. cit.* (see footnote 940 above), p. 148.

contingency plans and joint contingency plans for responding to incidents”.

### *Article 17. Notification of an emergency*

**The State of origin shall, without delay and by the most expeditious means, at its disposal, notify the State likely to be affected of an emergency concerning an activity within the scope of the present articles and provide it with all relevant and available information.**

#### *Commentary*

(1) This article deals with the obligations of States of origin in responding to an actual emergency situation. The provision is based on article 28, paragraph 2, of the Convention on the Law of the Non-navigational Uses of International Watercourses which reads:

A watercourse State shall, without delay and by the most expeditious means available notify other potentially affected States and competent international organizations of any emergency originating within its territory.

Similar obligations are also contained, for example, in Principle 18 of the Rio Declaration;<sup>944</sup> the Convention on Early Notification of a Nuclear Accident;<sup>945</sup> article 198 of the United Nations Convention on the Law of the Sea; article 14, paragraph 1 (d) of the Convention on Biological Diversity; article 5, paragraph 1 (c), of the International Convention on Oil Pollution Preparedness, Response and Cooperation, 1990 and a number of other agreements concerning international watercourses.<sup>946</sup>

(2) According to this article, the seriousness of the harm involved together with the suddenness of the emergency's occurrence justifies the measures required. However, suddenness does not denote that the situation

<sup>944</sup> See footnote 857 above.

<sup>945</sup> Article 5 of this Convention provides for detailed data to be notified to the States likely to be affected: “(a) the time, exact location where appropriate, and the nature of the nuclear accident; (b) the facility or activity involved; (c) the assumed or established cause and the foreseeable development of the nuclear accident relevant to the transboundary release of the radioactive materials; (d) the general characteristics of the radioactive release, including, as far as is practicable and appropriate, the nature, probable physical and chemical form and the quantity, composition and effective height of the radioactive release; (e) information on current and forecast meteorological and hydrological conditions, necessary for forecasting the transboundary release of the radioactive materials; (f) the results of environmental monitoring relevant to the transboundary release of the radioactive materials; (g) the off-site protective measures taken or planned; (h) the predicted behaviour over time of the radioactive release.”

<sup>946</sup> See, e.g., article 11 of the Agreement for the Protection of the Rhine against Chemical Pollution; the Agreement concerning the Activities of Agencies for the Control of Accidental Water Pollution by Hydrocarbons or Other Substances capable of Contaminating Water and Recognized as such under the Convention of 16 November 1962 between France and Switzerland concerning Protection of the Waters of Lake Geneva against Pollution (1977 Official Collection of Swiss Laws, p. 2204), reproduced in B. Ruester, B. Simma and M. Bock, *International Protection of the Environment*, vol. XXV (Dobbs Ferry, N.Y., Oceana, 1981), p. 285; and the Agreement on Great Lakes Water Quality, concluded between Canada and the United States (*United States Treaties and Other International Agreements, 1978-79*, vol. 30, part 2 (Washington, D.C., United States Government Printing Office, 1980), No. 9257).

needs to be wholly unexpected. Early warning systems established or forecasting of severe weather disturbances could indicate that the emergency is imminent. This may give the States concerned some time to react and take reasonable, feasible and practical measures to avoid or at any event mitigate ill effects of such emergencies. The words “without delay” mean immediately upon learning of the emergency and the phrase “by the most expeditious means, at its disposal” indicates that the most rapid means of communication to which a State may have recourse is to be utilized.

(3) Emergencies could result from natural causes or human conduct. Measures to be taken in this regard are without prejudice to any claims of liability whose examination is outside the scope of the present articles.

### *Article 18. Relationship to other rules of international law*

**The present articles are without prejudice to any obligation incurred by States under relevant treaties or rules of customary international law.**

#### *Commentary*

(1) Article 18 intends to make it clear that the present articles are without prejudice to the existence, operation or effect of any obligation of States under international law relating to an act or omission to which these articles apply. It follows that no inference is to be drawn from the fact that an activity falls within the scope of these articles, as to the existence or non-existence of any other rule of international law as to the activity in question or its actual or potential transboundary effects.

(2) The reference in article 18 to any obligation of States covers both treaty obligations and obligations under customary international law. It is equally intended to extend both to rules having a particular application, whether to a given region or a specified activity, and to rules which are universal or general in scope. This article does not purport to resolve all questions of future conflict of overlap between obligations under treaties and customary international law and obligations under the present articles.

### *Article 19. Settlement of disputes*

**1. Any dispute concerning the interpretation or application of the present articles shall be settled expeditiously through peaceful means of settlement chosen by mutual agreement of the parties to the dispute, including negotiations, mediation, conciliation, arbitration or judicial settlement.**

**2. Failing an agreement on the means for the peaceful settlement of the dispute within a period of six months, the parties to the dispute shall, at the request of any of them, have recourse to the establishment of an impartial fact-finding commission.**

**3. The Fact-finding Commission shall be composed of one member nominated by each party to the dispute and in addition a member not having the nationality of any of the parties to the dispute chosen by the nominated members who shall serve as Chairperson.**

**4. If more than one State is involved on one side of the dispute and those States do not agree on a common member of the Commission and each of them nominates a member, the other party to the dispute has the right to nominate an equal number of members of the Commission.**

**5. If the members nominated by the parties to the dispute are unable to agree on a Chairperson within three months of the request for the establishment of the Commission, any party to the dispute may request the Secretary-General of the United Nations to appoint the Chairperson who shall not have the nationality of any of the parties to the dispute. If one of the parties to the dispute fails to nominate a member within three months of the initial request pursuant to paragraph 2, any other party to the dispute may request the Secretary-General of the United Nations to appoint a person who shall not have the nationality of any of the parties to the dispute. The person so appointed shall constitute a single-member Commission.**

**6. The Commission shall adopt its report by a majority vote, unless it is a single-member Commission, and shall submit that report to the parties to the dispute setting forth its findings and recommendations, which the parties to the dispute shall consider in good faith.**

#### *Commentary*

(1) Article 19 provides a basic rule for the settlement of disputes arising from the interpretation or application of the regime of prevention set out in the present articles. The rule is residual in nature and applies where the States concerned do not have an applicable agreement for the settlement of such disputes.

(2) It is assumed that the application of this article would come into play only after States concerned have exhausted all the means of persuasion at their disposal through appropriate consultation and negotiations. These could take place as a result of the obligations imposed by the present articles or otherwise in the normal course of inter-State relations.

(3) Failing any agreement through consultation and negotiation, the States concerned are urged to continue to exert efforts to settle their dispute, through other peaceful means of settlement to which they may resort by mutual agreement, including mediation, conciliation, arbitration or judicial settlement. These are means of peaceful settlement of disputes set forth in Article 33 of the Charter of the United Nations, in the second paragraph

of the relevant section of the Declaration on Principles of International Law concerning Friendly Relations and Cooperation among States in accordance with the Charter of the United Nations<sup>947</sup> and in paragraph 5 of section I of the Manila Declaration on the Peaceful Settlement of International Disputes,<sup>948</sup> which are open to States as free choices to be mutually agreed upon.<sup>949</sup>

(4) If the States concerned are unable to reach an agreement on any of the means of peaceful settlement of disputes within a period of six months, paragraph 2 of article 19 obliges States, at the request of one of them, to have recourse to the appointment of an impartial fact-finding commission. Paragraphs 3, 4, and 5 of article 19 elaborate the compulsory procedure for the appointment of the fact-finding commission.<sup>950</sup> This compulsory procedure is useful and necessary to help States to resolve their disputes expeditiously on the basis of an objective identification and evaluation of facts. Lack of proper appreciation of the correct and relevant facts is often at the root of differences or disputes among States.

(5) Resort to impartial fact-finding commissions is a well-known method incorporated in a number of bilateral or multilateral treaties, including the Covenant of the League of Nations, the Charter of the United Nations and the constituent instruments of certain specialized agencies and other international organizations within the United Nations system. Its potential to contribute to the settlement of international disputes is recognized by General Assembly resolution 1967 (XVIII) of 16 December 1963 on the "Question of methods of fact-finding" and the Declaration on Fact-Finding by the United Nations in the Field of the Maintenance of International Peace and Security adopted by the General Assembly in its resolution 46/59 of 9 December 1991, annex.

(6) By virtue of the mandate to investigate the facts and to clarify the questions in dispute, such commissions usually have the competence to arrange for hearings of the parties, the examination of witnesses or on-site visits.

(7) The report of the Commission usually should identify or clarify "facts". Insofar as they involve no assessment or evaluation, they are generally beyond further contention. States concerned are still free to give such weight as they deem appropriate to these "facts" in arriving at a resolution of the dispute. However, article 19 requires the States concerned to give the report of the fact-finding commission a good-faith consideration at the least.<sup>951</sup>

<sup>947</sup> See footnote 273 above.

<sup>948</sup> General Assembly resolution 37/10 of 15 November 1982, annex.

<sup>949</sup> For an analysis of the various means of peaceful settlement of disputes and references to relevant international instruments, see *Handbook on the Peaceful Settlement of Disputes between States* (United Nations publication, Sales No. E.92.V.7).

<sup>950</sup> See article 33 of the Convention on the Law of the Non-navigational Uses of International Watercourses.

<sup>951</sup> The criteria of good faith are described in the commentary to article 9.

# Oxford Public International Law

## **Part III The Sources of International Responsibility, Ch.19.3 Attribution of Conduct to the State: Private Individuals**

**Olivier de Frouville**

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Edited By: James Crawford, Alain Pellet, Simon Olleson, Kate Parlett (Assistant)

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In international law, attribution fulfils a double function in the theory of responsibility. The first consists of designating a responsible person (legal or natural) who will bear the consequences of this responsibility, even though the person in question may not necessarily be the direct author of the act. The second function lies in the triggering of the application of a particular regime of responsibility: international responsibility of a State or an international organization, where the

conduct at issue is attributable to one of these legal persons, or criminal responsibility of the individual where the conduct is attributable to a natural person. The application of the two regimes of responsibility can be simultaneous, as the two cases relating to the *Application of the Convention on the Prevention and Punishment of the Crime of Genocide*<sup>1</sup> at the International Court and the trial of Slobodan Milosevic, former president of the Federal Republic of Yugoslavia before the International Criminal Tribunal for the former Yugoslavia, show. In this instance there is a parallelism which results in no confusion. The two regimes have their own rules and pursue different objectives. Here, we will only discuss the international responsibility of the State, that is to say the situations in which an internationally wrongful act can be attributed to the State.

(p. 258) A reading of classical authors shows that, for the main part, the general principles of State responsibility for or in relation to the conduct of private individuals have hardly changed. But the theoretical assumptions which underpin these principles have been altered, so that the solutions maintained by the ILC Articles do not bear any resemblance to those proposed by Hugo Grotius.

The essentials of the subject can nevertheless be found in *The Rights of War and Peace*.<sup>2</sup> In this work Grotius approached the question of attribution from two perspectives. In search of causes for which wars are undertaken Grotius distinguished between two types of acts that give rise to reparation or punishment.<sup>3</sup> The first type related to what would today be called civil responsibility, while the second was more concerned with criminal responsibility. One can be *a priori* surprised that academic authors refer only to the discussion relating to criminal law contained in Chapter XXI (*Of the Communication of Punishments*) of Book II and neglect Grotius' reflections on reparation for injuries in Chapter XVII (*Of the Damage done By an Injury, and of the Obligation Thence Arising*); it seems evident that the latter are more easily transferrable to international law, where the system or responsibility has more the character of civil than criminal responsibility. But on the one hand, Grotius himself wrote that the rules on attribution are fairly similar in the criminal and civil field: 'For generally, by the same Means a Man may be Partaker of another's Crime, as he is made liable to the Reparation of such Damages'.<sup>4</sup> On the other hand, the specific topic of the responsibility of any kind of group for the act of an individual is not dealt with until Chapter XXI, which makes the formulations that can be found there *a priori* more interesting for an internationalist in search of teachings on the issue of State responsibility for the acts of individuals. In reality, this specificity is only evident through the intermediary of the person of the sovereign, having its own will. It is in Chapter XXI that the key idea can be found, stating that where the act in question does not have any link with the State, it should not be imputed to it as a collectivity:

No civil Society, or other publick Body, is accountable for the Faults of its particular Members, unless it has *concurred* with them, or has been *negligent* in attending to its Charge.<sup>5</sup>

Grotius, as always, relies on the practice and on the writings of classic thinkers. He notes in particular that:

And the *Rhodians* beg of the Senate to distinguish betwixt the Fact of the Publick, and the Fault of particular Men; affirming that *there is no State which has not sometimes wicked Subjects and always an ignorant Mob to deal with*. So neither is a Father responsible for his Children's Crimes, nor a Master for his Servants, nor any other Superior for the Faults of those under his Care; if there be nothing criminal in his conduct, with respect to the Faults of those, over whom he has Authority.<sup>6</sup>

The principle of irresponsibility is thus nuanced by the theory of active or passive *complicity* of the State, to which the idea of co-responsibility in Chapter XVII corresponds. Grotius distinguishes complicity/co-responsibility by action where a person *contributes by his own act* to the act from complicity/co-responsibility by omission where it shows *negligence*.

(p. 259) Active co-responsibility is defined in Chapter XVII in the following manner:



Besides the Person that doth the Injury himself, there are others also who may be responsible for it, either by *doing what they ought not, or not doing what they ought to have done*. By doing what they ought not to have done, *Primarily*, or *Secondarily*. *Primarily*, as he who commands it to be done, he who gives the necessary Consent for doing it, he who assists in the Action, he who protects him that committed it, or becomes in any other manner a Party in doing the Injury. *Secondarily*, He that advises the doing it, or commends and flatters him who does it.<sup>7</sup>

As for responsibility for negligence, it does not apply under the same conditions for acts that are subject to punishment and acts entailing reparation.

The lack of action in relation to acts subject to punishment automatically engages responsibility in the form of passive complicity. According to Grotius, this negligence can occur in two forms: tolerance (*patientia*) and the offer of a retreat (*receptus*) or, in other words, the act of on the one side not having prevented the commission of a delict while having knowledge of the existence of this delict; and on the other hand the act of not having punished or handed over the criminal.<sup>8</sup>

On the other hand, negligence in relation to an act giving rise to reparation only engages responsibility in so far as the omission breaches an obligation of its author:

*By not doing what he ought*, a Man is likewise bound to make Reparation, primarily, or secondarily. *Primarily*, when by his Station or Office he ought to hinder the doing it, by giving his Commands to the contrary, or to succour him that has the Wrong done him, and does it not ...

*Secondarily*, He that doth not dissuade when he ought, or conceals the Fact when he ought to have discovered it. In all which Cases the word *ought*, has Respect to that Right which is properly so called, and is the Object of expletive Justice whether it arise from the Law or from a certain Quality in the Person.

For if it be due only by the Rules of Charity, the Omission of it is indeed a Fault, but not such an one as obliges one to make reparation; which, as I have already said, arises only from Right properly so called.<sup>9</sup>

In this theory, there is thus no co-responsibility in the sense of shared responsibility for the same act. The co-responsibility which is envisaged here is understood to be two responsibilities for two distinct acts, the first original and the second intervening in relation with the first. We find here the premises of the responsibility by *catalysis* later described by Roberto Ago.

Grotius' reflections on the question of attribution are, as we can see, rich and complex and the past and current presentations of the law in the area owe much to it. As for the past, the transposition of the Grotian doctrine to the modern framework of international law can be attributed to Emmerich de Vattel, whose work on the topic has enriched the doctrine and jurisprudence of the 19th and early 20th century.

(p. 260) In his masterpiece<sup>10</sup> Vattel follows, on the subject of attribution, a two-fold approach. The first consists in the confirmation of the irresponsibility of the State for the acts of individuals:

However, as it is impossible for the best regulated state, or for the most vigilant and absolute sovereign, to model at his pleasure all the actions of his subjects, and to confine them on every occasion to the most exact obedience, it would be unjust to impute to the nation or the sovereign every fault committed by the citizens. We ought not then to say in general, that we have received an injury from a nation, because we have received it from one of its members.<sup>11</sup>

More than Grotius who adhered above all to the description of the 'practice', Vattel underlines the substantive foundation of the rule: it rests on the requirement of retributive justice linked to a recognition of the free will of the State, in other words a subjective conception of responsibility. This

is in fact only possible from the moment that, to paraphrase Dionisio Anzilotti,<sup>12</sup> there exists a relationship between the material fact that is complained of and a determined *subject*. The transposition to international law naturally happens through the recognition of the State as a legal person, which constitutes the premise for the modern theory of international law, Vattel being the first to formulate it in a coherent manner.<sup>13</sup>

The second step in Vattel's analysis resides in the listing of 'exceptions' to the rule of irresponsibility. Here he takes up again the theory of complicity/co-responsibility put forward by Grotius, nevertheless restricting it to situations where the State has not participated directly in the alleged acts. Responsibility can thus result from the action of the State:

But if a nation or its chief approves and ratifies the act of the individual, it then becomes a public concern and the injured party is to consider the nation as the real author of the injury, of which the citizen was perhaps only the instrument.<sup>14</sup>

Or its omission:

The sovereign who refuses to cause reparation to be made for the damage done by his subject, or to punish the offender, or finally, to deliver him up, renders himself in some measure an accomplice in the injury, and becomes responsible for it.<sup>15</sup>

Beyond their own complexity, these writings immediately allow us to discern the essence of the subject that we are concerned with, which has hardly changed since 1625.

The basic rule appeared clearly in the writings of past and current authors: the State should not be held responsible for acts committed by private persons. Here, we can see that the regime of international responsibility was and remains a regime that is mainly articulated around a subjective conception of responsibility. Responsibility results from the imputation of an act to a *subject* of the international legal order, in other words a legal (p. 261) person endowed with sovereignty, this being nothing more than the equivalent for the State on the international level of the liberty of the individual on the domestic level.<sup>16</sup> The process of 'objectivization' of this regime by erasing harm and fault under the influence of ILC Special Rapporteur Ago has certainly weakened this subjective character, but has not completely eliminated it.<sup>17</sup> There are two 'exceptions' which are not really exceptions at all, in the sense that they do not really constitute special cases where the responsibility of the State is engaged by the act of individuals in derogation from the general rule, but rather situations where the responsibility of the State is engaged in an autonomous manner, following classical principles of imputation. The first situation is where the responsibility of the State is engaged by acts which are *a priori* attributable to individuals but which eventually turn out to be attributable to the State, because of the existence of a factual link between these acts and State activity.

The second situation concerns the case where the responsibility of the State is catalysed by the act of a private person: the responsibility of the State is engaged not on the basis of this act, but on the basis of an act of the State by which it violates its own obligations in international law.

## **1 The rule of non-attribution of the conduct of private persons to the State**

First the statement of the rule must be examined, both from a theoretical and legal point of view, before determining its exact scope.

### **(a) The exposition of the rule**

In international law, the State as a person is only responsible for acts which are attributable to it. This autonomy of the State as a person makes it in theory impossible to attribute to the State acts of persons or things that it does not 'watch over'. The rule thus ensues above all from a theoretical

requirement: attribution can only occur in relation to an autonomous person and autonomy requires that only acts resulting from an exercise of free will can be attributed to it. Objectified, this condition implies that only acts that can be attached to a State objectively through a legal, functional, or factual link or through an organ can be attributed to that State.

In addition to this theoretical foundation, the rule is based on an important practical consideration: it cannot be required of a State that it is in control of all the events which take place on its territory, short of obliging it to become a totalitarian State. As a result, as the International Court held in *Corfu Channel*,<sup>18</sup> territorial sovereignty should not be considered as immediately entailing the responsibility of the State for all wrongful acts committed on its territory, or as implying a shift of the burden of proof of this responsibility.<sup>19</sup>

Such a systematic link between territorial sovereignty and responsibility can only result from a regime of objective responsibility 'for risk'. But responsibility on this basis is no longer based on the attribution of a wrongful act to the State. The rules which govern this (p. 262) type of responsibility do not have the character of 'secondary' rules, in other words rules the implementation of which is subordinate to the previous occurrence of a wrongful act, that is to say a breach of a 'primary' obligation. The rule which lays down the principle of objective responsibility is as such a new primary rule which prescribes reparation by the State for all harm caused on the territory, whoever the perpetrator of the harm may be.<sup>20</sup> From then on, there is no 'imputation' to the State of wrongful acts by private persons who are potentially the source of the harm, since responsibility does not require a wrongful act or the imputation of the act to this person for it to be engaged.

Within the ILC, the rule of non-attribution was drawn up by Special Rapporteur Ago in his Fourth Report in 1972.<sup>21</sup> The Special Rapporteur proposed to state it in the first paragraph of the draft article headed 'Conduct of private individuals'. The second paragraph had the purpose of specifying that this rule is without prejudice to the engagement of the responsibility of the State for the breach of its own obligations in relation to the acts of individuals: '[t]he conduct of a private individual or group of individuals, acting in that capacity, is not considered to be an act of the State in international law'.<sup>22</sup> The discussions of draft article 11 took place in 1975.<sup>23</sup> All the members agreed on the relevance of the principle stated in paragraph 1. Several members nevertheless highlighted the not very appropriate character of the term 'individual' and moved the Special Rapporteur and the Drafting Committee to replace it with the word 'person', which covers both legal and physical persons.

More profoundly, Paul Reuter observed during the discussion that draft article 11, as a whole, did not contribute anything to the draft articles in the sense that 'its only purpose was to explain the consequences of what had been stated in preceding articles and what would be stated in subsequent articles'. Therefore, 'if it did not appear in the draft articles, the substance of international law would not be changed'.<sup>24</sup>

Despite this lucid observation, draft article 11 was provisionally maintained in the draft and adopted by the Commission as revised by the Drafting Committee: '[t]he conduct of a person or a group of persons not acting on behalf of the State shall not be considered as an act of the State under international law'.<sup>25</sup> At the presentation of the text, the president of the Drafting Committee explained that 'for the sake of precision, and in order to employ the language already used in [draft] article 8' which dealt with the attribution to the State of the conduct of persons acting in fact on behalf of the State, the Committee preferred 'to replace the phrase "acting in a purely private capacity" by the phrase "not acting on behalf of the State"'.<sup>26</sup>

In this form, draft article 11(1) in fact appeared to be the converse of article 8(a). This explains why, in 1980 Chile proposed in its comments on the draft articles to merge the provisions of draft article 11(1) with draft article 8(a),<sup>27</sup> while in 1998, the United States proposed the simple deletion of draft article 11. This option was preferred by the new Special Rapporteur James Crawford, and subsequently also by the ILC itself. In his report, the Special Rapporteur notes the lack of autonomous content of draft article 11:

(p. 263) On analysis, it says nothing more than that the conduct of private individuals or groups is not attributable to the State unless that conduct is attributable under other provisions of chapter II. This is both circular and potentially misleading.<sup>28</sup>

James Crawford thus proposed the deletion of article 11, while suggesting that the substance of the commentary to the article should be maintained and redeployed elsewhere.

With the deletion of article 11(1), the draft articles have become undoubtedly less educational but more logical, in the sense that the subject of this part of the draft consists of the description of cases of attribution of conduct of private persons to the State. In fact, article 11(1) fulfilled no function because of its negative wording.

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 References

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## **(b) The scope of the rule**

The rule of non-attribution covers all acts of all private persons who do not act on behalf of the State, *including* acts of persons who, although they have the status of State agents, when they act do so in their personal capacity.<sup>29</sup> In essence, we can find here the old distinction of French administrative law between personal faults and faults in service (*fautes de service*).<sup>30</sup>

But the whole difficulty consists in drawing the line between purely private acts and *ultra vires* acts, or in other words the act committed by a person under the cover of his official function but in excess of his authority or in contradiction to instructions given to him. The stakes are not low: while purely private acts of a State agent should not be attributed to the State, *ultra vires* acts will always be attributable by virtue of a well-established rule of international law, which is codified in article 7 of the ILC Articles, headed 'Excess of authority or contravention of instructions':

The conduct of an organ of a State or of a person or entity empowered to exercise elements of the governmental authority shall be considered an act of the State under international law if the organ, person or entity acts in that capacity, even if it exceeds its authority or contravenes instructions.<sup>31</sup>

To resolve this problem, international law uses the 'theory of appearance'. Thus in the Commentary by the ILC to the predecessor to article 7 adopted on first reading (then draft article 10) it was stated:

In international law, the State must recognize that it acts whenever persons or groups of persons whom it has instructed to act in its name in a given area of activity *appear* to be acting effectively in its name.<sup>32</sup>

The 'theory of appearance' apparently fulfils a protective function for the person or the victim State following 'an excusable error, that is to say done in good faith', in relation to an act of a functionary which appeared to be an official act.<sup>33</sup> It should thus not serve as a basis for the institution of a form of objective responsibility 'for risk'. In fact, the theory (p. 264) of appearance does not exclude the wrongful act of the State: it constitutes it through a fiction the purpose of which it is to protect the interests of the person and the State injured by the act having the appearance of an official act.

We now understand the necessity of defining 'the excusable error'—to draw the limit between what can reasonably be considered as an act of the State following appearances, and what is *manifestly* not State activity. Three awards given by the US/Mexico General Claims Commission deal with this difficulty by distinguishing between a 'simple fraud' and situations where one can speak of an 'excess of power'.<sup>34</sup> Inspired by this jurisprudence and other precedents, Special Rapporteur Ago distinguished the case where 'the individual organ obviously acts in an individual capacity and commits acts which have nothing to do with its place in the State machinery' from that

of 'the individual organ' which 'is manifestly acting in the discharge of State functions and not in a purely personal capacity' but whose acts are:

although allegedly committed in the name of the State, are so completely and manifestly outside his competence, or fall within the scope of State functions so visibly different from those of the official in question, that no one could be mistaken on that score.<sup>35</sup>

We can see here a development in international law of a distinction which in French administrative law would correspond to 'degrees' of personal fault, ranging from pure personal fault to personal fault which is not without any link to the service. Ago translated this 'exception' to the rule of attribution of the *ultra vires* act into the text of his draft article 10(2), which is worded:

However, such conduct is not considered to be an act of the State if, by its very nature, it was wholly foreign to the specific functions of the organ or if, even from other aspects, the organ's lack of competence was manifest.<sup>36</sup>

Unfortunately, this important specification is not taken up in the version of the article adopted by the ILC on first reading, or in the current article 7, even though one can find a trace of it in the Commentary to article 7<sup>37</sup> and even though the words 'if the organ, person or entity acts *in that capacity*' can potentially be interpreted as excluding the case of manifest incompetence.<sup>38</sup>

The rule of non-attribution being so stated and specified in its scope, it is now necessary to see in what cases an act which is *prima facie* attributable to an individual can nevertheless engage the responsibility of the State. A first group of situations concerns the case where the act of the private person considered is linked in some way to the State activity.

## **2 The attribution to the State of conducts of private person linked to the activity of the State**

According to the ILC 'attribution of conduct to the State as a subject of international law is based on criteria determined by international law and not on the mere recognition of a link of factual causality'.<sup>39</sup>

(p. 265) Here, Dionisio Anzilotti's imprint can be seen: for him attribution can only be in any legal order 'an effect of the norms that compose it'.<sup>40</sup> Attribution thus constitutes a question of law before being a question of fact: it can only occur in the application of rules and fixed criteria of international law. Furthermore, these rules and criteria are defined in an autonomous manner by international law and take precedence over the rules of domestic law. That being the case, the domestic rules of attribution of competences should not determine the attribution of an act to the State, at least where international law does not designate them as relevant criteria.

As we have seen, the fundamental rule is that the acts that relate to the decision of the State as an autonomous person must be attributed to the State. This power of decision is presumed where the author of the act is an organ of the State, even though this presumption can be rebutted by showing that the organ-individual has acted in its personal capacity (on the other hand, as we have seen above, the fact that the organ acts *ultra vires* does not suffice). This is the sense of article 4 ARSIWA 'Conduct of organs of a State'. Outside this situation, the power of decision can be established in two different ways: either by showing that the State has made the reproached conduct *a priori* his own: this is the situation envisaged by ARSIWA, article 11 'Conduct acknowledged and adopted by a State as its own'; or by showing a link between the individual perpetrator of the act and the State (understood as the organ apparatus *or* as function): this link may be *de jure* or *de facto*. The first situation, the *de jure* link, is illustrated by ARSIWA article 5 'Conduct of persons or entities exercising elements of governmental authority' as far as the person or entity concerned is, according to this article, 'empowered by the law of that State to exercise elements of the governmental authority'. The second situation is illustrated by ARSIWA articles 6 'Conduct of organs placed at the disposal of a State by another State', 8 'Conduct directed or

controlled by a State', and 9 'Conduct carried out in the absence or default of the official authorities'.

Of these different situations, only three interest us in this study: on the one hand, the two cases of attribution based on a *de facto* link where the acts of private persons are taken into account (ARSIWA, articles 8 and 9); and on the other hand the *a posteriori* endorsement of conduct which is originally not attributable to the State (ARSIWA, article 11).

### **(a) Control of the State: the de facto organ (ARSIWA, article 8)**

The original version of article 8 presented by Ago in 1974, as well as that adopted by the ILC in 1974, included the different concepts of the *fonctionnaire de fait* (the person who exercises elements of governmental authority in the absence or default of the official authorities) and of the *de facto* organ. The dissociation only took place at a later stage, under the initiative of James Crawford, and the current text comprises article 8 on *de facto* organs and article 9 on the *fonctionnaire de fait*.

It is nevertheless true that these two situations are based on similar logic: in both cases, international law bases the attribution of acts committed by private persons to the State on the existence of certain given facts, as opposed to an attribution based on an institutional or legal link. Ago's first draft takes note of this similarity in approach, but also of the substantial difference which divides the two concepts:

(p. 266) The conduct of a person or group of persons who, under the internal legal order, do not formally possess the character of organs of the State or of a public institution separate from the State, but in fact perform public functions or in fact act on behalf of the State, is also considered to be an act of the State in international law.<sup>41</sup>

In the first situation, it is the nature of the function which makes the act attributable to the State. In the second, it is the existence of a factual link between the private person and the State which allows one to deduce from it that the former acts on behalf of the latter.

The whole complexity of the notion of *de facto* organ lies in the explication of this notion of action undertaken 'on behalf' of the State, which can be found in the second version of the text, adopted by the Commission in 1974:

The conduct of a person or group of persons shall also be considered as an act of the State under international law if

(a) it is established that such person or group of persons was in fact acting on behalf of that State ...<sup>42</sup>

In the commentary adopted in relation to this article, the ILC explains that it intended to bring together two distinct phenomena: the first concerns cases where 'the organs of the State supplement their own action and that of their subordinates by the action of private persons or groups who act as "auxiliaries" while remaining outside the official structure of the State'.<sup>43</sup> The second regroups the cases where the State entrusts private persons with the execution of 'duties and tasks' which it does not want to carry out directly: in other words, as Paul Reuter explains (with fewer circumlocutions), 'the lower work of the State: spying, provocation, sabotage, etc'.<sup>44</sup>

But the ILC provided only few elements to define the notion of an act completed on behalf of the State. It confined itself to drawing attention to the difficulty of showing proof for the *de facto* link:

The Commission wishes nevertheless to make it quite clear that, in each specific case in which international responsibility of the State has to be established, it must be genuinely proved that the person or group of persons were actually *appointed* by organs of the State to discharge a particular function or to carry out a particular duty, that they performed a

given task at the instigation of those organs.<sup>45</sup>

It was on exactly this point that the efforts of the new Special Rapporteur James Crawford would focus. In truth, he had more material to work with than Roberto Ago: between 1980 and 1998, several courts, quasi-courts, and tribunals had decided on the issue of imputation relating to a situation of fact.

Thus, in his first report, Crawford cited several 'precedents': the judgment on the merits by the ICJ in *Military and Paramilitary Activities in and against Nicaragua*,<sup>46</sup> the award of the Iran-US Claims Tribunal in *Yeager*;<sup>47</sup> the case of *Loizidou* where the European Court of Human Rights delivered two judgments on the preliminary objections<sup>48</sup> and the (p. 267) merits;<sup>49</sup> and finally the *Tadić* case which gave rise to two decisions of the International Criminal Tribunal for the former Yugoslavia in which the issue of the *de facto* organ is dealt with: a judgment of the Trial Chamber on 7 May 1997 and a judgment of the Appeals Chamber of 15 July 1999 (*Tadić II*).<sup>50</sup>

To this list we can add the report of the European Commission of Human rights on the case of *Stocké v Germany*<sup>51</sup> on the collusion between an informer and the German police with view to the arrest of a criminal, the judgments in *A v France*<sup>52</sup> and *MM v The Netherlands*<sup>53</sup> concerning phone tapping carried out by private persons upon the instigation and under the direction of the police, the judgments and decisions of the European Court of Human Rights that confirm the *Loizidou* case<sup>54</sup> as well as the decision of the Working Group on Arbitrary Detention in relation to the 'Handling of communications concerning detention at the Al-Khiam prison (southern Lebanon)' that bases its conclusions on the reasoning of the ICTY Appeals Chamber in the *Tadić II* judgment.<sup>55</sup>

Here, 'jurisdictionalization of international law' is at work! And, in light of this jurisprudence, it is easier to understand why some are concerned about the risks of 'fragmentation' which this multiplication of international courts could create for the international legal order.<sup>56</sup> In fact, the solutions devised for the same problem are very diverse and even sometimes contradictory. If we wanted to draw a rough sketch of the debate, we would say that there are the supporters of a strict conception of the *de facto* organ, based on the notion of 'complete dependence' or, at least, effective control of the State over the person or group of private persons on the one side, and the supporters of a supple conception based on the notion of global control on the other.

The former position was defined by the Court in *Nicaragua* in 1986 in relation to the link that the United States had with the 'Unilaterally Controlled Latino Assets' ('UCLAs') on the one side, and the *contras* on the other.<sup>57</sup> As for the former, the Court recognized that their acts were imputable to the United States in so far as they were 'paid by, and acting on the direct instructions of, United States military or intelligence personnel'.<sup>58</sup> But the Court refused on the other hand to recognize the latter as *de facto* organs, even though they were financed, aided and supported in various ways by the United States: on the one hand, the *contras* were not a pure creation of the United States and were not, as such, in a state of 'complete dependence' that would permit them to be assimilated with an organ of the State; on the other hand, the United States did not exercise 'effective control' over (p. 268) them in all their military or paramilitary operations. Nothing in fact proved that the United States had specifically 'directed or enforced the perpetration of the acts contrary to human rights and humanitarian law alleged by the applicant State'.<sup>59</sup> In the absence of any effective control, the *contras* could have committed these acts *outside* of the control of the United States.<sup>60</sup>

This position was energetically supported by Roberto Ago who had become a judge of the Court, in his separate opinion. For Ago, the position of the Court agreed perfectly with the ILC draft articles on the subject. According to him, it was impossible to attribute *prima facie* the acts of the *contras* to the United States:

Only in cases where certain members of those forces happened to have been specifically charged by United States authorities to commit a particular act, or carry out a particular task of some kind on behalf of the United States, would it be possible so to regard them.<sup>61</sup>

In this context, the determination of the quality as *de facto* organ depends on the fulfilment of two

conditions:

- the existence of a *de facto* link between the State and the person or group of private persons, in the form of, for example, 'United States participation ... in the financing, organizing, training, supplying and equipping of the *contras*, the selection of its military or paramilitary targets, and the planning of the whole of its operation' <sup>62</sup> ; and
- either a complete dependence of the person or group of private persons on the State; or the exercise by the State of an *effective control* over those persons or groups, that allows to deduce from it that the acts in question have been ordered or imposed on this person by the State.

The existence of the second condition—which supplements the finding of a simple factual link—is in the end only the symptom or the consequence of a conception of responsibility that is still subjective, in which *fault* continues to play a role as a generating fact. It is the idea that the act must come from the free will of the State which translates the condition of 'effective control', in other words, it must be *wanted* by the State-person. In a subjective conception of responsibility, this will is *presumed* where the author of the act is an organ of the State from a legal point of view or because of the organ structure. On the other hand, where the author is only linked to the State by an objective factual attachment that does not in itself suffice to determine attribution, this will must be demonstrated. This explains why, for Roberto Ago, the attribution of an *ultra vires* act may be possible in one case (where there is a State organ *de jure*), and impossible in the other case (where there is a *de facto* organ):<sup>63</sup> since the *ultra vires* act is by definition committed *without* the control of the State, by going beyond or breaching its orders or instructions.

It is to be noted that this strict conception of attribution has been repeated by the Court in its more recent ruling of 26 February 2007 in the case of the *Application of the Convention on the Prevention and Punishment of the Crime of Genocide*. However, the Court took a slightly different stand by distinguishing between the hypothesis of the '*de facto* organ' and that of a private person acting under the 'effective control' or instructions by the State. The Court considered the former under the heading of article 4 of the ILC Articles and (p. 269) the latter under the heading of article 8. This approach does not convince us, as it mixes two distinct cases of attribution, the one being based on legal or institutional links, and the other on factual links.

Contrary to what was suggested in Crawford's First Report, the *Loizidou* judgments of the European Court of Human Rights are not on the same level as the *Nicaragua* judgment.<sup>64</sup> In this case, the Greek Cypriot applicant complained of a breach of her right for the respect for her possessions as guaranteed under Article 1 of the Protocol 1 to the European Convention, following the occupation and persistent control of the Northern part of Cyprus by Turkish armed forces that had prevented several attempts to access her home. The Turkish government alleged that the acts raised by the applicant were not within its competence but in that of the 'Turkish Republic of Northern Cyprus' (TRNC), created in 1983 and recognized on an international level only by Turkey.

The Court did not at any time consider the question of classifying the TRNC as a *de facto* organ of Turkey. It immediately classified it as 'subordinate local administration' which echoes article 4 ARSIWA, rather than article 8:

Bearing in mind the object and purpose of the Convention, the responsibility of a Contracting Party may also arise when as a consequence of military action—whether lawful or unlawful—it exercises effective control of an area outside its national territory. The obligation to secure, in such an area, the rights and freedoms set out in the Convention derives from the fact of such control whether it be exercised directly, through its armed forces, or through a subordinate local administration.<sup>65</sup>

Even though it invokes the notion of 'global control', this is not the point:

It is obvious from the large number of troops engaged in active duties in northern Cyprus



[...] that her army exercises effective overall control over that part of the island. Such control, according to the relevant test and in the circumstances of the case, entails her responsibility for the policies and actions of the 'TRNC' [...]. Those affected by such policies or actions therefore come within the 'jurisdiction' of Turkey for the purposes of Article 1 of the Convention (art. 1). Her obligation to secure to the applicant the rights and freedoms set out in the Convention therefore extends to the northern part of Cyprus.<sup>66</sup>

The use of the notion 'overall control' really aims at determining the factual sway of Turkey outside its national frontiers, on a territory and a population that does not belong to it. Within the context of the Convention, this test fulfils a double function: at the stage of admissibility, it is about knowing whether the persons who are in the Northern part of Cyprus fall within the 'jurisdiction' of Turkey within the meaning of Article 1 of the Convention; at the merits stage, the existence of overall control allows one to establish that all acts committed by its organs *de jure* or *de facto* on this territory are attributable to Turkey. 'Overall control' thus expresses the extraterritorial dimension of the responsibility of State Parties to the Convention. But it has nothing to do with the definition of a *de facto* organ.

On this point, the contribution of the International Criminal Tribunal for the former Yugoslavia is more useful, even though it may seem unlikely if one relates it to the internal logic and the mandate of the Tribunal. It may be questioned why a court which is responsible for establishing the responsibility of individuals in international criminal law has reflected on (p. 270) the criteria of attribution in the framework of international State responsibility. In fact, the Tribunal has resorted to these criteria as a complement in the interpretation of the notions of humanitarian law, ie the concept of the protected person and the distinction between international and internal armed conflicts. It has thus ruled that after the retreat of the Federal Republic of Yugoslavia from the territory of Bosnia-Herzegovina on 19 May 1992, the Bosnian conflict could not be classified as international and the Muslim Bosnians subject to the power of the Serbs considered as protected persons under the Geneva Convention IV unless the acts of the Bosnian Serb Army (VRS) were in fact attributable to the FRY, in other words if the VRS was a *de facto* organ of the FRY.

This means that the two regimes have been mixed up; in doing so the Tribunal ignored the specificity of the question of attribution, the criteria of which are only established for the purpose of establishing international responsibility of a State. The classification of a conflict as internal or international for the purposes of the application of international humanitarian law is a mere question of fact which calls for the evaluation of the degree of intervention of a State in an internal conflict. The forms of intervention can be very different, and, in any case, may have aspects other than 'control' exercised over one of the parties of the internal conflict.<sup>67</sup>

Even though it is possible to contest the opportunity of intrusion of the ICTY into the field of attribution, one cannot as such deny that its reasoning constitutes a useful approach to the question. The jurisprudence is set by the Appeals Chambers in its judgment in *Tadić II*.<sup>68</sup> In that judgment, the Appeals Chamber overruled the judgment of the Chamber at first instance of 7 May 1997, insofar as it had resorted to the criterion of 'effective control' enunciated in the *Nicaragua* judgment to determine if the VRS could be considered as *de facto* organ of the FRY. The appeals chamber considered that this criterion could not be reconciled with either the 'Logic of the Law on Responsibility'<sup>69</sup> nor with 'Judicial and State Practice'.<sup>70</sup> In its place, it substituted a three-pronged criterion according to the type of situation that is encountered: 'specific instructions', approval or endorsement *ex post facto* for isolated persons or armed bands that are not structured; 'overall control', where we are dealing with a hierarchical group which is well organized, which means that the State has organized, coordinated, or planned the military action of the armed group, and has financed, trained, equipped, or supplied it with operational support; finally, the Chamber envisaged a last situation, drawn from precedents in criminal law: where a person who is not formally part of the administration of the State participates in its activities with all the appearances of the organ of the State.<sup>71</sup>

In essence, this is reserving the criterion of 'effective control' to acts committed by isolated

individuals or non-hierarchical groups. It is questionable what justifies this distinction. One can without doubt explain it with an argument of opportunity—it is more difficult to prove that the act has been committed on behalf of the State within the framework of a nonhierarchical group—and by a logical argument—there is a presumption of intention within the framework of a hierarchical structure. But in the end, the Tribunal remained in the same conceptual area as the International Court: requiring proof of control, whether ‘effective’ (p. 271) control or ‘overall’ control, relates to a subjective conception of State responsibility that does not really have a place any more, as from the moment where it was decided to objectivize responsibility by excluding fault and harm as conditions for responsibility.

From this point of view, the formulation that was chosen in the end by the ILC is a good compromise, in the sense that it is sufficiently vague to allow different interpretations. James Crawford was in favour of a more subjective conception of attribution, in keeping with Roberto Ago. His draft was worded as follows:

The conduct of a person or group of persons shall also be considered as an act of the State under international law if:

- (a) The person or group of persons was in fact acting on the instructions of, or under the direction and control of, that State in carrying out the conduct.<sup>72</sup>

The solution chosen by the ILC in article 8 ARSIWA consisted of replacing the ‘and’ between ‘direction’ and ‘control’ with ‘or’:

The conduct of a person or group of persons shall be considered an act of a State under international law if the person or group of persons is in fact acting on the instructions of, or under the direction or control of, that State in carrying out the conduct.

The criterion of ‘control’ thus becomes an autonomous criterion, alternative in relation to two others.<sup>73</sup>

The ILC also abstained from qualifying the type of control that is required: that being the case, it can thus be understood either as a subjective condition of attribution—‘effective’ or ‘overall’ control—or as an objective condition, a form of factual link, just like an ‘instruction’ given or ‘directives’.

The attempt of the ILC to settle the question of the *ultra vires* act of the *de facto* organ is less convincing:

In general a State, in giving lawful instructions to persons who are not its organs, does not assume the risk that the instructions will be carried out in an internationally unlawful way. On the other hand, where persons or groups have committed acts under the effective control of a State, the condition for attribution will still be met even if particular instructions may have been ignored. The conduct will have been committed under the control of the State and it will be attributable to the State in accordance with article 8.<sup>74</sup>

The theory of objective responsibility for a risk here erupts in an inopportune manner to distinguish two cases which are in the end not very different, if it is accepted that attribution is founded on the existence of a factual link between the State and the private person. The only notable difference is in fact temporal: in one case a factual link at a particular point, while in the other, ‘control’ constitutes a continuous factual link.

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 References

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## **(b) The use of public power in the absence or default of the State (ARSIWA, article 9)**

Unlike the previous hypothesis, the use of public power hardly raises any difficulties. It has always been broadly agreed by the ILC, both in relation to its principle and the conditions of its application. Attribution rests mainly on the finding of the exercise of State functions (p. 272) by a private person in circumstances which make this exercise legitimate. This action is purely spontaneous: the individual acts from his own initiative.

The criterion of State activity which can be found in several places in the draft articles lies in the exercise of prerogatives of public power. The problem of incompetence is covered by the absence or default of the official authorities and by the fact that public functions would, in one way or another, be called for 'though not necessarily the conduct in question'. The ILC states in its Commentary to article 9:

Such cases occur only rarely, such as during revolution, armed conflict or foreign occupation, where the regular authorities dissolve, are disintegrating, have been suppressed or are for the time being inoperative.<sup>75</sup>

In other words, public action is *necessary* as a principle considering the circumstances, which does not as such make the act of the individual who has intended to substitute himself for the failing public authorities lawful. This nuance was badly conveyed by the expression 'in circumstances which justified the exercise of those elements of authority' which was used in the version of the text adopted on first reading.<sup>76</sup> This is why Crawford proposed to replace 'which justified' with 'call for' to better express the idea that the conduct itself could not be 'justified', that is to say rendered lawful because of the circumstances. In the final version of the text, the ILC adopted an expression which translates the same idea 'in circumstances such as to call for the exercise of those elements of authority'.

In this form, what the successive Special Rapporteurs themselves have assimilated to the theory of the *fonctionnaire de fait* is not so much grounded on the theory of appearance, but rather on a particular form of the state of necessity—not that which is recognized by the ILC text in article 25 ARSIWA, insofar as the effect of necessity is not, here, to exclude the wrongfulness of the act, but simply to proceed to the attribution to the State of a wrongful act committed under certain conditions. In fact, according to the text, it is not decisive that the private person is *apparently* competent to exercise public functions. Rather, the attribution results from the conjunction of the absence or insolvency of the authorities and from the necessity for the individual who is confronted with an exceptional situation, to act immediately by using the prerogatives that flow from public power.

Under these conditions, it may be asked whether article 9 includes the classic situation of the act which is adopted by an incompetent authority which nevertheless has, in the eyes of others, the appearance of authority normally vested with the exercised competence, when such an act is adopted under perfectly normal circumstances.<sup>77</sup> Roberto Ago had envisaged this case, but it seems that he lost sight of it afterwards. The same observation can be made concerning the theory of '*gestion d'affaire*', where an individual finds himself in the position to make use of public finances and manages them.

Even though the principle was familiar to all national legal traditions, the examples in international law, as they emerge from the ILC reports, are not uniform. The theory of the *fonctionnaire de fait* seems to have been received first in international humanitarian law, (p. 273) through the idea of the *levée en masse*, which is expressed in article 2 of the Regulations concerning the Laws and Customs of War on Land, annexed to Hague Convention II of 1899 and Hague Convention IV of 1907 respecting the Laws and Customs of War on Land, and in article 4(A)(6) of the Geneva Convention (III) relative to the Treatment of Prisoners of War.<sup>78</sup> These two provisions extend the category of 'belligerent' to the population of a non-occupied territory which, on approach by the enemy, spontaneously takes to the arms to fight invading troops. The acts of this improvised army are attributed to the attacked State.

The second 'precedent' cited by the ILC in its commentary to article 9 is the award given by the

Iran-US Claims Tribunal in *Yeager*. But if the Tribunal had recourse to this hypothesis, then it was by reference to draft article 8 adopted in 1980. The hypothesis of the *fonctionnaire de fait* is not invoked exclusively, but is coupled with that of the *de facto* organ, the two paragraphs of draft article 8 thus constituting alternative foundations for the attribution to Iran of the acts of the 'Komitehs' or 'Revolutionary Guards' who had harmed the applicant.<sup>79</sup>

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### **(c) A posteriori endorsement of conduct by a State (ARSIWA, article 11)**

The singularity of this last hypothesis was highlighted by Crawford in his first report to the ILC. Roberto Ago had not clearly distinguished it from the cases where a State does not show the diligence required to prevent or punish a wrong attributable to private persons, in accordance with its international obligations. The analysis of the award by the British-Colombian Mixed Commission in the *Cotesworth and Powell case* of 5 November 1875, presented in Ago's Fourth Report, shows that he skimmed over the question, without reflecting on it as a separate issue. He cites the following thought-provoking passage from the award:

One nation is not responsible to another for the acts of its individual citizens, except when it approves or ratifies them. It then becomes a public concern, and the injured party may consider the nation itself the real author of the injury. And this approval, it is apprehended, need not be in express terms; but may fairly be inferred from a refusal to provide means of reparation when such means are possible; or from its pardon of the offender when such pardon necessarily deprives the injured party of all redress.<sup>80</sup>

The barely modified passages from *Droit des gens* by Vattel can be recognized (it was cited in the introduction to this chapter). But where Vattel carefully distinguished the two situations of co-responsibility for action and for omission, the award confuses them. What is worse, it makes the latter a modality of the former! The passage only interested Roberto Ago because of this contradiction: he is keen to show that the award goes astray by attributing the act of the individual to the State, while it is responsible only because of its own act, for having been negligent to punish or for having given amnesties to guilty parties. But then, he sidesteps the first hypothesis of attribution which is evoked by Vattel, based on the approval or ratification of the act of the individual by the State. It is this hypothesis that Crawford resurrected and that the ILC integrated in article 11 as finally adopted.

(p. 274) In the case of *negligence* as in the case of endorsement, the State does not directly participate in the commission of the act: it is committed by a third party entirely. But while responsibility is based in the former case on inaction in breach of international obligations of the State which is faced with the act of the private person, it results in the latter case from this act itself, that the State has made its own by approving it.

The case of *United States Diplomatic and Consular Staff in Tehran*<sup>81</sup> perfectly illustrates the passage from one hypothesis to the other. The International Court of Justice carefully distinguished two phases in the attack and occupation of the United States embassy in Tehran. In a first phase, it is evident that the militants who attacked the embassy did not have the status of agents of the State, whether *de jure* or *de facto*. Their acts are thus not imputable to Iran.<sup>82</sup> As such, the Court specifies, this does not excuse Iran from its responsibility for its own conduct in relation to its acts, conduct which was incompatible with its international obligations under various provisions of the 1961 and 1963 Vienna Conventions on diplomatic and consular relations: Iran in fact took no measures to protect the premises, staff, and archives of the mission of the United States against the attack of the militants. It also did not do anything to prevent this attack or to stop it from succeeding.

In a second phase, Iran not only did nothing to resolve the situation, but endorsed the acts of 'students' through the ministry of foreign affairs and through the Ayatollah Khomeini himself:

The approval given to these facts by the Ayatollah Khomeini and other organs of the Iranian State, and the decision to perpetuate them, translated continuing occupation of the Embassy and detention of the hostages into acts of that State. The militants, authors of the invasion and jailers of the hostages, had now become agents of the Iranian State for whose acts the State itself was internationally responsible.<sup>83</sup>

In its commentary to article 11, the ILC sought to prevent errors such as that in the *Cotesworth and Powell* award by affirming the contrast between approval-tolerance and approval-endorsement. The least that one can say is that there is a difference in degree that is not always easy to grasp:

The phrase 'acknowledges and adopts the conduct in question as its own' is intended to distinguish cases of acknowledgement and adoption from cases of mere support or endorsement.... [A]s a general matter, conduct will not be attributable to the State under article 11 where a State merely acknowledges the factual existence of conduct or expresses its verbal approval of it. In international controversies States often take positions which amount to 'approval' or 'endorsement' of conduct in some general sense but do not involve any assumption of responsibility. The language of 'adoption', on the other hand, carries with it the idea that the conduct is acknowledged by the State as, in effect, its own conduct.<sup>84</sup>

But how should adoption and simple approval be distinguished in practice? The commentaries of the ILC lack concrete illustrations in this regard to enlighten the reader. The impression of confusion is even more accentuated by this proposal, the substance of which is taken from old commentaries:

(p. 275) Acknowledgement and adoption of conduct by a State might be express (as for example in the *Diplomatic and Consular Staff* case), or it might be inferred from the conduct of the State in question.<sup>85</sup>

If oral 'approval' does not suffice, it is difficult to see how simple 'conduct', even an ostensible one, could be so as to manifest the intention of the State to *adopt* the reproached conduct. Here again there is a lack of examples.

The originality of this case of attribution is due to the fact that it takes place *a posteriori*, after the commission of the act or during this commission, if it is a continuous act. In the latter case, the question of the *temporal scope* of the attribution may be raised: does the State assume it from the moment onwards when it makes it its own, or *ab initio*, in a retroactive fashion? For Crawford, 'If the adoption is unequivocal and unqualified ... there is good reason to give it retroactive effect.'<sup>86</sup> The Special Rapporteur cites in this sense the *Lighthouses* arbitration where an arbitral tribunal declared Greece responsible for breaching a concession agreement concluded by Crete when it was an autonomous territory of the Ottoman Empire, partly because the breach was 'endorsed by [Greece] as if it had been a regular transaction ... and eventually continued by her, even after the acquisition of territorial sovereignty over the island'.<sup>87</sup>

Another question is the *material scope* of attribution. This may vary depending on the content of the act by which the State takes position on the act of the individual. The State may in fact intend to assume only a part of this act. This idea is precisely translated in article 11 by the words 'if and to the extent that'.

In all the situations that we have just considered, the act which is *prima facie* attributable to a private person is *in fine* imputed to the State, because the deeper study of the situation reveals a link between this act and the State. These situations must thus be carefully distinguished from those where the act that is imputable to the private person only has the function of a catalyst for State responsibility. Responsibility is then the result of an act that pertains to the latter.

### 3 'Catalysis' of international State responsibility for conducts of private persons

The use of the notion of 'complicity' by a certain number of authors of the 19th century allow the establishment of an additional case of attribution of acts by natural persons to the State. Its rejection by the voluntarist doctrine at the beginning of the 20th century has the effect of excluding this issue from the framework of this chapter: in the future, it is clearly recognized that the act of the individual can at the very most *catalyse* the responsibility of the State which is engaged on the basis of a distinct foundation.

#### (a) Rejection of the theory of complicity

The notion of complicity is employed by certain authors of the 19th century to establish State responsibility where it refuses to prosecute or where it grants amnesty to an act that causes harm to a foreigner: this acquiescence or tolerance is interpreted as a form of (p. 276) *participation* in the act, a contribution which engages State responsibility for this act.<sup>88</sup> From then on, the amount of reparation owed by the State is calculated on the basis of the harm caused by the act itself and on the degree of participation of the State in the commission of the act.

According to Paul Reuter<sup>89</sup> the Anglo-Saxon doctrine has thus come to distinguish two types of responsibility:

- primary (original) responsibility of the State where the act committed emanates from the government or a person acting as its agent; and
- derived (*vicarious*) responsibility where the act emanates from any other person but the State has not taken the necessary measures to prevent or punish this conduct.

The notion of complicity is fiercely criticized by the voluntarist authors at the beginning of the 20th century in the name of a dualist conception of the legal orders. The international and internal legal orders constitute two separate spheres, with their own subjects. As a result, the individual, subject of internal law, cannot breach international law under which he has no obligations. In the same way, the State should not be co-responsible or accomplice to a breach of internal law of the State by an individual. The duality of these legal orders leads to a watertight nature for the systems of responsibility. But that does not exclude that State responsibility can arise at the commission of a breach of internal law by an individual, as Dionisio Anzilotti explains:

These acts, as done by individuals, are not contrary to international law, since individuals, being foreign to the rules of this law, should not breach its precepts; it is thus in the conduct of the State, that has omitted to prohibit these acts or to take measures necessary to prevent them, that the breach of international law is found: the wrongful act, from the point of view of international law, is, in such a case, the omission of the State and not the positive act of individuals; and the State is thus obliged because of *its* act, but not in its quality as *accomplice* of individuals, as has often been said since Grotius.<sup>90</sup>

Special Rapporteur Roberto Ago explained this mode of engaging responsibility with the idea of catalysis. The individual act is foreign to the act of the State. But it constitutes a *catalytic* element for its responsibility, insofar as, when confronted with such an act, the State breaches its international obligations.<sup>91</sup>

In fact, from a theoretical point of view, the rejection of the idea of complicity is not necessarily

linked to a dualist conception of the legal orders. It simply follows from the classical structure of normativity in international law which is articulated around the obligations, the only subjects of which are States and which are imposed on a more or less large circle of States which are bound by the same norm. Going beyond the dualist explanation seems necessary if one wishes to envisage certain phenomena that Anzilotti maybe could not distinguish clearly in his time.

(p. 277) First, contemporary international law directly imposes obligations on individuals, the breach of which can be the subject of criminal sanctions, this being the cases regardless of the position—official or not—of the author of the breach. So, a system of specific responsibility is associated with these obligations. The duality can thus be found at the level of international law: if the individual cannot be an ‘accomplice’ to a wrongful act of the State, the State can conversely not be the accomplice of an *international crime* within the meaning of international criminal law. However, this can find a clear exception when the norms that are breached do address both individuals and State at the same level. According to the ICJ, this is the case for the prohibition of genocide: in *Application of the Convention on Genocide*, the Court accepted the idea—although its conclusion was negative—that the Federal Republic of Yugoslavia could be found complicit in the crime of genocide perpetrated by the Republika Sprska—a non-State actor—in Srebrenica.<sup>92</sup>

In the same way, one cannot exclude that the notion of complicity can find a place in international law, if the renewed forms of normativity induced by the institutionalization and centralization of the international society are taken into account. More and more, international organizations in fact tend to formulate norms which equally address private persons and States. If a private person and a State are bound by the same norm of international law, why should they not be capable of being considered as accomplices in its breach? It is still necessary that they are effectively bound by this norm, whether they have both accepted it voluntarily, or whether it is imposed on them in an ‘authoritarian’ manner, a situation which mainly concerns, in the case of States, the norms enacted by the UN Security Council where it acts under the terms of Chapter VII of the Charter.<sup>93</sup>

If these situations resulting from the recent evolution of international law are taken aside, it is certain that the idea of complicity has not adapted in the great majority of norms of public international law, the only subject of which is the State.

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## **(b) Responsibility of the State for its own act**

Generally speaking the State thus does not make itself an accomplice to the act of the individual. But it may be that it breaches its own obligations in relation to such an act. The classic foundation for the form of ‘responsibility by catalysis’ can be found in the obligation of due diligence which falls on any State with regard to nationals of foreign States that are on its territory.<sup>94</sup> This general obligation conceals two main obligations: the obligation to prevent attacks on persons and the obligation to punish the perpetrators of such attacks. And these two main obligations come in a variety of contextualized obligations, specified by treaty law (for example the Vienna Conventions on diplomatic and consular relations) or even by the international judge, depending on the case submitted to the court.

In the subject matter of human rights the jurisprudence has transposed the classic doctrine of due diligence to give rise to the general obligation of the State to *protect* individuals (p. 278) who fall within its jurisdiction against acts committed by private persons and who would be susceptible to being qualified as a breach of their rights, in the sense of the considered treaty (this is thus not in any way a ‘horizontal’ effect of the Convention).<sup>95</sup> Under this logic, the judge recognizes implicit ‘positive obligations’ for the State party for every human right.

So, for example, in *Osman v The United Kingdom*<sup>96</sup> the European Court of Human Rights had to determine if the responsibility of the United Kingdom was engaged under article 2 of the Convention (the right to life) because of an omission of the police that could not prevent the murder of a private

person by another private person. The Court considered on this occasion the extent of the obligation of due diligence that falls on States under article 2:

The Court notes that the first sentence of Article 2 § 1 enjoins the State not only to refrain from the intentional and unlawful taking of life, but also to take appropriate steps to safeguard the lives of those within its jurisdiction [...]. It is common ground that the State's obligation in this respect extends beyond its primary duty to secure the right to life by putting in place effective criminal-law provisions to deter the commission of offences against the person backed up by law-enforcement machinery for the prevention, suppression and sanctioning of breaches of such provisions.<sup>97</sup>

Having stated the problem, the Court defined the following standard:

In the opinion of the Court where there is an allegation that the authorities have violated their positive obligation to protect the right to life in the context of their above-mentioned duty to prevent and suppress offences against the person [...] it must be established to its satisfaction that the authorities knew or ought to have known at the time of the existence of a real and immediate risk to the life of an identified individual or individuals from the criminal acts of a third party and that they failed to take measures within the scope of their powers which, judged reasonably, might have been expected to avoid that risk. [...] For the Court, and having regard to the nature of the right protected by Article 2, a right fundamental in the scheme of the Convention, it is sufficient for an applicant to show that *the authorities did not do all that could be reasonably expected of them to avoid a real and immediate risk to life of which they have or ought to have knowledge*. This is a question which can only be answered in the light of all the circumstances of any particular case.<sup>98</sup>

In this particular context of the Convention, the State party that has to exercise due diligence—that is to say that to take all measures that can reasonably be expected of it—to prevent and sanction an act of a private person that intervenes in breach of article 2. But *in fine*, it is not the act of the private person that engages the responsibility of the State party, but rather the fact that the State itself is not in accordance with the required standard and thus with the positive obligation that falls upon it under article 2 of the Convention.<sup>99</sup>

(p. 279) The European Court has pushed this logic to a height in its judgment on merits in *Ilaşcu*.<sup>100</sup> The applicants found themselves in the hands of the authorities of the Moldavian Republic of Transdnistria (MRT), situated on Moldovan territory but having declared independence, it was under *de facto* overall control by the Russian Federation. Rather than contenting itself with engaging the responsibility of the Russian Federation—to which the acts of the MRT were imputed according to the principles of the *Loizidou* jurisprudence—the Court ruled that responsibility of Moldova in relation to the acts of the MRT could be engaged under its positive obligations. In other words:

even in the absence of effective control over the Transdnistrian region, Moldova still has a positive obligation under Article 1 of the Convention to take the diplomatic, economic, judicial or other measures that it is in its power to take and are in accordance with international law to secure to the applicants the rights guaranteed by the Convention.<sup>101</sup>

More recently, the ICJ applied the same kind of reasoning on the basis of the obligations to 'prevent' and 'punish' under the Genocide Convention.<sup>102</sup>

Did the rule of responsibility by catalysis have a place in the Articles on State responsibility? At first, the ILC responded positively to this question, under the influence of Special Rapporteur Ago. He considered it necessary to accompany the statement of the rule of non-attribution of acts of natural persons to the State under draft article 11(1) with a 'reservation' or a type of safeguard clause. This was situated in draft article 11(2) and specified that notwithstanding the rule of non-attribution, the State remained responsible 'by their passive attitude towards the action of



individuals'.<sup>103</sup> At the same time, Ago observed that it was necessary that 'no attempt whatsoever must be made to define, in this context, the content of the various obligations of protection incumbent upon the State with regard to foreign States, their official representatives or simply their nationals'.<sup>104</sup>

But during the discussions of this article, Ushakov remarked with clear-sightedness that the proposition of the Special Rapporteur contained a contradiction in terms:

In referring to the way in which an organ ought to have acted according to a primary rule of international law—which required it to prevent or punish the conduct of an individual—the Commission was taking a subjective element into consideration and leaving the sphere of 'acts of the State' to enter that of wrongful acts of the State.<sup>105</sup>

Ago rejected Ushakov's criticism but recognized that it was possible to detect in draft article 11 'a shift from the subjective element of attribution to the State, to the objective element of breach of an international obligation'.<sup>106</sup> During the discussion of the revised article by the Drafting Committee, Kearney observed that the paragraph could be deleted and replaced in the text of paragraph 1 with the idea that the rule of nonattribution does not prejudice the previously listed cases of attribution. But Ago stood fast and defended his paragraph with the help of explanations that Kearney judged to be 'not (p. 280) ... entirely satisfactory'.<sup>107</sup> The ILC thus adopted the article as revised by the Committee, with paragraph 2 worded as follows:

2. Paragraph 1 [which stated the rule of non-attribution of acts by private persons to the State] is without prejudice to the attribution to the State of any other conduct which is related to that of the persons or groups of persons referred to in that paragraph and which is to be considered as an act of the State, by virtue of articles 5 to 10.<sup>108</sup>

Ushakov and Kearney were right: with this paragraph 2, Ago derogated from the distinction which he himself had carefully elaborated between primary and secondary obligation—a distinction which both constituted the starting point and in a way the parapet of the new codification attempt that was undertaken under his leadership.

But as we know, some twenty years later, the new Special Rapporteur Crawford decided to offer a radical solution to these problems by purely and simply eliminating draft article 11 from the Articles. Since it is not as such a case of attribution of a wrongful act to the State, the idea of responsibility by catalysis has its place in textbooks of international law rather than in the codification of international law.

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 References

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### **Further reading**

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## Footnotes:

**1** *Application of the Convention on the Prevention and Punishment of the Crime of Genocide (Bosnia and Herzegovina v Serbia and Montenegro)*, Judgment of 26 February 2007; merits pending in *Croatia v Yugoslavia*.

**2** H Grotius, *The Rights of War and Peace* (R Tuck (ed), Indianapolis, Liberty Fund, 2005; 3 Vols) . I would like to warmly thank Professor Emmanuelle Jouannet for reviewing the lines that follow.

**3** *Ibid*, Vol II, 1053; Book II, Chapter XXI, I, 1; and see Book II, Chapter I .

**4** *Ibid*, 1053; Book II, Chapter XXI, I, 1 .

**5** *Ibid*, 1055; Book II, Chapter XXI, II, 1 (emphasis in original).

**6** *Ibid*, 1056; Book II, Chapter XXI, II, 1 .

**7** *Ibid*, 887-888; Book II, Chapter XVII, VI, VII .

**8** *Ibid*, 1053ff; Book II, Chapter XXI, I, 2 .

**9** *Ibid*, 888 ff; Book II, Chapter XVII, VIII, IX . The distinction established by Grotius between 'Expletive Justice' and 'Attributive Justice' (*ibid*, vol I, 142-147; Book I, Chapter I, VIII) constitutes a slightly deformed application of the Aristotelian distinction between commutative and distributive justice. The notion of 'Expletive Justice' refers *grosso modo* to commutative justice in Aristotle, but at the same time diverges from it since Grotius considers it as the only type that has 'perfect rights' as its objective, in other words rights that are binding and directly enforceable: see on this point E Jouannet, *Emer de Vattel et l'émergence doctrinale du droit international classique* (Paris, Pedone, 1998), 167ff .

**10** E Vattel, *The Law of Nations or, Principles of the Law of Nature Applied to the Conduct and Affairs and Nations and Sovereigns* (B Kapossy and R Whatmore (eds), Indianapolis, Liberty Fund, 2008; 2 Vols), Vol 1, 30 9ff;), Book II, Chapter VI .

**11** *Ibid*, 310; Book II, Chapter VI, para 73 .

**12** D Anzilotti, 'La responsabilité internationale des États à raison des dommages soufferts par des étrangers' (1906) 13 *RGDIP* 5, 13 .

**13** E Jouannet, *Emer de Vattel et l'émergence doctrinale du droit international classique* (Paris, Pedone, 1998) , *passim*.

**14** E de Vattel, *The Law of Nations or, Principles of the Law of Nature Applied to the Conduct and Affairs and Nations and Sovereigns* (B Kapossy and R Whatmore (eds), Indianapolis, Liberty Fund, 2008; 2 Vols), Vol I, 31 1; Book II, Chapter VI, para 74 .

**15** *Ibid*, 312; Book II, Chapter VI, para 77 .

**16** Cf J Combacau, 'Pas une puissance, une liberté: la souveraineté internationale de l'État' (1993) 67 *Pouvoirs* 47 .

**17** See P-M Dupuy, 'Le fait générateur de la responsabilité internationale des États' (1984-V) 188 *Recueil des cours* 9, 32 .

**18** *Corfu Channel Merits, Judgment, ICJ Reports 1949*, p 4.

**19** *Ibid*, 18.

- 20** On this point, see P-M Dupuy, *Droit international public* (6th edn, Paris, Dalloz, 2002), 464 .
- 21** R Ago, Fourth Report on State Responsibility, *ILC Yearbook 1972*, Vol II, 71 .
- 22** *Ibid*, 126 (para 146) .
- 23** *ILC Yearbook 1975*, Vol I, 214 .
- 24** *ILC Yearbook 1975*, Vol I, 31 (para 30) .
- 25** *Ibid*, 214 (para 10) .
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- 28** *Ibid*, 32 (para 247) .
- 29** See eg J-L Brierly, 'Règles générales du droit de la paix' (1936-IV) 58 *Recueil des cours* 172 .
- 30** Cf *Pelletier*, Tribunal des conflits, 30 July 1873, reproduced in *Les grands arrêts de la jurisprudence administrative* (13th edn, Paris, Dalloz, 2001), 8 .
- 31** A rule which can also be derived from international humanitarian law, as shown in *Armed Activities on the Territory of the Congo (Democratic Republic of Congo v Uganda)*, Judgment of 19 December 2005, para 214.
- 32** ARSIWA, Commentary to draft art 10, para 17, *ILC Yearbook 1975*, Vol II, 67 (emphasis added).
- 33** J-P Quéneudec, *La responsabilité internationale de l'Etat pour les fautes personnelles de ses agents* (Paris, LGDJ, 1966), 144–146 .
- 34** These awards are studied by Quéneudec, *ibid*, 142–143 .
- 35** R Ago, Fourth Report on State Responsibility, *ILC Yearbook 1972*, Vol II, 71, 93 (para 55) .
- 36** *Ibid*, 95 (para 60) .
- 37** Cf ARSIWA, Commentary to Art 7, paras 7–8.
- 38** In this sense see L Condorelli, 'L'imputation à l'État d'un fait internationalement illicite: solutions classiques et nouvelles tendances' (1984-VI) 189 *Recueil des cours* 9, 84 .
- 39** ARSIWA, Introductory Commentary to Part One, Chapter II, para 4.
- 40** D Anzilotti, *Cours de droit international* (1st edn, Paris, Librairie du Recueil Sirey, 1929 ; reprinted, Paris, Ed. Panthéon-Assas, 1999), 469 .
- 41** *ILC Yearbook 1974*, Vol I, 32 (para 1) .
- 42** *ILC Yearbook 1974*, Vol I, 152–153 (para 14) .
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- 44** P Reuter, 'La responsabilité internationale. Problèmes choisis (Cours de D.E.S. Droit public, 1955–1956)', in *Le développement de l'ordre juridique international. Ecrits de droit international* (Paris, Economica, 1995), 377, 461 .
- 45** *ILC Yearbook 1974*, Vol II(1), 284 (emphasis added).
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- 47** (1987) 17 *Iran-US CTR* 92ff.
- 48** *Loizidou v Turkey* (App No 15318/89), *Preliminary Objections*, *ECHR, Series A, No 310*.
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- 51** *Stocké v Germany* (App No 11755/85); the report is reproduced after the judgment of the Court

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**53** *MM v The Netherlands* (App No 39339/98), (2004) 39 *EHRR* 19.

**54** *Cyprus v Turkey* (App No 25781/94), *ECHR Reports 2001-IV*, paras 69–81; *Ilasçu and others v Moldova and Russia* (App No 48787/99), *ECHR*, Decision on Admissibility of 4 July 2001 [GC]; *Adali v Turkey* (App No 38187/97), *ECHR*, Decision on Admissibility of 31 January 2002.

**55** Cf Report of the Working Group on Arbitrary Detention at the UN Commission on Human Rights, E/CN.4/2000/4.

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**57** *Military and Paramilitary Activities in and against Nicaragua (Nicaragua v United States of America)*, *Merits*, Judgment, *ICJ Reports 1986*, p 14.

**58** *Ibid*, 45 (para 75); 50–51 (para 86).

**59** *Ibid*, 64 (para 115).

**60** *Ibid*, 64–65 (para 115).

**61** *Ibid*, Separate Opinion of Judge Ago, 188 (para 16).

**62** *Ibid*, 64 (para 116).

**63** R Ago, Fourth Report on State Responsibility, *ILC Yearbook 1972*, Vol II, 71, 72 (footnote 4) .

**64** *Military and Paramilitary Activities in and against Nicaragua (Nicaragua v United States of America)*, *Merits*, Judgment, *ICJ Reports 1986*, p 14.

**65** *Loizidou v Turkey* (Application No 15318/89), *Preliminary Objections*, *ECHR, Series A, No 310*, para 62.

**66** *Loizidou v Turkey* (Application No 15318/89), *Merits and Just Satisfaction*, *ECHR Reports 1996-VI*, para 56.

**67** See in this sense T Meron, 'Classification of Armed Conflicts in the Former Yugoslavia: Nicaragua's Fallout' (1998) 92 *AJIL* 236 ; R Kolb, 'The Jurisprudence of the Yugoslav and Rwandan Criminal Tribunals on their Jurisdiction and on International Crimes' (2000) 71 *BYIL* 259, 277–278 .

**68** ICTY, *Prosecutor v Tadić*, Case No IT-94-1-A, Appeals Chamber, Judgment of 15 July 1999.

**69** *Ibid*, 47 (para 115).

**70** *Ibid*, 51 (para 124).

**71** *Ibid*, 60–62 (paras 137–141).

**72** J Crawford, First Report on State Responsibility, *ILC Yearbook 1998*, Vol II(1), 1, 4 .

**73** See ARSIWA, Commentary to art 8.

**74** ARSIWA, Commentary to art 8, para 8.

**75** ARSIWA, Commentary to art 9, para 1.

**76** Draft Articles on the Responsibility of States for Internationally Wrongful Acts, as adopted on first reading, Report of the ILC, 48th Session, *ILC Yearbook 1996*, Vol II(2), 59, art 8 .

**77** See eg in French administrative law, although in the framework of a dispute as to the of legality of an administrative act: Conseil d'Etat *Assoc. des fonctionnaires de l'administration centrale des Postes*, 2 November 1923, *Rec Lebon*, p 699 and more recently Conseil d'Etat *Sect, Préfet de police c/ M. Ihsen Mtimet*, 16 May 2001, *Revue de Droit Public* 2001, no 3, 655–656, note by X Pretot, 645–654.

**78** 75 *UNTS* 135.

- 79** *Yeager v Iran*, 17 *Iran-US CTR* 92, 103 (para 42).
- 80** Cited in R Ago, Fourth Report on State Responsibility, *ILC Yearbook 1972*, Vol II, 71, 101 (para 77).
- 81** *United States Diplomatic and Consular Staff in Tehran (United States of America v Iran)*, Judgment, *ICJ Reports 1980*, p 3.
- 82** *Ibid*, 29 (para 58).
- 83** *Ibid*, 35 (para 74).
- 84** ARSIWA, Commentary to art 11, para 6.
- 85** *Ibid*, para 9.
- 86** J Crawford, First Report on State Responsibility, *ILC Yearbook 1998*, Vol II(1), 1, 43 (para 283).
- 87** *Affaire relative à la concession des phares de l'Empire ottoman*, 24 July 1956, 12 *RIAA* 155, 198, cited in J Crawford, First Report on State Responsibility, *ILC Yearbook 1998*, Vol II(1), 1, 42 (para 282).
- 88** See eg M Bluntschli, *Le droit international codifié* (2nd edn, Paris, Librairie de Guillaumin et Cie, 1873), 264.
- 89** P Reuter, 'La responsabilité internationale. Problèmes choisis (Cours de D.E.S. Droit public, 1955–1956)', in *Le développement de l'ordre juridique international. Ecrits de droit international* (Paris, Economica, 1995), 377, 393.
- 90** D Anzilotti, 'La responsabilité internationale des Etats à raison des dommages soufferts par des étrangers' (1906) 13 *RGDIP* 5–29, 285–309, 14–15.
- 91** R Ago, Fourth Report on State Responsibility, *ILC Yearbook 1972*, Vol II, 71, 97 (para 65) and fn 120.
- 92** See Judgment of 26 February 2007, paras 416ff. On the link between the State's and individual's regimes of responsibility, see R Maison, *La responsabilité individuelle pour crime d'Etat en droit international public* (Brussels, Bruylant, 2004).
- 93** On the notion of 'unilateral authoritarian act' ('acte unilatéral autoritaire') in public international law see H Ascencio, *L'autorité de chose décidée en droit international public* (thèse, Université Paris X-Nanterre, 1997).
- 94** See T Koivurova, 'What Is the Principle of Due Diligence', in J Petman & J Klabbbers (eds), *Nordic Cosmopolitanism: Essays in International Law for Martti Koskenniemi* (Leiden, Martinus Nijhoff, 2003), 341; R Pisillo Mazzeschi, 'The Due Diligence Rule and the Nature of the International Responsibility of States' (1992) 35 *German Yearbook of International Law* 9.
- 95** Cf L Condorelli, 'L'imputation à l'État d'un fait internationalement illicite: solutions classiques et nouvelles tendances' (1984-VI) 189 *Recueil des cours* 9, 149–156; G Cohen-Jonathan, 'Responsabilité pour atteinte aux droits de l'homme', in SFDI, *La responsabilité dans le système international* (Paris, Pedone, 1991) 101, 112–115; H Dipla, *La responsabilité de l'Etat pour violation des droits de l'homme. Problèmes d'imputation* (Paris, Pedone, 1994).
- 96** *Osman v The United Kingdom* (App No 23452/94), *ECHR Reports 1998-VIII*.
- 97** *Ibid*, para 115.
- 98** *Ibid*, para 116 (emphasis added).
- 99** The jurisprudence offers many examples of responsibility by catalysis. See eg in relation to article 8, *X and Y v The Netherlands* (App No 8978/80), *ECHR, Series A, No 91* (1985), concerning the impossibility of bringing criminal proceedings with regard to the perpetrator of sexual violence against a mentally handicapped minor. See also, with regard to article 3, *A v The United Kingdom* (App No 25599/94), *ECHR Reports 1998-VI*; or on the subject of the freedom of expression (art 10): *Özgür Gündem v Turkey* (App No 23144/93), *ECHR Reports 2000-III*.

**100** *Ilașcu and others v Moldova and Russia* (App No 48787/99), *ECHR Reports 2004-VII* [GC].

**101** *Ibid*, paras 330–331. For a critical reading, see our commentary in the *chronique* edited by E Decaux & P Tavernier (2005) 132 *JDI* 472–477 .

**102** See *Application of the Convention on the Prevention and Punishment of the Crime of Genocide (Bosnia and Herzegovina v Serbia and Montenegro)*, Judgment of 26 February 2007, in particular para 430.

**103** R Ago, Fourth Report on State Responsibility, *ILC Yearbook 1972*, Vol II, 71, 126 (para 145) .

**104** *Ibid* .

**105** *ILC Yearbook 1975*, Vol I, 33 (para 51) .

**106** *Ibid*, 41 (para 20) .

**107** *Ibid*, 215 (para 16) .

**108** *Ibid*, 214 .

OXFORD PUBLIC INTERNATIONAL LAW

## Oxford Scholarly Authorities on International Law

**Part III The Sources of International Responsibility,  
Ch.17 The Elements of An Internationally Wrongful  
Act****Brigitte Stern**

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## **(p. 193) Chapter 17 The Elements of An Internationally Wrongful Act**

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The present Chapter concentrates on the elements of an internationally wrongful act, which will be examined comprehensively: first, the role played by the notion of the internationally wrongful act in the theory of international responsibility will be considered (Section 1), before examining the relationship between its constitutive elements (Section 2). Finally, its two constitutive elements— attribution to a State (Section 3) and breach of an international obligation (Section 4)—will be addressed in detail.

## **1 The internationally wrongful act of a subject of international law: the sole constituent element of international responsibility**

It is well known that traditionally international responsibility was considered as resting on three pillars: an internationally wrongful act; damage; and a causal link between the two. On closer examination, that conception in fact consisted of just two pillars, the link between (p. 194) them constituting the lynchpin of the whole structure. However, new developments have completely overturned the traditional approach to international responsibility.

### **(a) The traditional conception**

The traditional conception of international responsibility is evidenced in the *Dictionnaire Basdevant*, which defines international responsibility as being:

the obligation, under international law, of the State to which an act or an omission contrary



to its international obligations is imputable, to make reparation to the State which was the victim, either itself or through the person or property of its nationals.<sup>1</sup>

The obligation to make reparation therefore goes hand in hand with international responsibility. Charles de Visscher expressed this concept very clearly in these terms: 'International responsibility is a fundamental notion reducible to the obligation of a State to make reparation for the consequences for a wrongful act that is imputable to it.'<sup>2</sup>

If it is considered, as is the case today, that there exist some aspects of international responsibility other than the obligation to make reparation, it is advisable to expand the definition of what is included in the notion of responsibility, rather than to characterize those other aspects as the 'legal consequences' of responsibility. Here reference may be made to Decencière-Ferrandière who, well before the innovations introduced by Ago, wrote that 'responsibility may be defined as the entirety of the obligations that arise for a subject as the result of an act, action or omission which is imputable to it'.<sup>3</sup>

The obligation to make reparation (and nowadays the other consequences of an internationally wrongful act) is not the 'consequence' of international responsibility. International responsibility is the obligation to make reparation (and also now the other consequences of an internationally wrongful act identified by the ILC).

## **(b) The current conception**

In contrast to the traditional concept of international responsibility, reference may be made to article 1, which was not modified from the draft provision adopted on first reading.<sup>4</sup> It provides: 'Every internationally wrongful act of a State entails the international responsibility of that State.' As is apparent, no mention is made of either damage nor of the necessary causal link. All but one of the three—or two—pillars have disappeared from the Articles, which obviously casts a very different light on things. Without doubt, there was a desire that responsibility should arise as soon as an international obligation was breached, or in other words, to introduce a certain objective review of legality into the institution of international responsibility. However, the ILC did not take this logic to its natural conclusion—even if Arangio-Ruiz tried—because it did not accept the (very simple) idea that legal injury arises without more as the result of the simple breach of an obligation; that step, if achieved, would have meant that this normative advance did not remain half-achieved, or at least, in the realm of the unsaid.

In reality, the ILC changed its position considerably in respect of the introduction of an objective control of legality into the theory of international responsibility. Although starting with the idea, contained in the first reading draft, that States could be injured in (p. 195) different ways—as the result of material or moral damage or, in certain cases, by the fact of the simple breach of an obligation—under the guidance of the final Special Rapporteur, it abandoned this approach and rather introduced a dichotomy between the notions of the injured State and 'the State other than the injured State'.<sup>5</sup>

Draft article 40 of the 1996 draft, although far from perfect, nevertheless went further than the final text in taking account of what one may refer to as 'legal injury'. Due to its complexity, draft article 40 bears citation in full:

### **Article 40 Meaning of injured State**

- 1.** For the purposes of the present Articles, 'injured State' means any State a right of which is infringed by the act of another State, if that act constitutes, in accordance with Part One, an internationally wrongful act of that State.
- 2.** In particular, 'injured State' means:
  - (a)** if the right infringed by the act of a State arises from a bilateral treaty, the other

State party to the treaty;

**(b)** if the right infringed by the act of a State arises from a judgement or other binding dispute settlement decision of an international court or tribunal, the other State or States parties to the dispute and entitled to the benefit of that right;

**(c)** if the right infringed by the act of a State arises from a binding decision of an international organ other than an international court or tribunal, the State or States which, in accordance with the constituent instrument of the international organization concerned, are entitled to the benefit of that right;

**(d)** if the right infringed by the act of a State arises from a treaty provision for a third State, that third State;

**(e)** if the right infringed by the act of a State arises from a multilateral treaty or from a rule of customary international law, any other State party to the multilateral treaty or bound by the relevant rule of customary international law, if it is established that:

**(i)** the right has been created or is established in its favour;

**(ii)** the infringement of the right by the act of a State necessarily affects the enjoyment of the rights or the performance of the obligations of the other States parties to the multilateral treaty or bound by the rule of customary international law; or

**(iii)** the right has been created or is established for the protection of human rights and fundamental freedoms;

**(f)** if the right infringed by the act of a State arises from a multilateral treaty, any other State party to the multilateral treaty, if it is established that the right has been expressly stipulated in that treaty for the protection of the collective interests of the States parties thereto.

**3.** In addition, 'injured State' means, if the internationally wrongful act constitutes an international crime, all other States.

The first paragraph recalled the well-established rule according to which only the violation of a right gives rise to a right to reparation. The second paragraph made explicit that generic formulation, setting out different types of relations between States in the framework of which a breach of a right may occur. It is, however, clear that the enumeration of situations contained in the provision was not truly systematic. There were dealt with in turn rights arising under bilateral treaties, judgments or international arbitral awards, (p. 196) binding decisions of international organs, provisions of treaties in favour of third States, multilateral treaties, rules of customary international law, as well as, finally, the situation where an international crime had been committed. The text mixed a formal analysis based on the types of relations between States capable of giving rise to a breach, with a material analysis which had regard to the content of the norms in question. There is no need to dwell in any detail upon the first four situations envisaged: it is not contested that, in the case of a breach, a State party to a bilateral treaty (paragraph 2(a)), the beneficiary of a judicial decision or an international arbitral award (paragraph 2(b)), the beneficiary of a right conferred by the binding decision of an international organ (paragraph 2(c)), or the beneficiary of a provision in a treaty provision between other states and stipulated in its favour (paragraph 2(d)) may claim reparation as the result of the violation of the right breached. As regards the other situations, relating to rights under a rule of customary international law or a treaty, there were two possibilities: either the case fell into the general category, in which case a State could only invoke the responsibility of the State which was the author of the violation if it could show that it was directly injured, either because the right breached was created or established in its favour (paragraph 2(e)(i)) or because the violation 'affected' either its rights or the obligations deriving from the customary or treaty rule violated (paragraph 2(e)(ii)). Or the case fell within the specific situations in which an *actio popularis* was to be recognized, although draft article 40 carefully avoided using that term. That situation arose in three hypotheses: first, where the breach infringed a customary or treaty rule protecting human

rights and fundamental freedoms (paragraph 2(e)(iii)); second, where the breach infringed an obligation arising under a multilateral treaty providing for the protection of the collective interests of the States parties (paragraph 2(f)); or, finally, where the violation constituted an international crime (paragraph 3). Despite its complexity, the 1996 draft appears to be far more coherent than the approach finally followed in 2001: the 1996 draft proceeded on the basis that a State could be injured if it suffered material or moral damage, but equally that it could be injured solely in its legal interests, for example, when an international crime had been committed which, by definition, infringes the legal interests of all States making up the international community. Draft article 40 thus introduced an innominate concept of legal injury. However, it was necessary to go much further. But, in the final Articles as adopted in 2001, the contrary occurred, as the notion of injured State was considerably narrowed and as a result, for instance, all States are no longer considered injured when a serious violation of obligations arising under peremptory norms of general international law is committed.

In fact, in the final Articles of 2001 the category of 'injured State' has been fragmented and it is therefore necessary to distinguish injured States from 'States other than injured States'. Accordingly, article 42 is devoted to 'Invocation of responsibility by an injured State' while article 48 concerns 'Invocation of responsibility by a State other than an injured State'. It is at the least curious that some States may invoke the responsibility of another State even if they are not injured. If a State is the beneficiary of an obligation which is violated, it is difficult to see why it should not be considered to be an injured State. It is well established— and the ICJ has clearly affirmed—that, in the case of an international obligation towards the international community as a whole, all States have a legal interest in ensuring that there is compliance.<sup>6</sup> In other words, it seems that all States able to invoke international responsibility should be considered to be injured States; if that is not the case, what is the justification (p. 197) for the fact that they may have a cause of action against the author of the internationally wrongful act? The illogical nature of the approach finally adopted by the ILC results clearly from a passage from a work by Alexandros Kolliopoulos, according to whom:

States other than a State affected by the wrongful act can invoke the international responsibility of the author State if the norm violated breaches their legal interests, either due to its importance for the international community or because it constitutes an essential norm for all parties under a multilateral treaty.<sup>7</sup>

There could not be clearer proof that, in reality, 'States other than injured States' are merely States which are injured differently; if their legal interests were not injured they would have no basis upon which they could invoke the responsibility of the responsible State.

Certain commentators see a step forward as the result of this new conception; thus Alain Pellet considers that it is part of:

a 're-conceptualisation' of the very notion of international responsibility, which, by the elimination of injury as a condition for its existence, finds itself 'objectivised', in the sense that, from a purely inter-state approach we have passed to a more 'communitarian' or 'societal' vision: responsibility exists in and of itself, independently of its effects.<sup>8</sup>

However, that progress would have been just as significant, if not even more so, at the symbolic level, if the ILC had considered that every breach of an international obligation constitutes a legal injury for which reparation was to be made by the re-establishment of the legal order which had been violated.

Eventually, the ILC arrived at this result, albeit by a somewhat round-about path. That approach required it, on the one hand, to introduce, in addition to the obligation to make reparation, other obligations deriving from the existence of an internationally wrongful act, and on the other hand, to give rights to States 'other than the injured State', despite the fact that it is difficult to see on what basis they can act, if not on the basis of the declaration contained in article 48, the legal value of

which is not at all clear. Undoubtedly, in the Articles, there is an affirmation of the existence of responsibility as soon as there is a wrongful act; however the affirmation takes the limited form of the (perfectly logical) right to request cessation of the wrongful act. What is less logical is that the right to invoke responsibility is not founded on the existence of what could be considered legal injury, recognized as such, and that cessation of the wrongful act is not analysed as constituting reparation for that legal injury.

Would it not have been better to recognize clearly that, in the absence of any legal personification of the international community, as a result of which it is impossible to implement the responsibility of a State which violates a norm owed to that community, all members thereof are injured by the simple breach of such a norm? That would have constituted recognition of a strong form of solidarity, of the fusion of all States in the concept of international community; an affirmation that an attack against the whole is an attack against each party and that each party is accountable to each of the others as regards compliance with the fundamental norms of international law. This is the idea expressed (p. 198) by Alexandros Kolliopoulos, when he analyses the case of breach of an *erga omnes* norm. In his view:

One might ... consider that the interest of all States in relation to obligations *erga omnes* consists not only of an interest for the purposes of bringing a claim for the sole benefit of the international community in the case of a breach, but also as associated with a real right based in primary legality: a right to demand that all States respect those obligations.<sup>9</sup>

Far from being oriented towards the simple protection of subjective interests and State sovereignty, to the extent that 'States have a legal interest in seeing such or such international rules respected, responsibility will play the role of a *guarantor of the international legal order*'.<sup>10</sup> In other words, the recognition of legal injury would have been an even more significant advance towards a communitarian vision than the approach which was eventually adopted: a recognition that States have not only a right to act in the name of the international community, but also that, due to their close participation in the international community, they act in their own capacity, as fundamentally affected in their legal interests by any violation of norms which are fundamental for that community.

The concept of legal injury, if it thus translates the concern of all States for the respect of certain fundamental international legal rules, in fact permits a reunification of the concept of responsibility which at present seems to be separated into disparate elements which it is difficult to regroup together. Under the scheme of the Articles, in some cases, if there is an injured State, responsibility consists of cessation of the breach (and possibly the provision of guarantees of non-repetition) together with the obligation to make reparation. In other cases, if there is no injured State, States other than the injured State may request the cessation of the wrongful act (and possibly guarantees of non-repetition), but nothing else. Finally, in certain cases in which there is an injured State, States other than the injured State may request cessation of the wrongful act (and possibly guarantees of non-repetition), and, perhaps, implementation of the obligation to make reparation to the injured State or the individuals who are the beneficiaries of the obligation. From this description of articles 42 and 48 as finally adopted, it is obvious that the content of international responsibility is not uniform.

The notion of legal injury permits the reunification of the concept of responsibility from two points of view. On the one hand, there would be only *one single concept*, that of the injured State, which can be injured in different ways, material, moral or legal; on the other, there would be only a *single aspect of responsibility* (or a single consequence of the internationally wrongful act), *the obligation to make reparation*.

In the first place, the recognition of legal injury removes the laborious distinction introduced by the ILC between injured States and 'States other than the injured State', which are not even 'States having a legal interest'. If one considers, as seems obvious, that all breaches of international law create a legal injury suffered by those to whom the obligation breached is owed (whether a single State, a group of States or the international community as a whole), then responsibility can *always*

be invoked by an injured State. Using the notion of legal injury, there would never be a situation in which there would be both (p. 199) an injured State as well as 'States other than the injured State'. There would always be one (or more) injured State(s) which have suffered legal injury—whether alone, or accompanied by material or moral injury. There would thus always be one (or more) State(s) which could demand by way of reparation (whether in their own name, or that of a group of States or of the international community as a whole) the re-establishment of the legal order which has been violated, whether or not accompanied by a claim for reparation in relation to material or moral injury.

In the second place, using the concept of legal injury allows the consequences of the internationally wrongful act to be characterized as one obligation—the obligation to make reparation. To the extent that all wrongful acts which cause material or moral damage also imply the existence of a legal injury *inherent in the violation of the right*, it is logical that responsibility entails reparation of not only the material or moral damage, but also equally of the legal injury. In this regard, it may be argued that cessation of the internationally wrongful act (article 30) has been unduly isolated as being a consequence different from the obligation to make reparation, although it can be seen as simply the obligation of restitution of the legal order violated, that is, reparation for the legal injury. Further, as concerns assurances and guarantees of non-repetition (likewise contained in article 30),<sup>11</sup> if it is necessary at all costs to integrate such measures into the concept of the obligation to make reparation, such measures may be regarded as contributing to the goal of reestablishment of the legal order violated, although for the future rather than for the past. It is also worth recalling that this is consistent (in part) with the view taken by the ILC in the 1996 draft, where assurances and guarantees of non-repetition were included as part of the full reparation to which the injured State was entitled under draft article 42.

Responsibility would accordingly no longer be a series of disparate obligations, as is presently the case; rather those obligations could in sum be defined simply as the obligation to make reparation for the injury suffered by an injured State. This is so whether the injury suffered was solely legal (the situation envisaged by article 48), in which case the obligation to make reparation merges with the right to require the restoration of the legal order, or if the injury suffered was material or moral, necessarily accompanied by a legal injury, in which case, logically, at the same time there is both a right to claim the restoration of the legal order (article 30) and a right of reparation for the material and/or moral injury suffered (article 31). Accordingly, reparation would have inevitably included an obligation to re-establish the legal order, as reparation for the legal injury, in all instances.

On the analysis presented here, where there is a wrongful act which causes material or moral damage there exists an obligation to make reparation for the legal injury (cessation of the wrongful act, article 30) and an obligation to make reparation for the material or moral damage (article 31) to which the different modalities would apply: restitution (article 35), compensation (article 36), or satisfaction (article 37).

When there is a wrongful act which has caused only legal injury, the obligation to make reparations translates into *restitutio* (article 48(2)(a)), ie cessation of the wrongful act, if the wrongful act persists, or in reparation in kind, ie an explicit declaration of the wrongful character, where the internationally wrongful act has terminated. That latter (p. 200) consequence is, of course, always implicit where reparation for material or moral injury resulting from an internationally wrongful act is required.

What the ILC calls an 'injured State', that is to say a State which is individually or specially affected, suffers both legal injury and material and/or moral injury, and could therefore ask for full reparation, in conformity with articles 30 and 31. Such reparation would include restitution of the violation of the legal order as reflected in cessation of the wrongful act as well as assurances and guarantees of non-repetition, which form part of the same logic aimed at ensuring international legality and restitution, compensation or satisfaction for the material or moral damage caused.

What the ILC calls a 'State other than an injured State' suffers solely a legal injury, which permits it to demand precisely what the Articles grant it the right to invoke under article 48, although on an

unknown legal basis, namely the re-establishment of the legal order by cessation of the wrongful act and possibly the provision of assurances and guarantees of non-repetition.

In reality, it appears that the distinction between injured States and 'others' was adopted by the ILC in order to avoid the unforeseeable and potentially damaging consequences of the decision to integrate countermeasures into the theory of international responsibility. It may be noted in passing that this decision is equally open to criticism, given that the attempt to subject countermeasures to a dispute settlement procedure in the draft adopted on first reading,<sup>12</sup> abandoned in the Articles as finally adopted, was the only acceptable justification for the indirect legitimation of countermeasures. Moreover, that problem could have been avoided either by entirely eliminating countermeasures from the theory of international responsibility altogether (which would have been by far the most preferable solution), or by indicating that countermeasures are not available to States which suffer only legal injury as the result of an internationally wrongful act.

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## 2 The constituent elements of an internationally wrongful act committed by a subject of international law

Given that it is an institution of the international legal system, international responsibility may only be invoked by and against a subject of international law. Only subjects of international law are subjected to the international legal order and therefore only they are capable of invoking a breach of its norms<sup>13</sup> or of violating them.<sup>14</sup> Article 2, which sets out the 'Elements of an internationally wrongful act of a State', explains the conditions under which a State incurs responsibility:

There is an internationally wrongful act of a State when conduct consisting of an action or omission:

- (a) is attributable to the State under international law; and
- (b) constitutes a breach of an international obligation of the State.

### (p. 201) (a) The necessary conjunction of two elements

Article 2 sets out the legal conditions necessary for it to be established that a State has committed an internationally wrongful act. Those conditions are two: behaviour which is attributable to the State (to which Chapter II of Part One, comprising articles 4 to 11, is devoted); and the breach of an international obligation by a State as the result of such behaviour (to which Chapter III, comprising articles 12 to 15, is devoted). In other words, on the one hand, there must be conduct which is *attributable* to a State, and on the other hand, that conduct must be *wrongful*. These two conditions are naturally determined by the international legal order, and by the international legal order alone.

When reference is made to international responsibility, most often what is being referred to is the responsibility of States, as the first and primary subjects of international law. However international organizations, as derivative subjects of international law, may also incur responsibility,<sup>15</sup> just as they can invoke the responsibility of other subjects of international law.<sup>16</sup> Article 57 expressly reserves the question of the responsibility of international organizations, and the ILC has recently adopted on first reading draft Articles on the Responsibility of International Organizations.<sup>17</sup>

The necessity for these two elements of international responsibility has been frequently recalled by the Permanent Court of International Justice and the International Court of Justice. In the *Phosphates in Morocco* case, the PCIJ indicated that international responsibility arose from an 'act being attributable to a State and described as contrary to the treaty right of another State'.<sup>18</sup> Even if the restriction to violations of treaties is clearly no longer an accurate reflection of the law, the assertion that the two elements of attribution and international wrongfulness are required to give

rise to international responsibility is still valid.

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## (b) The order of the two elements

In the *Tehran Hostages* case, the International Court indicated the necessity of the presence of these two elements, making it clear that there were two necessary steps in the process of determining the existence of international responsibility:

*First* it must determine how far, legally, the acts in question, may be regarded as imputable to the Iranian State. *Second*, it must determine the compatibility or incompatibility with the obligations of Iran under treaties in force or any other rules of international law that may be applicable.<sup>19</sup>

It may be noted that, although there is a reference to all international norms, and not only treaty obligations, there is no change in relation to the basic elements from which international responsibility arises. This sequence is logical since an act on its own cannot be assessed against the rules of public international law; it is first necessary to ensure that an act is attributable to the State before examining whether that act is in conformity with what is required from that State under international law.

(p. 202) Certain authors consider, however, that the two elements contained in article 2 are 'paradoxically inverted'. Pierre-Marie Dupuy considers that it is possible to determine first whether international law has been breached and, only thereafter, examine the question of whether this breach is attributable to a subject of international law. The example he gives is that it is possible to objectively determine an infringement of international law, committed, for example, by armed groups committing acts in violation of international humanitarian law, without it being possible thereafter to attribute those acts to a subject of international law which is capable of incurring international responsibility.<sup>20</sup> In this regard, it is to be noted that the ICJ in *Bosnian Genocide* followed this order; that approach is to be welcomed, insofar as it constitutes a means of recording for history all the atrocities committed during the ethnic cleansing in Bosnia, even if those atrocities were thereafter held either not to constitute genocide, or not attributable to the Federal Republic of Yugoslavia (FRY).

The two elements have sometimes been characterized as objective (the breach of an obligation) and subjective (attribution); however, this terminology is not really pertinent (for example, there are subjective elements in the breach of the law prohibiting genocide) and it was for good reason that it was not retained by the ILC.

The ascertainment of the existence of an internationally wrongful act of a State therefore requires two cumulative steps: '[a]s a normative operation, attribution must be clearly distinguished from the characterization of conduct as internationally wrongful.'<sup>21</sup> This is implied in article 2. The implications of these two normative operations will be examined in the following sections.

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## 3 The question of attribution

Traditionally, the term 'imputation' was more often used than 'attribution'. The ILC justified its substitution of the term 'attribution' as follows: 'the term "attribution" avoids any suggestion that the legal process of connecting conduct to the State is a fiction, or that the conduct in question is "really" that of someone else'.<sup>22</sup> It is necessary to be conscious, however, of the fact that even when using the term 'attribution', the legal fiction does not become any less necessary, given that

the process of attribution consists of attributing the acts of a physical person to the State, a legal person.

Attribution deals with a classic problem, that of imputing acts which are necessarily committed by physical persons to the legal person constituted by the State. In this area, the ILC has only codified well-established customary rules which are hardly in dispute, or at least so it appears from the debates. States, as abstract entities, do not act directly. States cannot act other than through the intermediary of physical persons—whether acting in isolation or in a group—who have a certain relationship with the State. The PCIJ had already recognized this obvious fact at the beginning of the last century: ‘States can act only by and through their agents and representatives’.<sup>23</sup> Even if the idea of representatives is interpreted broadly, a sovereign State will only be considered responsible for acts which are sufficiently linked to it, to its sovereignty, such that it must account for their (p. 203) consequences. The extent of the attributability of certain acts to a State therefore traces the limits of its sovereignty.

### **(a) Organs of the State and persons or entities exercising elements of governmental authority**

It is, according to the ICJ, a ‘well-established rule, one of the cornerstones of the law of State responsibility, that the conduct of any State organ is to be considered an act of the State under international law’.<sup>24</sup>

No problems are posed by the attribution to the State of the acts of its agents and organs (article 4) —whether they exercise constitutional, executive, legislative or judicial power, or are agents and organs of territorial units or subdivisions;<sup>25</sup> or are public or private entities exercising elements of governmental authority (article 5).<sup>26</sup>

Article 5, entitled ‘Conduct of persons or entities exercising elements of governmental authority’, states that:

The conduct of a person or entity which is not an organ of the State under Article 4 but which is empowered by the law of that State to exercise elements of the governmental authority shall be considered an act of the State under international law, provided the person or entity is acting in that capacity in the particular instance.

To the extent that ‘what is regarded as governmental depends on the particular society, its history and traditions’,<sup>27</sup> article 5 does not provide a precise definition of its field of application. The decisive test here is whether the organ exercises elements of governmental authority.

As foreseen by article 7, these rules of attribution apply even if these entities act *ultra vires*, so long as they act in that capacity;<sup>28</sup> the only acts excluded are purely private acts, having no connection with official functions, committed by an agent or civil servant of the State, or a person or entity exercising governmental authority.

A single exception to this rule exists in time of war, a situation which is itself exceptional. In such a situation, the responsibility of the State is reinforced and all the wrongful acts of the military, whatever they may be, engage its responsibility.<sup>29</sup> Although the point is not mentioned in the Articles, it can be considered that this rule applies as *lex specialis*, the application of which is permitted by article 55.

Similarly, because of a strong link with the structure of the State, the acts of persons or entities who *de facto* exercise elements of governmental authority;<sup>30</sup> or the acts of (p. 204) victorious revolutionaries who have installed themselves in power<sup>31</sup> likewise does not pose any difficulty.

Special mention should also be made in relation to the attribution to a State of acts of an organ placed at its disposal by another State.<sup>32</sup> The ICJ referred to the rules in this regard in *Bosnian Genocide*; although it concluded that the ‘Scorpions’, a paramilitary group which had strong links with the Ministry of Defence of the FRY, could not be considered an organ of the FRY, whether *de*



*jure* or *de facto*, the Court noted that 'in any event the act of an organ placed by a State at the disposal of another public authority shall not be considered an act of that State if the organ was acting on behalf of the public authority at whose disposal it had been placed'.<sup>33</sup>

The rule of attribution of the acts of organs follows from the principle of the unity of a State under international law and is simply the expression of a well-established principle of customary international law, as recalled by the ICJ in its advisory opinion on *Difference Relating to Immunity from Legal Process of a Special Rapporteur of the Commission on Human Rights*: 'According to a well-established rule of international law, the conduct of any organ of a State must be regarded as an act of that State. This rule ... is of a customary character.'<sup>34</sup> The Court also affirmed the customary character of the principle in its 2005 decision in *Armed Activities on the Territory of the Congo*,<sup>35</sup> and applying it to the facts of the case concluded that the Uganda Peoples' Defence Forces, part of the army of Uganda, was a State organ and accordingly its conduct was attributable to the State.<sup>36</sup>

The question whether a person or entity is an organ of the State depends in principle on its characterization as such by the structure of the municipal law of the State; however, international law permits one to consider that any institution which fulfils one of the traditional functions of the State, even if such functions have been privatized, should be considered as an organ of the State from the point of view of international law and for the purposes of the law of responsibility. The idea is that, once again, 'international law does not permit a State to escape its international responsibilities by a mere process of internal subdivision'.<sup>37</sup> Thus the mere fact that a State confers management of its prisons or control of immigration in its airports, or even certain police functions, to private entities, does not mean that the State can absolve itself from all international responsibility when those entities commit acts contrary to the State's international obligations.

In *LaGrand*, the ICJ recognized the general principle of attribution of the acts of its organs to a State, whether the organs are those of its central government or territorial entities of a unitary State, or even the constituent entities making up a federal State:

Whereas the international responsibility of a State is engaged by the action of the competent organs and authorities acting in that State, whatever they may be; whereas the United States should take all measures at its disposal to ensure that Walter LaGrand is not executed pending the final decision in these proceedings; whereas, according to the information available to the Court, implementation of the measures indicated in the present Order falls within the jurisdiction of the Governor of Arizona; (p. 205) whereas the Government of the United States is consequently under the obligation to transmit the present Order to the said Governor; whereas the Governor of Arizona is under the obligation to act in conformity with the international undertakings of the United States.<sup>38</sup>

In *Bosnian Genocide*, the ICJ also discussed the possible participation of organs of the FRY in the genocide; as is well-known, only the acts committed in Srebrenica in July 1995 were found to constitute genocide. Thus, the question of attribution of those acts was raised. The Court explained the steps of its reasoning as follows:

This question has in fact two aspects, which the Court must consider separately. First, it should be ascertained whether the acts committed at Srebrenica were perpetrated by organs of the Respondent, i.e., by persons or entities whose conduct is necessarily attributable to it, because they are in fact the instruments of its action. Next, if the preceding question is answered in the negative, it should be ascertained whether the acts in question were committed by persons who, while not organs of the Respondent, did nevertheless act on the instructions of, or under the direction or control of, the Respondent.<sup>39</sup>

After examining all the elements, the ICJ considered that none of Republica Srpska itself, the officers of the VRS (the army of the Republica Srpska), nor the paramilitary groups such as the

'Scorpions' could be considered to constitute organs *de jure* of the FRY.

However, the ICJ did not stop its reasoning there, given the pleadings of the Parties, which it summarized in the following manner:

The argument of the Applicant however goes beyond mere contemplation of the status, under the Respondent's internal law, of the persons who committed the acts of genocide; it argues that Republika Srpska and the VRS, as well as the paramilitary militias known as the 'Scorpions', the 'Red Berets', the 'Tigers' and the 'White Eagles' must be deemed, notwithstanding their apparent status, to have been '*de facto* organs' of the FRY, in particular at the time in question, so that all of their acts, and specifically the massacres at Srebrenica, must be considered attributable to the FRY, just as if they had been organs of that State under its internal law; reality must prevail over appearances. The Respondent rejects this contention, and maintains that these were not *de facto* organs of the FRY.

The ICJ, therefore examined first the theoretical question of '... whether it is possible in principle to attribute to a State conduct of persons or groups of persons who, while they do not have the legal status of State organs, in fact act under such strict control by the State that they must be treated as its organs for purposes of the necessary attribution leading to the State's responsibility for an internationally wrongful act'.<sup>40</sup> The answer was positive. According to the Court, persons, groups of persons or entities not forming part of the structure of the State may exceptionally be assimilated to *de facto* organs, such that their acts are attributable to the State; such assimilation is possible where they 'act in "complete dependence" on the State, of which they are ultimately merely the instrument', although such assimilation is exceptional. The Court observed:

... persons, groups of persons or entities may, for purposes of international responsibility, be equated with State organs even if that status does not follow from internal law, provided that in (p. 206) fact the persons, groups or entities act in 'complete dependence' on the State, of which they are ultimately merely the instrument. In such a case, it is appropriate to look beyond legal status alone, in order to grasp the reality of the relationship between the person taking action, and the State to which he is so closely attached as to appear to be nothing more than its agent: any other solution would allow States to escape their international responsibility by choosing to act through persons or entities whose supposed independence would be purely fictitious.

However, so to equate persons or entities with State organs when they do not have that status under internal law must be exceptional, for it requires proof of a particularly great degree of State control over them, a relationship which the Court's judgment quoted above expressly described as 'complete dependence'.<sup>41</sup>

The ICJ seems thus to have created a new category of organs *de facto*, under article 4, defined as persons or entities acting in 'complete dependence' upon the State. However, that category is somewhat difficult to distinguish from the persons and entities on which the State exercises effective control under article 8, and therefore appears to constitute a redundant category. Applying that test to the facts of the case, the Court did not consider that any of the involved entities could be considered to constitute *de facto* organs.

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## **(b) Persons and entities acting on behalf of the State**

However, the State may also be considered responsible for the actions of certain private persons or groups formally outside the structure of the State and who are not authorized to exercise elements of governmental authority, if in one way or another such persons or groups can be considered as acting on its behalf. Different hypothetical situations can be considered in which

these private individuals are to be considered as acting for the State. The acts of persons or groups of persons may be attributable to the State, if, by explicitly or implicitly adopting or acknowledging those acts, the State makes them its own by approving the actions of certain persons or groups *after* the event.<sup>42</sup> Further, if the State entirely controls these persons or groups of people and can therefore be considered as having authorized their acts *before* the event, whether these persons or groups have acted 'on the instructions of, or under the direction or control of, that State', as stated in article 8, their acts will be attributable.<sup>43</sup> As the Commentary explains, '[i]n the text of Article 8, the three terms instructions, direction and control are disjunctive; it is sufficient to establish any one of them'.<sup>44</sup>

The test of control has given rise to debates in the jurisprudence. The question of control was at the heart of important cases: *Military and Paramilitary Activities in and against Nicaragua*<sup>45</sup> before the ICJ and the case of *Tadić* before the International Tribunal for the Former Yugoslavia (ICTY).<sup>46</sup> The position taken by the ICJ in *Bosnian Genocide* of course followed the position previously taken by the ICJ.

The decision of the ICJ in *Military and Paramilitary Activities in and against Nicaragua* illustrates perfectly the difficulties raised by the determination of the extent of control (p. 207) justifying the attribution of responsibility. If the acts of the UCLA (Unilaterally Controlled Latino Assets), isolated individuals receiving their instructions and remuneration from the United States, were attributed without difficulty, the same did not apply to the acts of the *contras* despite their very strong reliance on the support of the United States: '[t]he Court holds it established that the United States authorities largely financed, trained, equipped, armed and organized' the *contras*.<sup>47</sup> Nevertheless, their acts were held not to be attributable to the United States; according to the Court, in order for the acts of private persons to be attributed to a State, there has to be on the one hand, general control by the State over the group and on the other hand a precise order or injunction to commit the acts in question. This has come to be known as the 'effective control' test:

The Court has taken the view ... that United States participation, even if preponderant or decisive, in the financing, organizing, training, supplying and equipping of the *contras*, the selection of its military or paramilitary targets, and the planning of the whole of its operation, is still insufficient in itself, on the basis of the evidence in the possession of the Court, for the purpose of attributing to the United States the acts committed by the *contras* in the course of their military or paramilitary operations in Nicaragua. All the forms of United States participation mentioned above, and even the general control by the respondent State over a force with a high degree of dependency on it, would not in themselves mean, without further evidence, that the United States directed or enforced the perpetration of the acts contrary to human rights and humanitarian law alleged by the applicant State. Such acts could well be committed by members of the *contras* without the control of the United States. For this conduct to give rise to legal responsibility of the United States, it would in principle have to be proved that that State had effective control of the military or paramilitary operations in the course of which the alleged violations were committed.

The use of such strict criteria gave rise to intense debates in the *Tadić* case before the ICTY, both before the Trial Chamber and the Appeals Chamber.<sup>48</sup> To demonstrate that the army of the Republika Srpska was not controlled by the Yugoslavian army, or rather the FRY, the majority judges in the Trial Chamber (with the President giving a dissenting opinion) rigorously applied the test set out by the ICJ in *Military and Paramilitary Activities* and considered that the forces of the Bosnian-Serbs were not in a situation of dependence on Belgrade, such that all their acts could be imputed to the FRY. The Appeals Chamber reversed this decision, concluding that the Bosnian-Serb army should be considered as controlled by the Yugoslavian army and therefore by the FRY. The Appeals Chamber criticized the decision of the ICJ in *Military and Paramilitary Activities*, considering that this position was not consonant with the logic of State responsibility: 'A first ground on which the *Nicaragua* test as such may be held unconvincing is based on the very logic of the entire system of international law on State responsibility'.<sup>49</sup> That logic renders the State responsible

for everything that it controls in fact or in law; if, in relation to isolated individuals or informal groups of individuals, it may be necessary to establish control for each of the acts of the entity which is *de facto* controlled, the situation is different as regards the control of a hierarchically organized military or para-military group. According to the Appeals Chamber, *overall control* suffices without it being necessary to prove that specific (p. 208) orders have been given in relation to each action (here the acts of violence by the Bosnian-Serb army committed in the Prijedor region) undertaken by the group. According to the Appeals Chamber:

In order to attribute the acts of a military or paramilitary group to a State, it must be proved that the State wields overall control over the group, not only by equipping and financing the group, but also by coordinating or helping in the general planning of its military activity. Only then can the State be held internationally accountable for any misconduct of the group. However, it is not necessary that, in addition, the State should also issue, either to the head or to members of the group, instructions for the commission of specific acts contrary to international law.<sup>50</sup>

Applying that test to the facts of the case, the Appeals Chamber concluded that the army of the Republika Srpska was to be considered as being controlled by the FRY.

In *Bosnian Genocide* the question was again squarely before the Court and it explicitly preferred the formulation previously adopted in *Military and Paramilitary Activities*.<sup>51</sup> The Court, indeed, strongly criticized the approach of the Appeals Chamber of the ICTY in *Tadić*, qualified as 'the doctrine laid down in the *Tadić* case', while it reiterated its 'settled *jurisprudence*', concerning the effective control test.<sup>52</sup>

A final point which may be addressed quickly—although it is not mentioned in the ILC's text—is that of the consequences for international responsibility of the control exercised by a State over a company through a shareholding. That question is hardly controversial: it is accepted that the distinct personality of the company creates a corporate veil, which excludes acts of the company from being attributed to the State. This is true for companies having activities *jure gestionis*, but does not apply to entities which are engaged in activities *jure imperii* for the purposes of which they exercise elements of governmental authority, in which case their acts can be attributed to the State, not by virtue of article 8, but by virtue of article 5.

Finally, it is hardly controversial—even if, again, it is not mentioned in the ILC's text, because it derives from primary rules—that the State has to account for the consequences of acts of private persons where it is obliged to prevent or punish those acts. But here the question is less one of attributing to the State the acts of private individuals but rather of making the State responsible for its own breach of an obligation of 'due diligence', the classic example being the obligation to protect foreign embassies. In a sense, it could be said that when the obligation of due diligence is violated, there is an attribution to the State not of the acts but of the consequences of the acts of the private persons.

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### **(c) Attributable acts: actions and omissions**

Conduct of whatever character may be attributable to the State, if it falls within one or other of the rules of attribution sketched above, and examined in more detail in the other contributions in this Part. Put more precisely, conduct may consist of either acts or omissions, depending upon whether the State violates an obligation prohibiting particular conduct, or requiring the adoption of particular measures. Acts of omission play a particular role, to the extent that such acts are always in play when a State is made responsible as the (p. 209) result of the acts of private individuals due to the fact that it has failed to comply with its obligations of due diligence, ie its obligations to prevent or punish certain acts which damage the person or property of foreign nationals. But where there is

an omission to act in violation of an obligation of due diligence, it is not a question of attribution of the act of a private party, but rather a failure of the State itself to comply with its primary obligations. This aspect is clearly highlighted by Jean Combacau who observed that:

In relation to what appears on the face of it to be an 'activity' of an individual, international law only has regard to the 'passivity' of the State. What the State is responsible for is therefore not the act of another, which by definition may not to be attributed to it, but its own act, in the form of an omission. Here, responsibility enforces the obligation of diligence which international law imposes on the State.<sup>53</sup>

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## 4 The breach of an international obligation

There is an internationally wrongful act when behaviour attributable to a State or other subject of international law constitutes a failure to comply with an international obligation of that State or that subject of international law. Any breach has to be analysed in terms of the primary rule violated, although consideration of the primary rules which may give rise to international responsibility was explicitly excluded from the work of the ILC on State responsibility. The Articles set out only the secondary rules which define the contours of the concept of breach of an international obligation.

### (a) The abandonment of the idea of fault

According to article 12, '[t]here is a breach of an international obligation by a State when an act of that State is not in conformity with what is required of it by that obligation'. According to the Commentary:

The essence of an internationally wrongful act lies in the non-conformity of the State's actual conduct with the conduct it ought to have adopted in order to comply with a particular international obligation.<sup>54</sup>

We are dealing here with an objective idea of non-conformity: whatever may have been the subjective intention of the perpetrator of the internationally wrongful act is irrelevant. In other words, the idea of fault is not a necessary element in the commission of an internationally wrongful act in international law.

The abandonment of the notion of fault in the law of international responsibility is not recent; it occurred under the influence of the positivist voluntarist doctrine, of which one of the best known theoreticians was Anzilotti, according to whom:

the notion of a wrongful act implies the existence of two elements: an act, that is to say, a material fact, external and identifiable, and the rule of law with which it finds itself in contradiction ... An internationally wrongful act is an act contrary to positive international law.<sup>55</sup>

(p. 210) It is therefore clear that it is the objective contradiction between the action of a State and its international obligations which gives rise to its international responsibility, independently of any concept of fault or wrongful intention. Sovereign States are in fact sovereign legal persons and accordingly the notion of fault (*culpa*) does not seem appropriate to qualify their acts. The ILC Articles make no reference to intention or fault, preferring an objective approach, eliminating any subjective analysis in terms of whether or not a violation is intentional.

Despite this approach, it cannot be ignored that international law does not completely eliminate an

analysis of the intentions of a State as being relevant to the determination of a breach of international law in all domains. First, it may be noted that intention may sometimes be a constituent element of a breach of international law. Thus, massive and systematic attacks against a civilian population only constitute genocide if they are accompanied by the intention to destroy in whole or in part a national, ethnic, racial, or religious group, as such. Similarly, some unilateral economic sanctions that are lawful in themselves, may become unlawful if the intention of the State which adopts them is to override the sovereign will of another State and to intervene in its domestic affairs.<sup>56</sup> Likewise, any fault or negligence by the State victim of a wrongful act may be taken into consideration in the determination of the quantum of the reparation which the responsible State must make.<sup>57</sup>

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## **(b) The existence of a breach of an international obligation**

In the classic international law of State responsibility, the breach of international law was a necessary condition for international responsibility, even if it was not in and of itself sufficient. The decision in *Dickson Car Wheel Company*, rendered in 1931 by the United States-Mexico Claims Commission may be cited:

Under international law, apart from any convention, in order that a State may incur responsibility it is necessary that an unlawful international act be imputed to it, that is, that there exists a violation of a duty imposed by an international juridical standard.<sup>58</sup>

Although articles 2 and 12 speak of a breach of an international obligation and not a breach of a rule or norm of international law, the test of international responsibility is whether the act is contrary to international law. This is what article 3, entitled 'Characterization of an act of a State as internationally wrongful', makes clear:

The characterization of an act of a State as internationally wrongful is governed by international law. Such characterization is not affected by the characterization of the same act as lawful by internal law.

This article recalls that there is a distinction between the international legal order and the various domestic legal orders. An act may be contrary to a rule of international law even if it is perfectly consistent with the domestic law of the State to which it is attributable, or even if it is required by that domestic law. The corollary of this affirmation is of course (p. 211) that a State may never invoke its domestic law to override its international obligations, whether primary or secondary (as is emphasized by article 32). Conversely, an act may be in conformity with international law, even if it is in breach of the domestic legal order.

These two aspects of the same principle—the disjunction between the international and domestic legal orders—have been affirmed frequently in international jurisprudence. That an act in conformity with domestic law can be a breach of international law was affirmed by the PCIJ in the Advisory Opinion in *Treatment of Polish Nationals*:

a State cannot adduce as against another State its own Constitution with a view to evading obligations incumbent on it under international law or treaties in force ... The application of the Danzig Constitution may ... result in the violation of an international obligation incumbent on Danzig towards Poland, whether under treaty stipulations or under general international law ... However, in cases of such a nature, it is not the Constitution and other laws, as such, but the international obligation that gives rise to the responsibility of the Free City.<sup>59</sup>

That an act which breaches domestic law may be perfectly consistent with international law was

stated by the ICJ in the *ELSI* case:

Yet it must be borne in mind that the fact that an act of a public authority may have been unlawful in municipal law does not necessarily mean that that act was unlawful in international law, as a breach of treaty or otherwise.<sup>60</sup>

In order to determine whether the behaviour of a State is contrary to its international obligations, it is necessary to look to the content of the primary rule. As the Commentary indicates:

in the final analysis, whether and when there has been a breach of an obligation depends on the precise terms of the obligation, its interpretation and application, taking into account its object and purpose and the facts of the case.<sup>61</sup>

Finally, if the wrongful character of an act may arise from an act which is objectively contrary to an international obligation, it can also result from the abusive exercise of a right which is recognized by international law.<sup>62</sup>

International responsibility can arise whatever the international obligation breached, that is to say, whatever the origin, character, or content of the international obligation. The unitary character of international responsibility is thus clearly affirmed.

International responsibility may arise from all breaches of an obligation, regardless of the *origin* of the obligation.<sup>63</sup> As the Commentary states: '[t]he formula 'regardless of its origin' refers to all possible sources of international obligations'.<sup>64</sup> Article 12 takes a clear position as regards 'formal sources' of international obligations; as the Commentary notes, alluding to the never-ending debate between international lawyers on the distinction between the 'formal sources' and the 'material sources' of international law, the term (p. 212) 'origin' rather than 'source' is used to avoid 'the doubts and doctrinal debates the term source has provoked'.<sup>65</sup>

This generally accepted principle was expressed in particularly clear terms in the arbitral decision in the case of the *Rainbow Warrior*, where the Arbitral Tribunal declared that 'any violation by a State of any obligation, of whatever origin, gives rise to State responsibility, and consequently entails the duty to make reparation'.<sup>66</sup> It matters little whether the obligation breached has its origin in customary or treaty law. In other words, there is no differentiation in international law between the responsibility which arises from a failure to execute a treaty or an international agreement and the responsibility which results from the breach of customary rules of international law. Equally, it matters little whether the obligation results from another source, such as a general principle of law recognized by civilized nations, a unilateral act through which a State assumes an obligation, a binding decision of an international organization, an international judicial decision, or an award in an international arbitration.

Further, there is no differentiation resulting from the *nature* of the norm breached.<sup>67</sup> Certainly, the introduction of the notion of an 'international crime' in the first reading draft, and in particular draft article 19 (which was abandoned in favour of the wording 'serious violation of essential obligations towards the international community' in the 2000 draft and then 'serious breaches of obligations under peremptory norms of general international law' in the Articles finally adopted in 2001), might have been taken to indicate that there exists a distinction between 'civil' and 'criminal' responsibility, even if it has often been reaffirmed by States during the course of the debates in the ILC that the notion of a crime does not imply the introduction of criminal responsibility. However, this—it seems—was the initial idea of Roberto Ago, in whose view:

Up to the present ... in international law responsibility meant, essentially, civil responsibility. But it should now be decided whether internationally wrongful acts as a whole did not include a category of acts, the nature and consequences of which could be different—acts for which, in particular, it was unthinkable that reparation could be made by mere indemnification. That applied, for example, to some international crimes such as the violation of certain obligations essential to the maintenance of peace—in particular,

aggression or genocide.<sup>68</sup>

For him, the mere obligation to make reparation was insufficient for the most serious attacks on the values of international society:

the obligation to make reparation ... envisages restoring the situation that would have existed if the wrong had not been committed. It thus involves a simple function of reintegration or compensation ... Punishment has a totally different nature ... To the contrary, its nature is afflictive or repressive.<sup>69</sup>

In his work in the ILC, from the outset, Ago seems to have proceeded with the concept of a *criminal responsibility* of States in the background. But when his proposal for draft article 19 was discussed and adopted in 1996 (unanimously, it should be recalled), the focus was only on a '*aggravated*' responsibility for crimes—compared to that arising in relation to other international wrongs—without qualifying it as criminal. The difference (p. 213) was that in the case of a crime, it was the international community as a whole which was concerned, and thus there could be envisaged either a collective reaction to the crime or a reaction from all States (including the adoption of countermeasures), in addition to the obligation to make reparation which arises in the case of all internationally wrongful acts. The idea of a criminal, or even simply a 'different' responsibility was, however, little by little abandoned in the face of the reticence of States in relation to the possibility of being subjected to an international sanction—individual or collective—for crimes. As early as 1996, in the context of the debates as to the consequences of crimes, the additional measures envisaged did not involve a responsibility different in nature from the responsibility for any other internationally wrongful act, but rather a responsibility of the same nature, but very slightly aggravated. This called into question considerably the utility of the proposed distinction.

In the face of the opposition of a number of States, the final Special Rapporteur proposed in the draft of August 2000 to delete the notion of international crimes and to speak rather of 'grave violations of essential obligations towards the international community'. But the August 2000 draft was hardly more satisfying from the point of view of the consequences to be drawn from these grave violations of essential obligations towards the international community as a whole. Besides the vague obligations under former draft article 53, what the ILC had envisaged in the case of a grave breach of obligations owed to the international community was the idea of payment of 'compensation corresponding to the gravity of the breach', that is to say, punitive damages, an approach which appeared both inappropriate and derisory; after so many years, the only consequence of an international crime was that the responsible State would have to provide an 'indemnity'. The inappropriateness of the solution retained resulted in a new formulation: international crimes became 'serious breaches of obligations under peremptory norms of general international law', in other words, what had been an international crime became a breach of *jus cogens*. But the so-called 'particular consequences' foreseen in article 41 in its final version are not in fact particular. The idea of punitive damages has, fortunately, not been kept in the final text and the only explicit supplementary consequences are that 'States should cooperate to put an end to grave breaches' of norms of *jus cogens* and should not recognize the situation that arises from these breaches. Both the idea of an additional criminal responsibility of States and the idea of a '*aggravated*' responsibility for certain violations were therefore abandoned in the course of the ILC's work.

No one would deny that there are more and less serious breaches of international law. It is indisputable that there are acts which are more or less damaging to the values of the international society. As has been suggested elsewhere:

No one would dispute that not all wrongful acts are of the same seriousness. Who would not feel that there is little in common (apart from the formal legal characterisation still used today as a matter of positive law) between on the one hand, a minor [or even major] violation of a commercial treaty and on the other, a genocide?<sup>70</sup>



But sovereign States, too wary of the idea that they could face 'punishment', although accepting in the first instance the distinction between crimes and 'delicts'<sup>71</sup> and in the final version the concept of 'serious breaches of obligations under peremptory norms of general (p. 214) international law', would not accept the drawing of any decisive consequences from those distinctions.

The interest of the distinction between different categories of breaches introduced by the ILC appears in effect extremely limited when seen in the light of the differentiation of the consequences which result for the responsibility incurred. However, some differentiation— new and not based on existing customary international law—was already present in the August 2000 text, as already indicated, in the forms which reparation could take: a serious breach of essential obligations owed to the international community as a whole could entail an obligation to pay punitive damages corresponding to the seriousness of the breach, even though in principle the compensation payable is a function of the gravity of the injury. This proposition, with its distinctly punitive flavour, was, however, abandoned in the Articles as finally adopted. The absence of development of a criminal responsibility for States was explicitly confirmed by the decision of the International Criminal Tribunal for the Former Yugoslavia:

Under present international law it is clear that States, by definition, cannot be the subject of criminal sanctions akin to those provided for in national criminal systems.<sup>72</sup>

Finally, there is no differentiation even deriving from the *content* of the norm breached, whether relating to the *type of norm* or its *subject matter*. For example, there is no difference from the point of view of international responsibility whether the State is bound by an obligation of means ('*obligation de moyens*') or an obligation of result ('*obligation de résultat*'): this distinction might be only relevant in determining the moment when international responsibility, and thus the obligation to make reparation, arises. Moreover, obligations may concern whatever subject matter, and a breach may result from whatever type of act. In this regard, the Commentary states that:

the breach by the State of an international obligation constitutes an internationally wrongful act, whatever the subject matter or content of the obligation breached, and whatever description may be given to the non-conforming conduct.<sup>73</sup>

The example given in support of this position is that of an obligation in the domain of economic relations which may be violated not only by the adoption of specific contrary economic measures, but also by the use of force.<sup>74</sup>

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### **(c) The extension in time of a breach of an international obligation**

Numerous questions are posed by the temporal character of a wrongful act, including both problems relating to the duration of an international obligation and problems relating to the time of commission of an internationally wrongful act. Those issues are dealt with in articles 13 to 15.

On the problem of the application of inter-temporal law, the well-established customary principles can be recalled, which all derive from the basic principle set out by Arbitrator Huber in the *Island of Palmas* case: 'A juridical fact must be appreciated in the light (p. 215) of the law contemporary with it and not of the law in force at the time when a dispute in regard to it arises or falls to be settled.'<sup>75</sup>

It is evident first of all that for conduct of a State to be considered wrongful, it must be in conflict with an international obligation in force. This means that behaviour cannot violate an international obligation either before it has entered into force, or after it has expired. In this regard, article 13 affirms that: '[a]n act of a State does not constitute a breach of an international obligation unless the State is bound by the obligation in question at the time the act occurs'. This is a simple affirmation of common sense.

The fact that the Genocide Convention would not have entered into force at the time it was allegedly violated was invoked by the Federal Republic of Yugoslavia (Serbia and Montenegro) before the International Court of Justice in *Bosnian Genocide*, in order to argue that Bosnia-Herzegovina could not invoke its responsibility. According to the FRY, the Court could not base its jurisdiction on article IX of the Genocide Convention, which, under the rules of State succession to treaties, as they were interpreted by the FRY, had not been in force for Bosnia-Herzegovina at the relevant time. At the preliminary objections stage, the Court rejected that argument, considering that the Genocide Convention had been in force.<sup>76</sup>

However, in 2004, the Court dismissed the separate claims filed in 1999 by Serbia and Montenegro against eight NATO member States (Belgium, Canada, France, Germany, Italy, The Netherlands, Portugal, and the United Kingdom) on the basis that the applicant State 'was not a Member of the United Nations, and in that capacity a State party to the Statute of the International Court of Justice, at the time of filing its Application to institute present proceedings before the Court on 29 April 1999'.<sup>77</sup> The key factor in the Court's decision was that the Former Republic of Yugoslavia (as it then was) had formally applied anew for membership of the UN, thus clarifying that it had not succeeded to the SFRY's UN membership.<sup>78</sup>

In 2007, in dealing with the merits of the dispute in *Bosnian Genocide*, the Court concluded that its 1996 Judgment constituted *res judicata* both in relation to the contention that the respondent was not a State with capacity to appear before the Court under the terms of its Statute and the question whether the respondent was, at the time of institution of proceedings, a party to the Genocide Convention.<sup>79</sup> Further, in 2008, when addressing its jurisdiction in the application brought by Croatia against Serbia, the Court rejected Serbia's argument that it did not have capacity to appear before the Court at the time when Croatia's application was filed on 2 July 1999. In reaching its conclusion, the Court relied on the principle that where a procedural defect can be cured by subsequent action, considerations of judicial economy may justify its assessment at a later date. If the Court (p. 216) had found that it did not have jurisdiction on the ground that Serbia was not a member of the UN on 2 July 1999, Croatia would have been obliged to re-submit its application; in the circumstances, the sound administration of justice would not be served by dismissing the application.<sup>80</sup>

The principle that an obligation must be in force at the time of the alleged violation is also important in the context of contemporary problems raised by the slave trade and the requests for compensation sometimes advanced in this context. In the 19th century, arbitrators drew a distinction between periods where the trade was not forbidden by international law and periods when it had become a prohibited activity: for example, when Great Britain liberated slaves seized from American boats, that act engaged the responsibility of Great Britain for having violated the principle of respect for foreign property during the former period, but did not engage its responsibility in the later period, when the slave trade had become 'contrary to the law of nations'.<sup>81</sup>

The rule according to which responsibility is appreciated according to the law in force at the moment of the commission of the act in question is applicable even when a norm of *jus cogens* has emerged. A norm of *jus cogens* is no more retroactive than any other international norm.

When an international obligation is extinguished, responsibility for a continuing violation also disappears from the moment of the disappearance of the obligation, but the responsibility already incurred for the period when the obligation was in force is not erased. There is a kind of vested right to reparation, which cannot be suppressed, even if the wrongful act would not necessarily give rise to a right to reparation if it were committed at a later time.

This does not mean that a norm must always be interpreted in the light of the prevailing law at the moment it is elaborated; however this is not contrary to the rule enunciated in article 13. Rather, at the moment at which it is necessary to ascertain whether any given conduct is in conformity with an international obligation, an evolutionary interpretation may be applied, in light of the development of international law at the moment of the application of the rule in the particular

case.<sup>82</sup>

To the extent that international responsibility arises only when an act attributable to a State is contrary to international law, it is necessary to know at what point a violation takes place and for how long it lasts. Issues of the moment at which an internationally wrongful act occurs and its extension in time are dealt with in articles 14 and 15. Article 14 distinguishes between breaches which are produced in an instantaneous way and do not extend in time (even if their consequences are lasting), such as the assassination of an ambassador, from continuing violations, for instance, the adoption of legislation contrary to the international obligations of the State. That characterization may result in some important consequences from the point of view of the jurisdiction of a tribunal or in relation to prescription. Notably, in the case of the proceedings in relation to crimes committed by the Chilean regime under Pinochet's rule, torture followed by forced disappearance has been considered to constitute a continuing act which lasts as long as the person is not found, so that any statute of limitations which might prevent proceedings is not applicable. The (p. 217) moment at which a composite act takes place—that is to say an act composed of a series of actions or omissions, the accumulation or the combination of which create a wrongful act (genocide or apartheid notably come to mind)—is determined by article 15.

The more precise distinctions which were included in the 1996 draft between violation of obligations requiring particular behaviour and obligations requiring a particular result, or between compound and complex internationally wrongful acts, were abandoned in the adoption of the final text.

In that regard, it should be mentioned that one of the new aspects introduced by the final Special Rapporteur, James Crawford, may be characterized as a step away from the 'Latin' approach in favour of a more 'Anglo-Saxon' approach, or rather from a relatively abstract and Cartesian approach in favour of a more concrete and pragmatic one. A whole series of elaborate concepts, including those to which reference has already been made, which had been forged, little by little, over the years, were consigned to the waste heap of history, denounced as being too complex. Thus in relation to the distinction between obligations of means (or behaviour), obligations of result and obligations of prevention, James Crawford wrote that 'they appear to be circular'.<sup>83</sup> The position which he thus adopted responded to the concerns of certain States. The United Kingdom, for example, stated (in a comment which should be read in the light of the characteristic British phlegm) that it was concerned that 'the fineness of the distinctions drawn ... between different categories of breach may exceed that which is necessary, or even helpful'.<sup>84</sup> Japan was not far behind in considering that certain aspects of the draft were supported by 'excessively abstract concepts ... laid down in unclear language'.<sup>85</sup> Germany agreed wholeheartedly, similarly highlighting that

there is a certain danger in establishing provisions that are too abstract in nature, since it is difficult to anticipate their scope and application ... They may also seem impractical to States less rooted in the continental European legal tradition, because such abstract rules do not easily lend themselves to the pragmatic approach normally prevailing in international law.<sup>86</sup>

Nevertheless, certain of the abandoned distinctions were perfectly usable, and useful.

Whether one is dealing with an instantaneous act or a continuing act, it is necessary to clearly identify the moment when behaviour becomes wrongful. The ICJ recalled this necessary distinction between the before and after of wrongfulness in its judgment in *Gabčíkovo-Nagymaros Project*, observing that: 'A wrongful act or offence is frequently preceded by preparatory actions which are not to be confused with the act or offence itself.'<sup>87</sup>

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## (d) Circumstances precluding wrongfulness

The Articles provide for various 'circumstances precluding wrongfulness' in Chapter V: consent;<sup>88</sup> self-defence;<sup>89</sup> countermeasures;<sup>90</sup> force majeure;<sup>91</sup> distress;<sup>92</sup> and necessity.<sup>93</sup> Article 26 clearly indicates that none of these circumstances can be invoked in case of a conflict of the behaviour with a peremptory norm of general international law.

(p. 218) Nevertheless, the view may be expressed that it would have been better to speak of circumstances excluding responsibility: that is, excluding essentially the obligation to make reparation, which seems to conform to the formulation adopted by the ICJ in *Gabčíkovo-Nagymaros Project*. While Hungary maintained that the wrongfulness of its behaviour was excluded by a state of necessity, the Court declared that:

The state of necessity claimed by Hungary—supposing it to have been established— ... could not permit of the conclusion that ... it had acted in accordance with its obligations under the 1977 Treaty or that those obligations had ceased to be binding upon it. It would only permit the affirmation that, under the circumstances, Hungary would not incur international responsibility by acting as it did.<sup>94</sup>

The Court, although clearly affirming that the existence of certain circumstances may excuse the conduct of a State but does not result in the extinction of its existing obligations (although it is not clear why this should be the case), also declared clearly that Hungary had not acted in conformity with its obligations, even if this might not have engaged its responsibility. Would it not be better to state that what is at issue are not circumstances precluding wrongfulness, but circumstances precluding responsibility, in spite of wrongfulness? The ICJ had in any case stated this clearly a few lines previously, stating that 'a state of necessity ... may only be invoked to exonerate from its responsibility a State which has failed to implement a treaty'.<sup>95</sup>

However, the exact consequences of 'circumstances precluding wrongfulness' remain uncertain at the level of the obligation to make reparation, to the extent that Article 27 provides that:

The invocation of a circumstance precluding wrongfulness... is without prejudice to:

...

**(b)** The question of compensation for any material loss caused by the act in question ...

The Commentary highlights the fact that 'material loss' is a more restrictive notion than that of 'damage', and that '[a]lthough the Article uses the term "compensation", it is not concerned with compensation within the framework of reparations provided for in Article 34.'<sup>96</sup> However, it is difficult to see that any 'compensation' payable constitutes anything other than compensation for the damage suffered by the fact of a wrongful act, and this even though the wrongfulness of that act was precluded.

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**10** B Bollecker-Stern, *Le préjudice dans la théorie de la responsabilité internationale* (Paris, Pedone, 1973), 20 (emphasis in original).

**11** For these purposes, laying to one side whatever doubts may exist both as to the extent to which these obligations reflect positive international law, as well as to the extent to which guarantees of non-repetition constitute a legal 'consequence' of an internationally wrongful act (given that they constitute merely measures to prevent a potential, different internationally wrongful act in the future).

**12** See Part Three of the 1996 draft, relating to the settlement of disputes: *ILC Yearbook 1996*, Vol II(2), 31.

**13** With the exception of the violations of human rights obligations under regional conventions, or violations of the rights of foreign investors under bilateral or multilateral treaties for the protection of foreign investments.

**14** With the exception resulting from the contemporary development of the international criminal responsibility of individuals.

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**61** Commentary to art 12, para 1.

**62** For a jurisdictional application of the principle according to which the powers of a State must be exercised in a reasonable way and in good faith, see *Rights of Nationals of the United States of America in Mo rocco (France v United States)*, ICJ Reports 1952, p 212.

**63** ARSIWA, art 12.

**64** Commentary to art 12, para 3.

**65** Ibid.

**66** *Rainbow Warrior (New Zealand v France)*, 30 April 1990, 20 RIAA 215, 251–252 (para 75).

**67** ARSIWA, art 12.

**68** *ILC Yearbook 1973*, Vol I, 5, para 9 (1202nd meeting).



- 69** R Ago, 'Le délit international' (1939) 68 *Recueil des cours* 525.
- 70** B Stern, 'Conclusions générales', in SFDI, *La responsabilité dans le système international* (Paris, Pedone, 1991), 326.
- 71** The famous art 19 in the 1996 draft: *ILC Yearbook 1996*, Vol II(2), 60. See Chapter 29.
- 72** ICTY, *Prosecutor v Blaskic*, Case No IT-95-14-AR 108 bis, Appeals Chamber, 29 October 1997, 110 *ILR* 607, 625–626 (para 27).
- 73** Commentary to art 12, para 10.
- 74** *Oil Platforms (Islamic Republic of Iran v. United States of America)*, Preliminary Objection, *ICJ Reports 1996*, p 803, 811–812 (para 21).
- 75** *Island of Palmas Case (Netherlands/USA)*, 4 April 1928, 2 *RIAA* 829, 845.
- 76** *Application of the Convention on the Prevention and Punishment of the Crime of Genocide, Preliminary Objections, Judgment*, *ICJ Reports 1996*, p 595.
- 77** See eg *Legality of Use of Force (Serbia and Montenegro v Belgium)*, Preliminary Objections, Judgment, *ICJ Reports 2004*, p 279, 311 (para 79).
- 78** The Court had held in 2003 that the admission of the FRY to the UN in 2000 was not a 'new fact within the meaning of art 61 of the Court's Statute which justified revision of its decision on jurisdiction': *Application for Revision of the Judgment of 11 July 1996 in the Case concerning Application of the Convention on the Prevention and Punishment of the Crime of Genocide (Bosnia and Herzegovina v Yugoslavia)*, Preliminary Objections (*Yugoslavia v Bosnia and Herzegovina*), *ICJ Reports 2003*, p 7.
- 79** *Application of the Convention on the Prevention and Punishment of the Crime of Genocide (Bosnia and Herzegovina v Serbia and Montenegro)*, Judgment, 26 February 2007, para 140.
- 80** *Application of the Convention on the Prevention and Punishment of the Crime of Genocide (Croatia v Serbia)*, Preliminary Objections, 18 November 2008, para 118.
- 81** *The 'Entreprise', The 'Hermosa' and The 'Créole'*, in AG de Lapradelle and NS Politis, *Recueil des arbitrages internationaux* (Paris, Editions Internationales, 1955), vol IV, 4373, 4374, 4375.
- 82** On the idea of 'evolutionary interpretation' see B Bollecker, 'L'avis consultatif du 21 juin 1971 dans l'affaire de la Namibie (Sud-Ouest africain)' (1971) 17 *AFDI* 290.
- 83** J Crawford, Second Report on State Responsibility, 1999, A/CN.4/498, para 90; in the French translation, the expression is rendered in a somewhat more colourful fashion: 'elles semblent se mordre la queue'.
- 84** *Ibid*, para 4 (citing A/CN.4/488, p 46).
- 85** *Ibid*.
- 86** *Ibid*, para 56 (citing A/CN.4/488, p 67).
- 87** *Gabčíkovo-Nagymaros Project (Hungary/Slovakia)*, *ICJ Reports 1997*, p 7, 54 (para 79).
- 88** ARSIWA, art 20.
- 89** ARSIWA, art 21.
- 90** ARSIWA, art 22.
- 91** ARSIWA, art 23.
- 92** ARSIWA, art 24.
- 93** ARSIWA, art 25.
- 94** *Gabčíkovo-Nagymaros Project (Hungary/Slovakia)*, *ICJ Reports 1997*, p 7, 39 (para 48).
- 95** *Ibid*, 63 (para 101).
- 96** Commentary to art 27, para 4.



INTERNATIONAL COURT OF JUSTICE

REPORTS OF JUDGMENTS,  
ADVISORY OPINIONS AND ORDERS

NORTH SEA CONTINENTAL SHELF CASES

(FEDERAL REPUBLIC OF GERMANY/DENMARK;  
FEDERAL REPUBLIC OF GERMANY/NETHERLANDS)

JUDGMENT OF 20 FEBRUARY 1969

**1969**

COUR INTERNATIONALE DE JUSTICE

RECUEIL DES ARRÊTS,  
AVIS CONSULTATIFS ET ORDONNANCES

AFFAIRES DU PLATEAU CONTINENTAL  
DE LA MER DU NORD

(RÉPUBLIQUE FÉDÉRALE D'ALLEMAGNE/DANEMARK;  
RÉPUBLIQUE FÉDÉRALE D'ALLEMAGNE/PAYS-BAS)

ARRÊT DU 20 FÉVRIER 1969

Official citation:

*North Sea Continental Shelf, Judgment, I.C.J. Reports 1969, p. 3.*

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20 FEBRUARY 1969

JUDGMENT

NORTH SEA CONTINENTAL SHELF CASES  
(FEDERAL REPUBLIC OF GERMANY/DENMARK;  
FEDERAL REPUBLIC OF GERMANY/NETHERLANDS)

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AFFAIRES DU PLATEAU CONTINENTAL  
DE LA MER DU NORD  
(RÉPUBLIQUE FÉDÉRALE D'ALLEMAGNE/DANEMARK;  
RÉPUBLIQUE FÉDÉRALE D'ALLEMAGNE/PAYS-BAS)

20 FÉVRIER 1969

ARRÊT

# INTERNATIONAL COURT OF JUSTICE

YEAR 1969

1969  
20 February  
General List:  
Nos. 51 & 52

20 February 1969

## NORTH SEA CONTINENTAL SHELF CASES

(FEDERAL REPUBLIC OF GERMANY/DENMARK;  
FEDERAL REPUBLIC OF GERMANY/NETHERLANDS)

*Continental shelf areas in the North Sea—Delimitation as between adjacent States—Advantages and disadvantages of the equidistance method—Theory of just and equitable apportionment—Incompatibility of this theory with the principle of the natural appurtenance of the shelf to the coastal State—Task of the Court relates to delimitation not apportionment.*

*The equidistance principle as embodied in Article 6 of the 1958 Geneva Continental Shelf Convention—Non-opposability of that provision to the Federal Republic of Germany, either contractually or on the basis of conduct or estoppel.*

*Equidistance and the principle of natural appurtenance—Notion of closest proximity—Critique of that notion as not being entailed by the principle of appurtenance—Fundamental character of the principle of the continental shelf as being the natural prolongation of the land territory.*

*Legal history of delimitation—Truman Proclamation—International Law Commission—1958 Geneva Conference—Acceptance of equidistance as a purely conventional rule not reflecting or crystallizing a rule of customary international law—Effect in this respect of reservations article of Geneva Convention—Subsequent State practice insufficient to convert the conventional rule into a rule of customary international law—The opinio juris sive necessitatis, how manifested.*

*Statement of what are the applicable principles and rules of law—Delimitation by agreement, in accordance with equitable principles, taking account of all relevant circumstances, and so as to give effect to the principle of natural prolongation—Freedom of the Parties as to choice of method—Various factors relevant to the negotiation.*

COUR INTERNATIONALE DE JUSTICE

ANNÉE 1969

20 février 1969

1969  
20 février  
Rôle général  
nos 51 & 52

AFFAIRES DU PLATEAU CONTINENTAL  
DE LA MER DU NORD

(RÉPUBLIQUE FÉDÉRALE D'ALLEMAGNE/DANEMARK;  
RÉPUBLIQUE FÉDÉRALE D'ALLEMAGNE/PAYS-BAS)

*Plateau continental de la mer du Nord — Délimitation entre Etats limitrophes — Avantages et inconvénients de la méthode de l'équidistance — Théorie de la répartition juste et équitable — Incompatibilité de cette théorie avec le principe du rattachement naturel du plateau continental à l'Etat riverain — La mission de la Cour concerne la délimitation et non la répartition.*

*Le principe de l'équidistance résultant de l'article 6 de la Convention de Genève de 1958 sur le plateau continental — Inopposabilité de cette disposition à la République fédérale d'Allemagne que ce soit à titre contractuel, à raison du comportement ou par le jeu de l'estoppel.*

*Equidistance et principe du rattachement naturel — Notion de plus grande proximité — Critique de cette notion, que le principe du rattachement n'implique pas — Caractère fondamental du principe selon lequel le plateau continental est le prolongement naturel du territoire.*

*Historique du droit de la délimitation — Proclamation Truman — Commission du droit international — Conférence de Genève de 1958 — Acceptation de l'équidistance en tant que règle purement conventionnelle ne consacrant ou ne cristallisant pas une règle de droit international coutumier — Effet à cet égard de l'article de la Convention de Genève relatif aux réserves — La pratique ultérieure des Etats ne suffit pas à transformer une règle conventionnelle en une règle de droit international coutumier — L'opinio juris sive necessitatis et ses manifestations.*

*Principes et règles de droit applicables — Délimitation par voie d'accord, conformément à des principes équitables, effectuée compte tenu de toutes les circonstances pertinentes et afin de donner effet au principe du prolongement naturel — Liberté des Parties quant au choix de la méthode — Divers facteurs présentant de l'intérêt pour les négociations.*

## JUDGMENT

*Present: President* BUSTAMANTE Y RIVERO; *Vice-President* KORETSKY; *Judges* Sir Gerald FITZMAURICE, TANAKA, JESSUP, MORELLI, Sir Muhammad ZAFRULLA KHAN, PADILLA NERVO, FORSTER, GROS, AMMOUN, BENGZON, PETRÉN, LACHS, ONYEAMA; *Judges ad hoc* MOSLER, SØRENSEN; *Registrar* AQUARONE.

In the North Sea Continental Shelf cases,

*between*

the Federal Republic of Germany,  
represented by

Dr. G. Jaenicke, Professor of International Law in the University of Frankfurt am Main,

as Agent,

assisted by

Dr. S. Oda, Professor of International Law in the University of Sendai,  
as Counsel,

Dr. U. Scheuner, Professor of International Law in the University of Bonn,

Dr. E. Menzel, Professor of International Law in the University of Kiel,

Dr. Henry Herrmann, of the Massachusetts Bar, associated with Messrs.  
Goodwin, Procter and Hoar, Counsellors-at-Law, Boston,

Dr. H. Blomeyer-Bartenstein, Counsellor 1st Class, Ministry of Foreign  
Affairs,

Dr. H. D. Treviranus, Counsellor, Ministry of Foreign Affairs,  
as Advisers,

and by Mr. K. Witt, Ministry of Foreign Affairs,  
as Expert,

*and*

the Kingdom of Denmark,  
represented by

Mr. Bent Jacobsen, Barrister at the Supreme Court of Denmark,  
as Agent and Advocate,

assisted by

Sir Humphrey Waldock, C.M.G., O.B.E., Q.C., Professor of International  
Law in the University of Oxford,

as Counsel and Advocate,

H.E. Mr. S. Sandager Jeppesen, Ambassador, Ministry of Foreign Affairs,

Mr. E. Krog-Meyer, Head of The Legal Department, Ministry of Foreign  
Affairs,

Dr. I. Foighel, Professor in the University of Copenhagen,

Mr. E. Lauterpacht, Member of the English Bar and Lecturer in the Uni-  
versity of Cambridge,



## ARRÊT

*Présents:* M. BUSTAMANTE Y RIVERO, *Président*; M. KORETSKY, *Vice-Président*; sir Gerald FITZMAURICE, MM. TANAKA, JESSUP, MORELLI, sir Muhammad ZAFRULLA KHAN, MM. PADILLA NERVO, FORSTER, GROS, AMMOUN, BENGZON, PETRÉN, LACHS, ONYEAMA, *juges*; MM. MOSLER, SØRENSEN, *juges ad hoc*; M. AQUARONE, *Greffier*.

En les affaires du Plateau continental de la mer du Nord,

*entre*

la République fédérale d'Allemagne,  
représentée par

M. G. Jaenicke, professeur de droit international à l'Université de Francfort-sur-le-Main,  
comme agent,

M. S. Oda, professeur de droit international à l'Université de Sendai,  
comme conseil,

M. U. Scheuner, professeur de droit international à l'Université de Bonn,  
M. E. Menzel, professeur de droit international à l'Université de Kiel,  
M. Henry Herrmann, du barreau du Massachusetts, membre associé du cabinet Goodwin, Procter and Hoar, avocats à Boston,  
M. H. Blomeyer-Bartenstein, conseiller de première classe au ministère des Affaires étrangères,  
M. H. D. Treviranus, conseiller au ministère des Affaires étrangères,  
comme conseillers,

et par

M. K. Witt, du ministère des Affaires étrangères,  
comme expert,

*et*

le Royaume du Danemark,  
représenté par

M. Bent Jacobsen, avocat à la Cour suprême du Danemark,  
comme agent et avocat,

sir Humphrey Waldock, C.M.G., O.B.E., Q.C., professeur de droit international à l'Université d'Oxford,  
comme conseil et avocat,

S. Exc. M. S. Sandager Jeppesen, ambassadeur, du ministère des Affaires étrangères,

M. E. Krog-Meyer, chef du service juridique du ministère des Affaires étrangères,

M. I. Foighel, professeur à l'Université de Copenhague,

M. E. Lauterpacht, membre du barreau anglais, maître de conférences à l'Université de Cambridge,

Mr. M. Thamsborg, Head of Department, Hydrographic Institute,  
as Advisers,  
and by

Mr. P. Boeg, Head of Secretariat, Ministry of Foreign Affairs,  
Mr. U. Engel, Head of Section, Ministry of Foreign Affairs,  
as Secretaries,

*and between*

the Federal Republic of Germany,  
represented as indicated above,

*and*

the Kingdom of the Netherlands,  
represented by

Professor W. Riphagen, Legal Adviser to the Ministry of Foreign Affairs,  
Professor of International Law at the Rotterdam School of Economics,

as Agent,

assisted by

Sir Humphrey Waldock, C.M.G., O.B.E., Q.C., Professor of International  
Law in the University of Oxford,

as Counsel,

Rear-Admiral W. Langeraar, Chief of the Hydrographic Department,  
Royal Netherlands Navy,

Mr. G. W. Maas Geesteranus, Assistant Legal Adviser to the Ministry of  
Foreign Affairs,

Miss F. Y. van der Wal, Assistant Legal Adviser to the Ministry of Foreign  
Affairs,

as Advisers,

and by

Mr. H. Rombach, Divisional Head, Hydrographic Department, Royal  
Netherlands Navy,

as Deputy-Adviser,

THE COURT,

composed as above,

*delivers the following Judgment:*

By a letter of 16 February 1967, received in the Registry on 20 February 1967,  
the Minister for Foreign Affairs of the Netherlands transmitted to the Registrar:

- (a) an original copy, signed at Bonn on 2 February 1967 for the Governments  
of Denmark and the Federal Republic of Germany, of a Special Agree-  
ment for the submission to the Court of a difference between those two  
States concerning the delimitation, as between them, of the continental  
shelf in the North Sea;
- (b) an original copy, signed at Bonn on 2 February 1967 for the Governments  
of the Federal Republic of Germany and the Netherlands, of a Special  
Agreement for the submission to the Court of a difference between those

M. M. Thamsborg, chef de service à l'Institut hydrographique,  
comme conseillers,

et par

M. P. Boeg, chef de secrétariat au ministère des Affaires étrangères,

M. U. Engel, chef de section au ministère des Affaires étrangères,  
comme secrétaires,

*et entre*

la République fédérale d'Allemagne,  
représentée comme il est dit ci-dessus,

*et*

le Royaume des Pays-Bas,  
représenté par

M. W. Riphagen, juriconsulte du ministère des Affaires étrangères, profes-  
seur de droit international à l'École des sciences économiques de Rotter-  
dam,  
comme agent,

sir Humphrey Waldock, C.M.G., O.B.E., Q.C., professeur de droit inter-  
national à l'Université d'Oxford,

comme conseil,

le contre-amiral W. Langeraar, chef du service hydrographique de la Marine  
royale des Pays-Bas,

M. G. W. Maas Geesteranus, juriconsulte adjoint du minist re des Affaires  
étrangères,

Mlle F. Y. van der Wal, juriconsulte adjoint du ministère des Affaires  
étrangères,

comme conseillers,

et par

M. H. Rombach, chef de division au service hydrographique de la Marine  
royale des Pays-Bas,

comme conseiller adjoint,

LA COUR,

ainsi composée,

*rend l'arrêt suivant:*

Par lettre du 16 février 1967, reçue au Greffe le 20 février 1967, le ministre  
des Affaires étrangères des Pays-Bas a adressé au Greffier :

- a) un exemplaire original d'un compromis, signé à Bonn le 2 février 1967 pour  
les Gouvernements du Danemark et de la République fédérale d'Allemagne,  
soumettant à la Cour un différend entre ces deux États relatif à la délimita-  
tion du plateau continental de la mer du Nord entre eux ;
- b) un exemplaire original d'un compromis, signé à Bonn le 2 février 1967  
pour les Gouvernements de la République fédérale d'Allemagne et des  
Pays-Bas, soumettant à la Cour un différend entre ces deux États relatif

- two States concerning the delimitation, as between them, of the continental shelf in the North Sea;
- (c) an original copy, signed at Bonn on 2 February 1967 for the three Governments aforementioned, of a Protocol relating to certain procedural questions arising from the above-mentioned Special Agreements.

Articles 1 to 3 of the Special Agreement between the Governments of Denmark and the Federal Republic of Germany are as follows:

*“Article 1*

- (1) The International Court of Justice is requested to decide the following question:

What principles and rules of international law are applicable to the delimitation as between the Parties of the areas of the continental shelf in the North Sea which appertain to each of them beyond the partial boundary determined by the above-mentioned Convention of 9 June 1965?

- (2) The Governments of the Kingdom of Denmark and of the Federal Republic of Germany shall delimit the continental shelf in the North Sea as between their countries by agreement in pursuance of the decision requested from the International Court of Justice.

*Article 2*

- (1) The Parties shall present their written pleadings to the Court in the order stated below:

1. a Memorial of the Federal Republic of Germany to be submitted within six months from the notification of the present Agreement to the Court;
2. a Counter-Memorial of the Kingdom of Denmark to be submitted within six months from the delivery of the German Memorial;
3. a German Reply followed by a Danish Rejoinder to be delivered within such time-limits as the Court may order.

- (2) Additional written pleadings may be presented if this is jointly proposed by the Parties and considered by the Court to be appropriate to the case and the circumstances.

- (3) The foregoing order of presentation is without prejudice to any question of burden of proof which might arise.

*Article 3*

The present Agreement shall enter into force on the day of signature thereof.”

Articles 1 to 3 of the Special Agreement between the Governments of the Federal Republic of Germany and the Netherlands are as follows:

*“Article 1*

- (1) The International Court of Justice is requested to decide the following question:

What principles and rules of international law are applicable to the delimitation as between the Parties of the areas of the continental shelf in the North Sea which appertain to each of them beyond the partial boundary determined by the above-mentioned Convention of 1 December 1964?

à la délimitation du plateau continental de la mer du Nord entre eux;

- c) un exemplaire original d'un protocole, signé à Bonn le 2 février 1967 pour les trois gouvernements précités, relatif à certaines questions de procédure résultant des compromis ci-dessus mentionnés.

Les articles 1 à 3 du compromis entre les Gouvernements du Danemark et de la République fédérale d'Allemagne sont ainsi conçus :

*« Article premier*

1) La Cour internationale de Justice est priée de trancher la question suivante:

Quels sont les principes et les règles du droit international applicables à la délimitation entre les Parties des zones du plateau continental de la mer du Nord relevant de chacune d'elles, au-delà de la ligne de délimitation partielle déterminée par la convention susmentionnée du 9 juin 1965?

2) Les Gouvernements du Royaume du Danemark et de la République fédérale d'Allemagne délimiteront le plateau continental de la mer du Nord entre leurs pays par voie d'accord conclu conformément à la décision demandée à la Cour internationale de Justice.

*Article 2*

1) Les Parties déposeront devant la Cour les pièces de la procédure écrite dans l'ordre suivant :

1. mémoire de la République fédérale d'Allemagne devant être soumis dans les six mois qui suivront la notification du présent accord à la Cour;
2. contre-mémoire du Royaume du Danemark devant être soumis dans les six mois qui suivront la remise du mémoire allemand;
3. réplique allemande suivie d'une duplique danoise, devant être soumise dans des délais à fixer par la Cour.

2) Des pièces écrites supplémentaires pourront être présentées si les Parties le proposent en commun et si la Cour l'estime approprié à l'affaire et aux circonstances.

3) L'ordre indiqué ci-dessus pour le dépôt des pièces ne préjuge en rien de la charge de la preuve.

*Article 3*

Le présent accord entrera en vigueur le jour de sa signature. »

Les articles 1 à 3 du compromis entre les Gouvernements de la République fédérale d'Allemagne et des Pays-Bas sont ainsi conçus :

*« Article premier*

1) La Cour internationale de Justice est priée de trancher la question suivante:

Quels sont les principes et les règles du droit international applicables à la délimitation entre les Parties des zones du plateau continental de la mer du Nord relevant de chacune d'elles, au-delà de la ligne de délimitation partielle déterminée par la convention susmentionnée du 1<sup>er</sup> décembre 1964?

(2) The Governments of the Federal Republic of Germany and of the Kingdom of the Netherlands shall delimit the continental shelf of the North Sea as between their countries by agreement in pursuance of the decision requested from the International Court of Justice.

*Article 2*

(1) The Parties shall present their written pleadings to the Court in the order stated below:

1. a Memorial of the Federal Republic of Germany to be submitted within six months from the notification of the present Agreement to the Court;
2. a Counter-Memorial of the Kingdom of the Netherlands to be submitted within six months from the delivery of the German Memorial;
3. a German Reply followed by a Netherlands Rejoinder to be delivered within such time-limits as the Court may order.

(2) Additional written pleadings may be presented if this is jointly proposed by the Parties and considered by the Court to be appropriate to the case and the circumstances.

(3) The foregoing order of presentation is without prejudice to any question of burden of proof which might arise.

*Article 3*

The present Agreement shall enter into force on the day of signature thereof.”

The Protocol between the three Governments reads as follows:

“Protocol

At the signature of the Special Agreement of today’s date between the Government of the Federal Republic of Germany and the Governments of the Kingdom of Denmark and the Kingdom of the Netherlands respectively, on the submission to the International Court of Justice of the differences between the Parties concerning the delimitation of the continental shelf in the North Sea, the three Governments wish to state their agreement on the following:

1. The Government of the Kingdom of the Netherlands will, within a month from the signature, notify the two Special Agreements together with the present Protocol to the International Court of Justice in accordance with Article 40, paragraph 1, of the Statute of the Court.
2. After the notification in accordance with item 1 above the Parties will ask the Court to join the two cases.
3. The three Governments agree that, for the purpose of appointing a judge *ad hoc*, the Governments of the Kingdom of Denmark and the Kingdom of the Netherlands shall be considered parties in the same interest within the meaning of Article 31, paragraph 5, of the Statute of the Court.”

Pursuant to Article 33, paragraph 2, of the Rules of Court, the Registrar at once informed the Governments of Denmark and the Federal Republic of Germany of the filing of the Special Agreements. In accordance with Article 34, paragraph 2, of the Rules of Court, copies of the Special Agreements were transmitted to the other Members of the United Nations and to other non-member States entitled to appear before the Court.

2) Les Gouvernements de la République fédérale d'Allemagne et du Royaume des Pays-Bas délimiteront le plateau continental de la mer du Nord entre leurs pays par voie d'accord conclu conformément à la décision demandée à la Cour internationale de Justice.

*Article 2*

1) Les Parties déposeront devant la Cour les pièces de la procédure écrite dans l'ordre suivant :

1. mémoire de la République fédérale d'Allemagne devant être soumis dans les six mois qui suivront la notification du présent accord à la Cour;
2. contre-mémoire du Royaume des Pays-Bas devant être soumis dans les six mois qui suivront la remise du mémoire allemand;
3. réplique allemande suivie d'une duplique néerlandaise, devant être soumises dans des délais à fixer par la Cour.

2) Des pièces écrites supplémentaires pourront être présentées si les Parties le proposent en commun et si la Cour l'estime approprié à l'affaire et aux circonstances.

3) L'ordre indiqué ci-dessus pour le dépôt des pièces ne préjuge en rien de la charge de la preuve.

*Article 3*

Le présent accord entrera en vigueur le jour de sa signature. »

Le protocole entre les trois gouvernements est ainsi conçu :

«Protocole

En signant les compromis intervenus ce jour entre le Gouvernement de la République fédérale d'Allemagne et les Gouvernements du Royaume du Danemark et du Royaume des Pays-Bas aux termes desquels sont soumis à la Cour internationale de Justice les différends entre les Parties concernant la délimitation du plateau continental de la mer du Nord, les trois gouvernements tiennent à déclarer leur accord sur ce qui suit :

1. Le Gouvernement du Royaume des Pays-Bas notifiera, dans le mois de la signature, les deux compromis et le présent protocole à la Cour internationale de Justice, conformément à l'article 40, paragraphe 1, du Statut de la Cour.

2. Une fois faite la notification prévue au paragraphe précédent, les Parties demanderont à la Cour de joindre les deux instances.

3. Les trois gouvernements conviennent qu'aux fins de la désignation d'un juge *ad hoc* les Gouvernements du Royaume du Danemark et du Royaume des Pays-Bas seront considérés comme faisant cause commune au sens de l'article 31, paragraphe 5, du Statut de la Cour. »

Conformément à l'article 33, paragraphe 2, du Règlement de la Cour, le Greffier a immédiatement notifié le dépôt des compromis aux Gouvernements du Danemark et de la République fédérale d'Allemagne. Conformément à l'article 34, paragraphe 2, dudit Règlement, copie des compromis a été transmise aux autres Membres des Nations Unies, ainsi qu'aux autres Etats non membres admis à ester devant la Cour.

By Orders of 8 March 1967, taking into account the agreement reached between the Parties, 21 August 1967 and 20 February 1968 were fixed respectively as the time-limits for the filing of the Memorials and Counter-Memorials. These pleadings were filed within the time-limits prescribed. By Orders of 1 March 1968, 31 May and 30 August 1968 were fixed respectively as the time-limits for the filing of the Replies and Rejoinders.

Pursuant to Article 31, paragraph 3, of the Statute of the Court, the Government of the Federal Republic of Germany chose Dr. Hermann Mosler, Professor of International Law in the University of Heidelberg, to sit as Judge *ad hoc* in both cases. Referring to the agreement concluded between them according to which they should be considered parties in the same interest within the meaning of Article 31, paragraph 5, of the Statute, the Governments of Denmark and the Netherlands chose Dr. Max Sørensen, Professor of International Law in the University of Aarhus, to sit as Judge *ad hoc* in both cases.

By an Order of 26 April 1968, considering that the Governments of Denmark and the Netherlands were, so far as the choice of a Judge *ad hoc* was concerned, to be reckoned as one Party only, the Court found that those two Governments were in the same interest, joined the proceedings in the two cases and, in modification of the directions given in the Orders of 1 March 1968, fixed 30 August 1968 as the time-limit for the filing of a Common Rejoinder for Denmark and the Netherlands.

The Replies and the Common Rejoinder having been filed within the time-limits prescribed, the cases were ready for hearing on 30 August 1968.

Pursuant to Article 44, paragraph 2, of the Rules of Court, the pleadings and annexed documents were, after consultation of the Parties, made available to the Governments of Brazil, Canada, Chile, Colombia, Ecuador, Finland, France, Honduras, Iran, Norway, Sweden, United Kingdom of Great Britain and Northern Ireland, United States of America and Venezuela. Pursuant to paragraph 3 of the same Article, those pleadings and annexed documents were, with the consent of the Parties, made accessible to the public as from the date of the opening of the oral proceedings.

Hearings were held from 23 to 25 October, from 28 October to 1 November, and on 4, 5, 7, 8 and 11 November 1968, in the course of which the Court heard, in the order agreed between the Parties and accepted by the Court, the oral arguments and replies of Professor Jaenicke, Agent, and Professor Oda, Counsel, on behalf of the Government of the Federal Republic of Germany; and of Mr. Jacobsen and Professor Riphagen, Agents, and Sir Humphrey Waldock, Counsel, on behalf of the Governments of Denmark and the Netherlands.

In the course of the written proceedings, the following Submissions were presented by the Parties:

*On behalf of the Government of the Federal Republic of Germany,*  
in the Memorials:

“May it please the Court to recognize and declare:

1. The delimitation of the continental shelf between the Parties in the North Sea is governed by the principle that each coastal State is entitled to a just and equitable share.



Par ordonnances du 8 mars 1967, les délais pour le dépôt des mémoires et contre-mémoires ont été fixés, en tenant compte de l'accord intervenu entre les Parties, aux 21 août 1967 et 20 février 1968 respectivement. Ces pièces de procédure ont été déposées dans les délais prescrits. Par ordonnances du 1<sup>er</sup> mars 1968, les délais pour le dépôt des répliques et dupliques ont été fixés aux 31 mai et 30 août 1968 respectivement.

En application de l'article 31, paragraphe 3, du Statut de la Cour, le Gouvernement de la République fédérale d'Allemagne a désigné M. Hermann Mosler, professeur de droit international à l'Université de Heidelberg, pour siéger comme juge *ad hoc* dans les deux affaires. Se référant à l'accord conclu entre eux et aux termes duquel ils devaient être considérés comme faisant cause commune au sens de l'article 31, paragraphe 5, du Statut, les Gouvernements du Danemark et des Pays-Bas ont désigné M. Max Sørensen, professeur de droit international à l'Université de Aarhus, pour siéger comme juge *ad hoc* dans les deux affaires.

Par ordonnance du 26 avril 1968, considérant que les Gouvernements du Danemark et des Pays-Bas ne comptaient, en ce qui concerne la désignation d'un juge *ad hoc*, que pour une seule Partie, la Cour a constaté que ces deux Gouvernements faisaient cause commune, joint les instances dans les deux affaires et, modifiant les prescriptions des ordonnances du 1<sup>er</sup> mars 1968, fixé au 30 août 1968 le délai pour le dépôt d'une duplique commune du Danemark et des Pays-Bas.

Les répliques et la duplique commune ayant été déposées dans les délais prescrits, les affaires se sont trouvées en état le 30 août 1968.

En application de l'article 44, paragraphe 2, du Règlement, les pièces de la procédure écrite ont, après consultation des Parties, été mises à la disposition des Gouvernements du Brésil, du Canada, du Chili, de la Colombie, des Etats-Unis d'Amérique, de l'Equateur, de la Finlande, de la France, du Honduras, de l'Iran, de la Norvège, du Royaume-Uni de Grande-Bretagne et d'Irlande du Nord, de la Suède et du Venezuela. En application du paragraphe 3 du même article, ces pièces ont, avec l'assentiment des Parties, été rendues accessibles au public à dater de l'ouverture de la procédure orale.

Des audiences ont été tenues du 23 au 25 octobre, du 28 octobre au 1<sup>er</sup> novembre et les 4, 5, 7, 8 et 11 novembre 1968, durant lesquelles ont été entendus en leurs plaidoiries et réponses, dans l'ordre convenu entre les Parties et accepté par la Cour: pour le Gouvernement de la République fédérale d'Allemagne, M. Jaenicke, agent, et M. Oda, conseil; et pour les Gouvernements du Danemark et des Pays-Bas, MM. Jacobsen et Riphagen, agents, et sir Humphrey Waldoock, conseil.

Dans la procédure écrite, les conclusions ci-après ont été présentées par les Parties:

*Au nom du Gouvernement de la République fédérale d'Allemagne,*

dans les mémoires:

«Plaise à la Cour reconnaître et dire:

1. Que la délimitation du plateau continental de la mer du Nord entre les Parties est régie par le principe selon lequel chacun des Etats riverains a droit à une part juste et équitable.

between the Parties which could not be settled by detailed negotiations, regarding the further course of the boundary beyond the partial boundary determined by the Convention of 9 June 1965;

Considering that under the terms of Article 1, paragraph 1, of the Compromis the task entrusted to the Court is not to formulate a basis for the delimitation of the continental shelf in the North Sea as between the Parties *ex aequo et bono*, but to decide what principles and rules of international law are applicable to the delimitation as between the Parties of the areas of the continental shelf in the North Sea which appertain to each of them beyond the partial boundary, determined by the above-mentioned Convention of 9 June 1965;

In view of the facts and arguments presented in Parts I and II of this Counter-Memorial,

May it please the Court to adjudge and declare:

1. The delimitation as between the Parties of the said areas of the continental shelf in the North Sea is governed by the principles and rules of international law which are expressed in Article 6, paragraph 2, of the Geneva Convention of 1958 on the Continental Shelf.

2. The Parties being in disagreement, unless another boundary is justified by special circumstances, the boundary between them is to be determined by application of the principle of equidistance from the nearest points of the baselines from which the breadth of the territorial sea of each State is measured.

3. Special circumstances which justify another boundary line not having been established, the boundary between the Parties is to be determined by application of the principle of equidistance indicated in the preceding Submission."

*On behalf of the Government of the Netherlands,*

in its Counter-Memorial:

"Considering that, as noted in the Compromis, disagreement exists between the Parties which could not be settled by detailed negotiations, regarding the further course of the boundary beyond the partial boundary determined by the Treaty of 1 December 1964;

Considering that under the terms of Article 1, paragraph 1, of the Compromis the task entrusted to the Court is not to formulate a basis for the delimitation of the continental shelf in the North Sea as between the Parties *ex aequo et bono*, but to decide what principles and rules of international law are applicable to the delimitation as between the Parties of the areas of the continental shelf in the North Sea which appertain to each of them beyond the partial boundary determined by the above-mentioned Treaty of 1 December 1964;

In view of the facts and arguments presented in Parts I and II of this Counter-Memorial,

May it please the Court to adjudge and declare:

1. The delimitation as between the Parties of the said areas of the continental shelf in the North Sea is governed by the principles and rules of international law which are expressed in Article 6, paragraph 2, of the Geneva Convention of 1958 on the Continental Shelf.

les Parties un désaccord qui n'a pu être réglé par des négociations approfondies, quant au prolongement de la ligne de délimitation au-delà de la ligne de délimitation partielle déterminée par la convention du 9 juin 1965;

Considérant que, aux termes de l'article premier, paragraphe 1, du compromis, la tâche qui incombe à la Cour n'est pas de formuler une base pour la délimitation du plateau continental de la mer du Nord entre les Parties *ex aequo et bono*, mais de décider quels sont les principes et les règles du droit international applicables à la délimitation entre les Parties des zones du plateau continental de la mer du Nord relevant de chacune d'elles, au-delà de la ligne de délimitation partielle déterminée par la convention susmentionnée du 9 juin 1965;

Vu les faits et arguments exposés dans les première et deuxième parties du présent contre-mémoire,

Plaise à la Cour dire et juger:

1. Que la délimitation entre les Parties desdites zones du plateau continental de la mer du Nord est régie par les principes et les règles du droit international énoncés à l'article 6, paragraphe 2, de la Convention de Genève de 1958 sur le plateau continental.

2. Que les Parties étant en désaccord, et à moins que des circonstances spéciales ne justifient une autre délimitation, la délimitation entre elles doit être opérée par application du principe de l'équidistance des points les plus proches des lignes de base à partir desquelles est mesurée la largeur de la mer territoriale de chacun de ces Etats.

3. Que, des circonstances spéciales justifiant une autre délimitation n'ayant pas été établies, la délimitation entre les Parties doit être opérée par application du principe de l'équidistance mentionné dans la conclusion précédente.»

*Au nom du Gouvernement des Pays-Bas,*

dans son contre-mémoire:

«Considérant que, ainsi qu'il est noté dans le compromis, il existe entre les Parties un désaccord qui n'a pu être réglé par des négociations approfondies, quant au prolongement de la ligne de délimitation au-delà de la ligne de délimitation partielle déterminée par la convention du 1<sup>er</sup> décembre 1964;

Considérant que, aux termes de l'article premier, paragraphe 1, du compromis, la tâche qui incombe à la Cour n'est pas de formuler une base pour la délimitation du plateau continental de la mer du Nord entre les Parties *ex aequo et bono*, mais de décider quels sont les principes et les règles du droit international applicables à la délimitation entre les Parties des zones du plateau continental de la mer du Nord relevant de chacune d'elles, au-delà de la ligne de délimitation partielle déterminée par la convention susmentionnée du 1<sup>er</sup> décembre 1964;

Vu les faits et arguments exposés dans les première et deuxième parties du présent contre-mémoire,

Plaise à la Cour dire et juger:

1. Que la délimitation entre les Parties desdites zones du plateau continental de la mer du Nord est régie par les principes et les règles du droit international énoncés à l'article 6, paragraphe 2, de la Convention de Genève de 1958 sur le plateau continental.

2. The Parties being in disagreement, unless another boundary is justified by special circumstances, the boundary between them is to be determined by application of the principle of equidistance from the nearest points of the baselines from which the breadth of the territorial sea of each State is measured.

3. Special circumstances which justify another boundary line not having been established, the boundary between the Parties is to be determined by application of the principle of equidistance indicated in the preceding Submission.”

*On behalf of the Governments of Denmark and the Netherlands,*  
in the Common Rejoinder:

“May it further please the Court to adjudge and declare:

4. If the principles and rules of international law mentioned in Submission 1 of the respective Counter-Memorials are not applicable as between the Parties, the boundary is to be determined between the Parties on the basis of the exclusive rights of each Party over the continental shelf adjacent to its coast and of the principle that the boundary is to leave to each Party every point of the continental shelf which lies nearer to its coast than to the coast of the other Party.”

In the course of the oral proceedings, the following Submissions were presented by the Parties:

*On behalf of the Government of the Federal Republic of Germany,*  
at the hearing on 5 November 1968:

“1. The delimitation of the continental shelf between the Parties in the North Sea is governed by the principle that each coastal State is entitled to a just and equitable share.

2. (a) The method of determining boundaries of the continental shelf in such a way that every point of the boundary is equidistant from the nearest points of the baselines from which the breadth of the territorial sea of each State is measured (equidistance method) is not a rule of customary international law.

(b) The rule contained in the second sentence of paragraph 2 of Article 6 of the Continental Shelf Convention, prescribing that in the absence of agreement, and unless another boundary is justified by special circumstances, the boundary shall be determined by application of the principle of equidistance, has not become customary international law.

(c) Even if the rule under (b) would be applicable between the Parties, special circumstances within the meaning of that rule would exclude the application of the equidistance method in the present case.

3. (a) The equidistance method cannot be used for the delimitation of the continental shelf unless it is established by agreement, arbitration, or otherwise, that it will achieve a just and equitable apportionment of the continental shelf among the States concerned.

(b) As to the delimitation of the continental shelf between the Parties in the North Sea, the Kingdom of Denmark and the Kingdom of the Netherlands cannot rely on the application of the equidistance method, since it would not lead to an equitable apportionment.

2. Que les Parties étant en désaccord, et à moins que des circonstances spéciales ne justifient une autre délimitation, la délimitation entre elles doit être opérée par application du principe de l'équidistance des points les plus proches des lignes de base à partir desquelles est mesurée la largeur de la mer territoriale de chacun de ces Etats.

3. Que, des circonstances spéciales justifiant une autre délimitation n'ayant pas été établies, la délimitation entre les Parties doit être opérée par application du principe de l'équidistance mentionné dans la conclusion précédente.»

*Au nom des Gouvernements du Danemark et des Pays-Bas,*  
dans la duplique commune :

«Plaise à la Cour dire et juger :

4. Que, si les principes et les règles du droit international mentionnés à la conclusion n° 1 des contre-mémoires ne sont pas applicables entre les Parties, la délimitation doit s'opérer entre elles sur la base des droits exclusifs de chacune des Parties sur le plateau continental adjacent à ses côtes et du principe selon lequel la délimitation doit laisser à chacune des Parties tous les points du plateau continental qui sont plus près de ses côtes que des côtes de l'autre Partie.»

Au cours de la procédure orale, les conclusions ci-après ont été présentées par les Parties :

*Au nom du Gouvernement de la République fédérale d'Allemagne,*  
à l'audience du 5 novembre 1968 :

«1. La délimitation du plateau continental de la mer du Nord entre les Parties est régie par le principe selon lequel chacun des Etats riverains a droit à une part juste et équitable.

2. a) La méthode consistant à déterminer les limites du plateau continental de telle sorte que tous les points de la ligne de délimitation soient équidistants des points les plus proches des lignes de base à partir desquelles est mesurée la largeur de la mer territoriale de chacun des Etats (méthode de l'équidistance) n'est pas une règle de droit international coutumier.

b) La règle énoncée dans la deuxième phrase de l'article 6, paragraphe 2, de la Convention sur le plateau continental, stipulant qu'à défaut d'accord, et à moins que des circonstances spéciales ne justifient une autre délimitation, celle-ci s'opère par application du principe de l'équidistance, n'est pas devenue une règle de droit international coutumier.

c) Même si la règle mentionnée à l'alinéa b) était applicable entre les Parties, des circonstances spéciales au sens de cette règle s'opposeraient à l'application de la méthode de l'équidistance dans la présente affaire.

3. a) La méthode de l'équidistance ne saurait être utilisée pour délimiter le plateau continental à moins qu'il ne soit établi par voie d'accord, d'arbitrage, ou autrement, qu'elle assurera une répartition juste et équitable du plateau continental entre les Etats intéressés.

b) En ce qui concerne la délimitation du plateau continental de la mer du Nord entre les Parties, le Royaume du Danemark et le Royaume des Pays-Bas ne peuvent se fonder sur l'application de la méthode de l'équidistance, car elle n'aboutirait pas à une répartition équitable.

4. Consequently, the delimitation of the continental shelf, on which the Parties must agree pursuant to paragraph 2 of Article 1 of the Special Agreement, is determined by the principle of the just and equitable share, based on criteria relevant to the particular geographical situation in the North Sea.”

*On behalf of the Government of Denmark,*

at the hearing on 11 November 1968, Counsel for that Government stated that it confirmed the Submissions presented in its Counter-Memorial and in the Common Rejoinder and that those Submissions were identical *mutatis mutandis* with those of the Government of the Netherlands.

*On behalf of the Government of the Netherlands,*

at the hearing on 11 November 1968:

“With regard to the delimitation as between the Federal Republic of Germany and the Kingdom of the Netherlands of the boundary of the areas of the continental shelf in the North Sea which appertain to each of them beyond the partial boundary determined by the Convention of 1 December 1964.

May it please the Court to adjudge and declare:

1. The delimitation as between the Parties of the said areas of the continental shelf in the North Sea is governed by the principles and rules of international law which are expressed in Article 6, paragraph 2, of the Geneva Convention of 1958 on the Continental Shelf.

2. The Parties being in disagreement, unless another boundary is justified by special circumstances, the boundary between them is to be determined by application of the principle of equidistance from the nearest points of the baselines from which the breadth of the territorial sea of each State is measured.

3. Special circumstances which justify another boundary line not having been established, the boundary between the Parties is to be determined by application of the principle of equidistance indicated in the preceding Submission.

4. If the principles and rules of international law mentioned in Submission 1 are not applicable as between the Parties, the boundary is to be determined between the Parties on the basis of the exclusive rights of each Party over the continental shelf adjacent to its coast and of the principle that the boundary is to leave to each Party every point of the continental shelf which lies nearer to its coast than to the coast of the other Party.”

\* \* \* \* \*

1. By the two Special Agreements respectively concluded between the Kingdom of Denmark and the Federal Republic of Germany, and between the Federal Republic and the Kingdom of the Netherlands, the Parties have submitted to the Court certain differences concerning “the delimita-

4. En conséquence la délimitation du plateau continental dont les Parties doivent convenir conformément à l'article 1, paragraphe 2, du compromis est déterminée par le principe de la part juste et équitable, en fonction de critères applicables à la situation géographique particulière de la mer du Nord.»

*Au nom du Gouvernement du Danemark,*

à l'audience du 11 novembre 1968, le conseil de ce Gouvernement a déclaré qu'il confirmait les conclusions présentées dans son contre-mémoire et dans la duplique commune et que ces conclusions étaient identiques *mutatis mutandis* à celles du Gouvernement des Pays-Bas.

*Au nom du Gouvernement des Pays-Bas,*

à l'audience du 11 novembre 1968:

«Pour ce qui est de la délimitation entre la République fédérale d'Allemagne et le Royaume des Pays-Bas des zones du plateau continental de la mer du Nord relevant de chacun d'eux, au-delà de la ligne de délimitation partielle déterminée par la convention du 1<sup>er</sup> décembre 1964,

Plaise à la Cour dire et juger:

1. Que la délimitation entre les Parties desdites zones du plateau continental de la mer du Nord est régie par les principes et les règles du droit international énoncés à l'article 6, paragraphe 2, de la Convention de Genève de 1958 sur le plateau continental.

2. Que les Parties étant en désaccord, et à moins que des circonstances spéciales ne justifient une autre délimitation, la délimitation entre elles doit être opérée par application du principe de l'équidistance des points les plus proches des lignes de base à partir desquelles est mesurée la largeur de la mer territoriale de chacun de ces Etats.

3. Que, des circonstances spéciales justifiant une autre délimitation n'ayant pas été établies, la délimitation entre les Parties doit être opérée par application du principe de l'équidistance mentionné dans la conclusion précédente.

4. Que, si les principes et les règles du droit international mentionnés à la conclusion n° 1 ne sont pas applicables entre les Parties, la délimitation doit s'opérer entre elles sur la base des droits exclusifs de chacune des Parties sur le plateau continental adjacent à ses côtes et du principe selon lequel la délimitation doit laisser à chacune des Parties tous les points du plateau continental qui sont plus près de ses côtes que des côtes de l'autre Partie.»

\* \* \* \* \*

1. Par les deux compromis respectivement conclus entre le Royaume du Danemark et la République fédérale d'Allemagne et entre la République fédérale d'Allemagne et le Royaume des Pays-Bas, la Cour est saisie de certaines divergences concernant «la délimitation entre les

tion as between the Parties of the areas of the continental shelf in the North Sea which appertain to each of them”—with the exception of those areas, situated in the immediate vicinity of the coast, which have already been the subject of delimitation by two agreements dated 1 December 1964, and 9 June 1965, concluded in the one case between the Federal Republic and the Kingdom of the Netherlands, and in the other between the Federal Republic and the Kingdom of Denmark.

2. It is in respect of the delimitation of the continental shelf areas lying beyond and to seaward of those affected by the partial boundaries thus established, that the Court is requested by each of the two Special Agreements to decide what are the applicable “principles and rules of international law”. The Court is not asked actually to delimit the further boundaries which will be involved, this task being reserved by the Special Agreements to the Parties, which undertake to effect such a delimitation “by agreement in pursuance of the decision requested from the . . . Court”—that is to say on the basis of, and in accordance with, the principles and rules of international law found by the Court to be applicable.

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3. As described in Article 4 of the North Sea Policing of Fisheries Convention of 6 May 1882, the North Sea, which lies between continental Europe and Great Britain in the east-west direction, is roughly oval in shape and stretches from the straits of Dover northwards to a parallel drawn between a point immediately north of the Shetland Islands and the mouth of the Sogne Fiord in Norway, about 75 kilometres above Bergen, beyond which is the North Atlantic Ocean. In the extreme north-west, it is bounded by a line connecting the Orkney and Shetland island groups; while on its north-eastern side, the line separating it from the entrances to the Baltic Sea lies between Hanstholm at the north-west point of Denmark, and Lindesnes at the southern tip of Norway. Eastward of this line the Skagerrak begins. Thus, the North Sea has to some extent the general look of an enclosed sea without actually being one. Round its shores are situated, on its eastern side and starting from the north, Norway, Denmark, the Federal Republic of Germany, the Netherlands, Belgium and France; while the whole western side is taken up by Great Britain, together with the island groups of the Orkneys and Shetlands. From this it will be seen that the continental shelf of the Federal Republic is situated between those of Denmark and the Netherlands.

4. The waters of the North Sea are shallow, and the whole seabed consists of continental shelf at a depth of less than 200 metres, except for the formation known as the Norwegian Trough, a belt of water 200-650 metres deep, fringing the southern and south-western coasts of Norway to a width averaging about 80-100 kilometres. Much the greater part of this continental shelf has already been the subject of delimitation



Parties des zones du plateau continental de la mer du Nord relevant de chacune d'elles», à l'exception des zones situées à proximité immédiate de la côte qui ont déjà été délimitées par deux accords signés les 1<sup>er</sup> décembre 1964 et 9 juin 1965 entre la République fédérale et le Royaume des Pays-Bas et entre la République fédérale et le Royaume du Danemark.

2. C'est à propos de la délimitation des zones du plateau continental prolongeant vers le large les zones déjà délimitées que la Cour est priée dans chacun des deux compromis de décider «quels sont les principes et les règles du droit international applicables». Il n'est pas demandé à la Cour d'établir effectivement les limites prolongées dont il s'agit; aux termes des compromis, cette tâche est réservée aux Parties qui s'engagent à procéder à la délimitation «par voie d'accord conclu conformément à la décision demandée à la Cour», c'est-à-dire sur la base et en conformité des principes et des règles de droit international tenus par la Cour pour applicables.

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3. La mer du Nord, telle qu'elle est décrite à l'article 4 de la convention du 6 mai 1882 sur la police de la pêche dans la mer du Nord, a en gros la forme d'un ovale limité à l'est par le continent européen et à l'ouest par la Grande-Bretagne; à partir du Pas de Calais, elle s'étend vers le nord jusqu'au parallèle passant immédiatement au nord des Shetland et rencontrant la Norvège à l'embouchure du Sognefjord (à soixante-quinze kilomètres environ au nord de Bergen), qui marque le début de l'Atlantique nord. Elle est bornée à son extrémité nord-ouest par la ligne qui joint les Orcades aux Shetland et, au nord-est, elle est séparée des détroits de la Baltique par une ligne allant de Hanstholm (points nord-ouest du Danemark) au cap Lindesnes (extrémité méridionale de la Norvège); au-delà commence le Skagerrak. Ainsi, sans constituer réellement une mer fermée, la mer du Nord en présente dans une certaine mesure l'apparence générale. Elle est bordée à l'est et en partant du nord par la Norvège, le Danemark, la République fédérale d'Allemagne, les Pays-Bas, la Belgique et la France, tout le côté ouest étant occupé par la Grande-Bretagne, avec les archipels des Orcades et des Shetland. Le plateau continental de la République fédérale est donc situé entre les plateaux continentaux du Danemark et des Pays-Bas.

4. La mer du Nord est peu profonde et son lit est entièrement constitué par un plateau continental à une profondeur de moins de deux cents mètres, à l'exception d'une bande de deux cents à six cent cinquante mètres de profondeur, dite fosse norvégienne, qui longe les côtes sud et sud-ouest de la Norvège sur une largeur moyenne de quatre-vingts à cent kilomètres. La majeure partie de ce plateau continental a déjà

by a series of agreements concluded between the United Kingdom (which, as stated, lies along the whole western side of it) and certain of the States on the eastern side, namely Norway, Denmark and the Netherlands. These three delimitations were carried out by the drawing of what are known as "median lines" which, for immediate present purposes, may be described as boundaries drawn between the continental shelf areas of "opposite" States, dividing the intervening spaces equally between them. These lines are shown on Map 1 on page 15, together with a similar line, also established by agreement, drawn between the shelf areas of Norway and Denmark. Theoretically it would be possible also to draw the following median lines in the North Sea, namely United Kingdom/Federal Republic (which would lie east of the present line United Kingdom/Norway-Denmark-Netherlands); Norway/Federal Republic (which would lie south of the present line Norway/Denmark); and Norway/Netherlands (which would lie north of whatever line is eventually determined to be the continental shelf boundary between the Federal Republic and the Netherlands). Even if these median lines were drawn however, the question would arise whether the United Kingdom, Norway and the Netherlands could take advantage of them as against the parties to the existing delimitations, since these lines would, it seems, in each case lie beyond (i.e., respectively to the east, south and north of) the boundaries already effective under the existing agreements at present in force. This is illustrated by Map 2 on page 15.

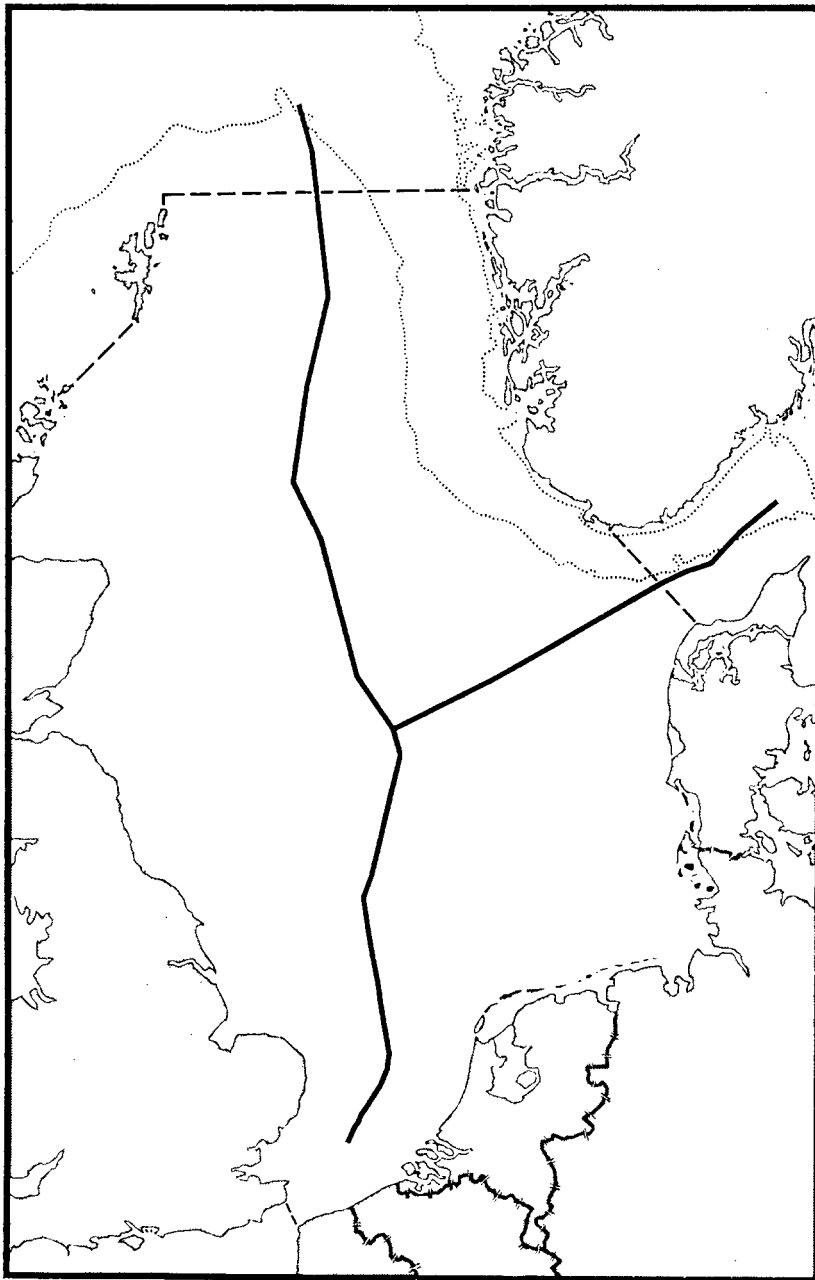
5. In addition to the partial boundary lines Federal Republic/Denmark and Federal Republic/Netherlands, which, as mentioned in paragraph 1 above, were respectively established by the agreements of 9 June 1965 and 1 December 1964, and which are shown as lines A-B and C-D on Map 3 on page 16, another line has been drawn in this area, namely that represented by the line E-F on that map. This line, which divides areas respectively claimed (to the north of it) by Denmark, and (to the south of it) by the Netherlands, is the outcome of an agreement between those two countries dated 31 March 1966, reflecting the view taken by them as to what are the correct boundary lines between their respective continental shelf areas and that of the Federal Republic, beyond the partial boundaries A-B and C-D already drawn. These further and un-agreed boundaries to seaward, are shown on Map 3 by means of the dotted lines B-E and D-E. They are the lines, the correctness of which in law the Court is in effect, though indirectly, called upon to determine. Also shown on Map 3 are the two pecked lines B-F and D-F, representing approximately the boundaries which the Federal Republic would have wished to obtain in the course of the negotiations that took place between the Federal Republic and the other two Parties prior to the submission of the matter to the Court. The nature of these negotiations must now be described.

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été délimitée par une série d'accords conclus entre le Royaume-Uni (qui, comme on l'a vu, le borde en totalité du côté ouest) et certains des Etats riverains du côté est: la Norvège, le Danemark et les Pays-Bas. Ces trois délimitations ont été réalisées par le tracé de lignes dites « médianes » qui, pour le moment, peuvent être décrites comme divisant en parties égales un plateau continental situé entre des Etats « se faisant face ». Ces lignes apparaissent sur la carte 1 (page 15), de même qu'une ligne analogue également établie par voie d'accord et délimitant les zones de plateau continental de la Norvège et du Danemark. En théorie, l'on pourrait aussi tracer dans la mer du Nord des lignes médianes entre le Royaume-Uni et la République fédérale (à l'est de l'actuelle ligne Royaume-Uni/Norvège-Danemark-Pays-Bas), entre la Norvège et la République fédérale (au sud de l'actuelle ligne Norvège/Danemark) et entre la Norvège et les Pays-Bas (au nord de la ligne, quelle qu'elle soit, qui sera finalement retenue comme délimitant le plateau continental entre la République fédérale et les Pays-Bas). Mais, si ces lignes médianes étaient tracées, la question se poserait de savoir si le Royaume-Uni, la Norvège et les Pays-Bas pourraient s'en prévaloir à l'encontre des parties aux accords de délimitation en vigueur, car elles seraient, semble-t-il, situées au-delà (c'est-à-dire respectivement à l'est, au sud et au nord) des limites déjà convenues dans les accords actuellement existants. Cela ressort de la carte 2 (page 15).

5. Outre les lignes de délimitation partielle République fédérale/Danemark et République fédérale/Pays-Bas qui, comme il est dit au paragraphe 1 ci-dessus, ont été respectivement établies par les accords du 9 juin 1965 et du 1<sup>er</sup> décembre 1964 et qui sont représentées par les lignes A-B et C-D sur la carte 3 (page 16), une autre ligne a été tracée dans cette partie de la mer du Nord: elle est figurée sur la même carte par la ligne E-F. Cette ligne, qui sépare des zones, revendiquées au nord par le Danemark et au sud par les Pays-Bas, résulte d'un accord du 31 mars 1966 entre les deux pays et correspond à la conception qu'ils se faisaient des limites entre leurs zones de plateau continental et celle de la République fédérale au-delà de la délimitation partielle déjà effectuée suivant A-B et C-D. Ces limites, qui n'ont pas été reconnues, sont représentées sur la carte 3 par les lignes pointillées B-E et D-E. Ce sont les lignes sur le bien-fondé juridique desquelles la Cour est en fait, encore qu'indirectement, appelée à se prononcer. On peut aussi voir sur la carte 3 deux lignes de tirets B-F et D-F indiquant approximativement les limites que la République fédérale aurait voulu obtenir au cours des négociations menées avec les deux autres Parties avant que la Cour soit saisie. Il convient d'indiquer ici en quoi ont consisté ces négociations.

\*

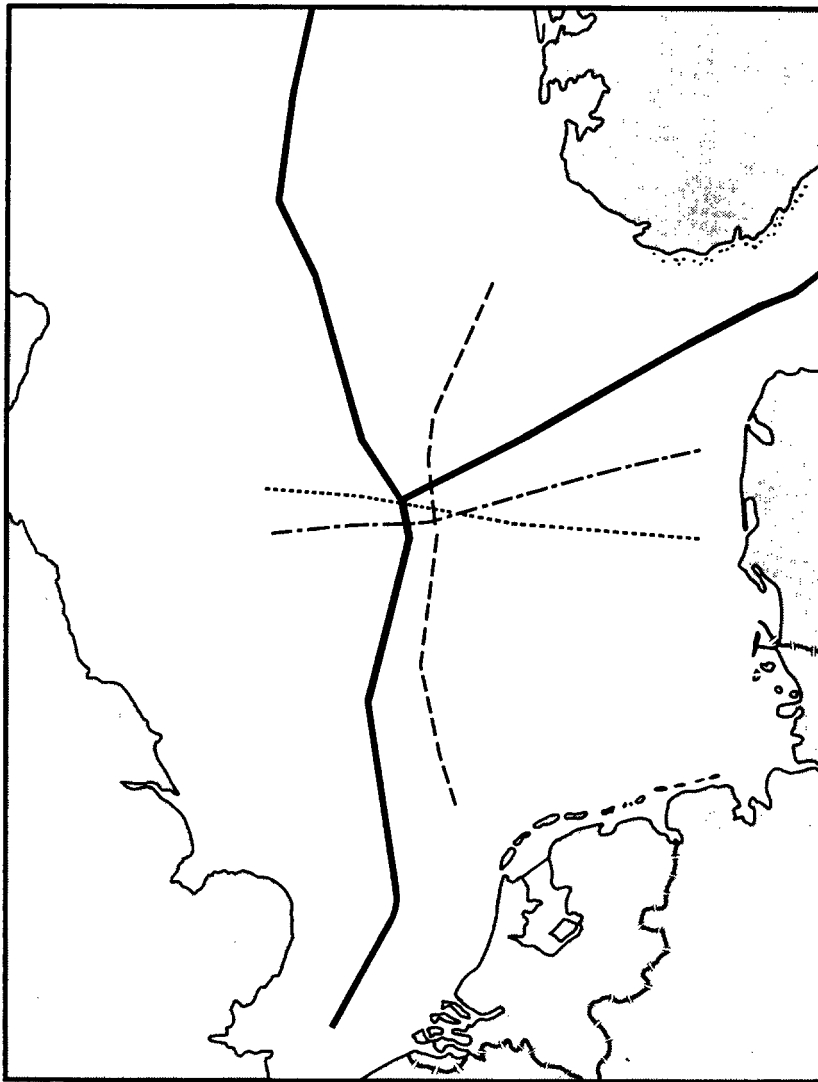


Map 1  
*(See paragraphs 3 and 4)*

Carte 1  
*(Voir paragraphes 3 et 4)*

200 metres line .....  
 Limits fixed by the 1882 Convention - - - - -  
 Median lines —————

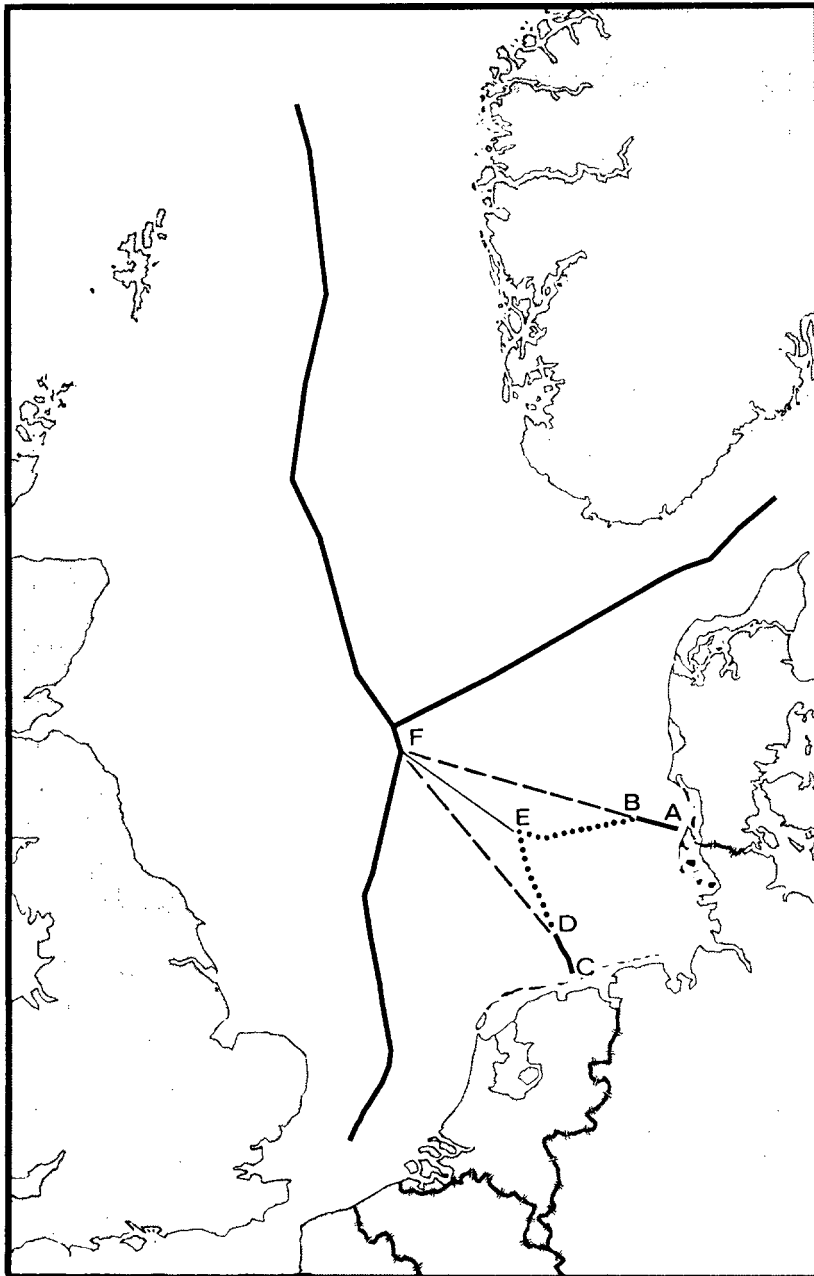
Isobathe des 200 mètres  
 Limites définies par la convention de 1882  
 Lignes médianes



Map 2  
(See paragraph 4)

Carte 2  
(Voir paragraphe 4)

United Kingdom/Norway-Denmark-Netherlands and Norway/Denmark	—————	Royaume-Uni/Norvège-Danemark-Pays-Bas et Norvège/Danemark
United Kingdom/Federal Republic	- - - - -	Royaume-Uni/République fédérale
Norway/Federal Republic	- · - · - ·	Norvège/République fédérale
Norway/Netherlands	· · · · ·	Norvège/Pays-Bas

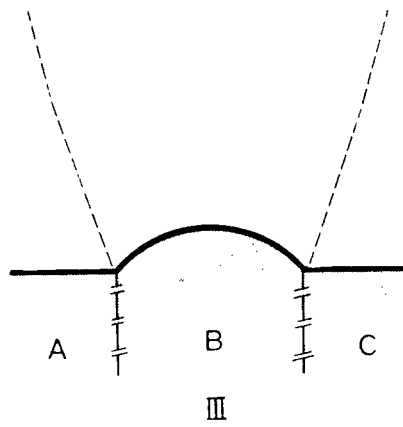
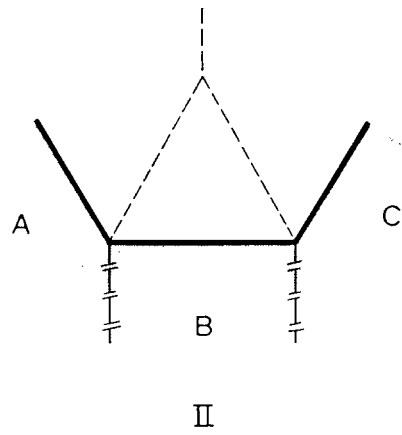
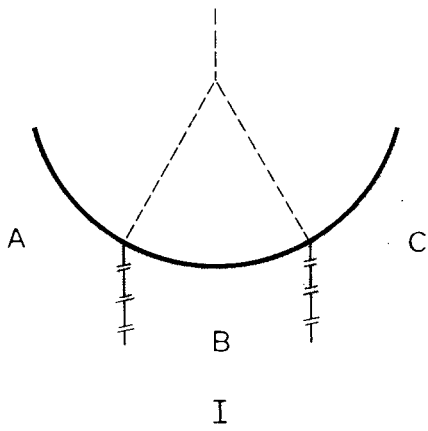


Map 3  
(See paragraphs 5-9)

Carte 3  
(Voir paragraphes 5-9)

*The maps in the present Judgment were prepared on the basis of documents submitted to the Court by the Parties, and their sole purpose is to provide a visual illustration of the paragraphs of the Judgment which refer to them.*

*Les cartes jointes au présent arrêt ont été établies d'après les documents soumis à la Cour par les Parties et ont pour seul objet d'illustrer graphiquement les paragraphes de l'arrêt qui s'y réfèrent.*



Sketches illustrating the geographical situations described in paragraph 8 of the Judgment

Croquis illustratifs des situations géographiques décrites au paragraphe 8 de l'arrêt

6. Under the agreements of December 1964 and June 1965, already mentioned, the partial boundaries represented by the map lines A-B and C-D had, according to the information furnished to the Court by the Parties, been drawn mainly by application of the principle of equidistance, using that term as denoting the abstract concept of equidistance. A line so drawn, known as an "equidistance line", may be described as one which leaves to each of the parties concerned all those portions of the continental shelf that are nearer to a point on its own coast than they are to any point on the coast of the other party. An equidistance line may consist either of a "median" line between "opposite" States, or of a "lateral" line between "adjacent" States. In certain geographical configurations of which the Parties furnished examples, a given equidistance line may partake in varying degree of the nature both of a median and of a lateral line. There exists nevertheless a distinction to be drawn between the two, which will be mentioned in its place.

7. The further negotiations between the Parties for the prolongation of the partial boundaries broke down mainly because Denmark and the Netherlands respectively wished this prolongation also to be effected on the basis of the equidistance principle,—and this would have resulted in the dotted lines B-E and D-E, shown on Map 3; whereas the Federal Republic considered that such an outcome would be inequitable because it would unduly curtail what the Republic believed should be its proper share of continental shelf area, on the basis of proportionality to the length of its North Sea coastline. It will be observed that neither of the lines in question, taken by itself, would produce this effect, but only both of them together—an element regarded by Denmark and the Netherlands as irrelevant to what they viewed as being two separate and self-contained delimitations, each of which should be carried out without reference to the other.

8. The reason for the result that would be produced by the two lines B-E and D-E, taken conjointly, is that in the case of a concave or recessing coast such as that of the Federal Republic on the North Sea, the effect of the use of the equidistance method is to pull the line of the boundary inwards, in the direction of the concavity. Consequently, where two such lines are drawn at different points on a concave coast, they will, if the curvature is pronounced, inevitably meet at a relatively short distance from the coast, thus causing the continental shelf area they enclose, to take the form approximately of a triangle with its apex to seaward and, as it was put on behalf of the Federal Republic, "cutting off" the coastal State from the further areas of the continental shelf outside of and beyond this triangle. The effect of concavity could of course equally be produced for a country with a straight coastline if the coasts of adjacent countries protruded immediately on either side of it. In contrast to this, the effect of coastal projections, or of convex or outwardly curving coasts such as are, to a moderate extent, those of Denmark and the Netherlands, is to cause boundary lines drawn on an equidistance basis to leave the



6. Dans les accords susmentionnés de décembre 1964 et juin 1965, les limites partielles représentées sur la carte par les lignes A-B et C-D avaient été tracées, selon les indications données à la Cour par les Parties, essentiellement par application du principe de l'équidistance — cette expression étant employée pour désigner le concept abstrait d'équidistance. La ligne construite suivant ce principe, ou « ligne d'équidistance », peut être définie comme celle qui attribue à chacune des parties intéressées toutes les portions du plateau continental plus proches d'un point de sa côte que de tout point situé sur la côte de l'autre partie. La ligne d'équidistance peut être soit une ligne « médiane » entre Etats « se faisant face », soit une ligne « latérale » entre Etats « limitrophes ». Dans certaines configurations géographiques dont les Parties ont fourni des exemples, la ligne d'équidistance peut revêtir à des degrés divers le double caractère d'une ligne médiane et d'une ligne latérale. Une distinction existe néanmoins entre ces deux types de lignes, ainsi qu'il sera indiqué par la suite.

7. Les négociations reprises entre les Parties en vue de prolonger les limites partielles ont échoué principalement parce que le Danemark et les Pays-Bas souhaitaient que le prolongement s'effectuât aussi d'après le principe de l'équidistance, ce qui aboutissait à un tracé correspondant aux lignes pointillées B-E et D-E de la carte 3; or la République fédérale jugeait ce résultat inéquitable parce qu'il réduisait exagérément ce qu'elle estimait devoir être sa juste part de plateau continental en proportion de la longueur de son littoral sur la mer du Nord. Il est à noter que ce résultat n'était pas attribuable à l'une ou l'autre des lignes prise isolément, mais à l'effet combiné des deux lignes prises ensemble, effet que le Danemark et les Pays-Bas considéraient comme sans pertinence, s'agissant à leur avis de deux délimitations distinctes et autonomes dont chacune devait être effectuée sans qu'il soit tenu compte de l'autre.

8. L'effet combiné des deux lignes B-E et D-E s'explique comme suit. Dans le cas d'une côte concave ou rentrante comme celle de la République fédérale sur la mer du Nord, l'application de la méthode de l'équidistance tend à infléchir les lignes de délimitation vers la concavité. Par suite, quand deux lignes d'équidistance sont tracées à partir d'une côte très concave, elles se rencontrent inévitablement à une distance relativement faible de la côte; la zone de plateau continental qu'elles encadrent prend donc la forme d'une sorte de triangle au sommet dirigé vers le large, ce qui, pour reprendre le terme de la République fédérale, « ampute » l'Etat riverain des zones de plateau continental situées en dehors du triangle. Il est évident que le même effet de concavité peut se produire si un Etat ayant une côte droite est encadré par deux Etats dont les côtes les plus proches font saillie par rapport à la sienne. A l'opposé, si la côte d'un Etat présente des saillants ou a une configuration convexe, ce qui est dans une certaine mesure le cas des côtes du Danemark et des Pays-Bas, les lignes de délimitation tracées d'après la méthode de l'équidistance s'écartent l'une de l'autre, de sorte que la zone de plateau continental

coast on divergent courses, thus having a widening tendency on the area of continental shelf off that coast. These two distinct effects, which are shown in sketches I-III to be found on page 16, are directly attributable to the use of the equidistance method of delimiting continental shelf boundaries off recessing or projecting coasts. It goes without saying that on these types of coasts the equidistance method produces exactly similar effects in the delimitation of the lateral boundaries of the territorial sea of the States concerned. However, owing to the very close proximity of such waters to the coasts concerned, these effects are much less marked and may be very slight,—and there are other aspects involved, which will be considered in their place. It will suffice to mention here that, for instance, a deviation from a line drawn perpendicular to the general direction of the coast, of only 5 kilometres, at a distance of about 5 kilometres from that coast, will grow into one of over 30 at a distance of over 100 kilometres.

9. After the negotiations, separately held between the Federal Republic and the other two Parties respectively, had in each case, for the reasons given in the two preceding paragraphs, failed to result in any agreement about the delimitation of the boundary extending beyond the partial one already agreed, tripartite talks between all the Parties took place in The Hague in February-March 1966, in Bonn in May and again in Copenhagen in August. These also proving fruitless, it was then decided to submit the matter to the Court. In the meantime the Governments of Denmark and the Netherlands had, by means of the agreement of 31 March 1966, already referred to (paragraph 5), proceeded to a delimitation as between themselves of the continental shelf areas lying between the apex of the triangle notionally ascribed by them to the Federal Republic (point E on Map 3) and the median line already drawn in the North Sea, by means of a boundary drawn on equidistance principles, meeting that line at the point marked F on Map 3. On 25 May 1966, the Government of the Federal Republic, taking the view that this delimitation was *res inter alios acta*, notified the Governments of Denmark and the Netherlands, by means of an aide-mémoire, that the agreement thus concluded could not “have any effect on the question of the delimitation of the German-Netherlands or the German-Danish parts of the continental shelf in the North Sea”.

10. In pursuance of the tripartite arrangements that had been made at Bonn and Copenhagen, as described in the preceding paragraph, Special Agreements for the submission to the Court of the differences involved were initialled in August 1966 and signed on 2 February 1967. By a tripartite Protocol signed the same day it was provided (*a*) that the Government of the Kingdom of the Netherlands would notify the two Special Agreements to the Court, in accordance with Article 40, paragraph 1, of the Court's Statute, together with the text of the Protocol itself; (*b*) that after such notification, the Parties would ask the Court to join the two cases; and (*c*) that for the purpose of the appointment

devant cette côte tend à aller en s'élargissant. Ces deux effets distincts, représentés sur les croquis I à III (page 16), sont directement imputables à l'application de la méthode de l'équidistance lorsque le plateau continental à délimiter s'étend devant une côte rentrante ou saillante. Il va sans dire que la méthode de l'équidistance a exactement les mêmes effets lorsqu'il s'agit de déterminer devant le même genre de côte les limites latérales de la mer territoriale des Etats intéressés. Etant donné cependant que les eaux territoriales sont à proximité immédiate de la terre, l'effet est beaucoup moins marqué, voire très faible, et d'autres éléments entrent en jeu, qui seront examinés en temps utile. Il suffira pour le moment d'observer que par exemple un écart, par rapport à une ligne tracée perpendiculairement à la direction générale de la côte, qui ne serait que de cinq kilomètres à une distance de cinq kilomètres environ de la côte dépasserait trente kilomètres à plus de cent kilomètres.

9. Pour les raisons indiquées aux deux paragraphes précédents, les négociations menées séparément entre la République fédérale et chacune des deux autres Parties n'ont pu aboutir à aucun accord sur la fixation de limites au-delà des lignes de délimitation partielle déjà convenues. Des pourparlers tripartites se sont ensuite tenus en 1966, à La Haye en février-mars puis à Bonn en mai et à Copenhague en août. Ces pourparlers s'étant également révélés infructueux, il a été décidé de soumettre le problème à la Cour. Entre-temps, par l'accord du 31 mars 1966 déjà mentionné au paragraphe 5, les Gouvernements du Danemark et des Pays-Bas avaient procédé à une délimitation, entre leurs deux pays, des zones de plateau continental comprises entre le sommet du triangle qu'ils attribuaient théoriquement à la République fédérale (point E de la carte 3) et la ligne médiane qui avait déjà été tracée dans la mer du Nord; pour ce faire, ils avaient tracé suivant le principe de l'équidistance une limite rencontrant la ligne médiane au point F de la carte 3. Le 25 mai 1966, estimant que cette délimitation était *res inter alios acta*, le Gouverneur de la République fédérale a adressé aux Gouvernements du Danemark et des Pays-Bas un aide-mémoire par lequel il leur notifiait que l'accord ainsi conclu ne saurait «en rien affecter la question de la délimitation des parties germano-néerlandaise ou germano-danoise du plateau continental de la mer de Nord».

10. A la suite de la décision prise à Bonn et à Copenhague par les trois Etats et évoquée au paragraphe précédent, des compromis soumettant à la Cour les divergences entre les Parties ont été paraphés en août 1966 et signés le 2 février 1967. Un protocole tripartite signé le même jour prévoyait: *a)* que le Gouvernement du Royaume des Pays-Bas notifierait les deux compromis à la Cour, conformément à l'article 40, paragraphe 1, du Statut de la Cour, en même temps que le texte du protocole lui-même; *b)* qu'une fois cette notification faite les Parties demanderaient à la Cour de joindre les deux instances; *c)* qu'aux fins de la désignation d'un juge *ad hoc* les Royaumes du Danemark et des

of a judge *ad hoc*, the Kingdoms of Denmark and the Netherlands should be considered as being in the same interest within the meaning of Article 31, paragraph 5, of the Court's Statute. Following upon these communications, duly made to it in the implementation of the Protocol, the Court, by an Order dated 26 April 1968, declared Denmark and the Netherlands to be in the same interest, and joined the proceedings in the two cases.

11. Although the proceedings have thus been joined, the cases themselves remain separate, at least in the sense that they relate to different areas of the North Sea continental shelf, and that there is no *a priori* reason why the Court must reach identical conclusions in regard to them,—if for instance geographical features present in the one case were not present in the other. At the same time, the legal arguments presented on behalf of Denmark and the Netherlands, both before and since the joinder, have been substantially identical, apart from certain matters of detail, and have been presented either in common or in close co-operation. To this extent therefore, the two cases may be treated as one; and it must be noted that although two separate delimitations are in question, they involve—indeed actually give rise to—a single situation. The fact that the question of either of these delimitations might have arisen and called for settlement separately in point of time, does not alter the character of the problem with which the Court is actually faced, having regard to the manner in which the Parties themselves have brought the matter before it, as described in the two preceding paragraphs.

12. In conclusion as to the facts, it should be noted that the Federal Republic has formally reserved its position, not only in regard to the Danish-Netherlands delimitation of the line E-F (Map 3), as noted in paragraph 9, but also in regard to the delimitations United Kingdom/Denmark and United Kingdom/Netherlands mentioned in paragraph 4. In both the latter cases the Government of the Federal Republic pointed out to all the Governments concerned that the question of the lateral delimitation of the continental shelf in the North Sea between the Federal Republic and the Kingdoms of Denmark and the Netherlands was still outstanding and could not be prejudiced by the agreements concluded between those two countries and the United Kingdom.

\* \* \*

13. Such are the events and geographical facts in the light of which the Court has to determine what principles and rules of international law are applicable to the delimitation of the areas of continental shelf involved. On this question the Parties have taken up fundamentally different positions. On behalf of the Kingdoms of Denmark and the Netherlands it is contended that the whole matter is governed by a

Pays-Bas seraient considérés comme faisant cause commune au sens de l'article 31, paragraphe 5, du Statut de la Cour. Ces communications lui ayant été dûment faites en exécution du protocole, la Cour a constaté, par ordonnance du 26 avril 1968, que le Danemark et les Pays-Bas faisaient cause commune et elle a joint les instances dans les deux affaires.

11. Malgré la jonction des instances, les affaires restent distinctes en ceci au moins qu'elles ont trait à des zones différentes du plateau continental de la mer du Nord et qu'il n'y a pas de raison a priori que la Cour parvienne à leur égard à des conclusions identiques: il se pourrait, par exemple, que certaines particularités géographiques existent dans l'un des cas, mais non dans l'autre. Il reste qu'avant comme après la jonction des instances les arguments juridiques du Danemark et des Pays-Bas ont été en substance les mêmes, sauf sur certains points de détail, et qu'ils ont été présentés soit en commun, soit en étroite coopération. Dans cette mesure les deux affaires peuvent donc être traitées comme une seule et l'on doit constater que, si deux délimitations distinctes sont en cause, elles concernent — on peut même dire qu'elles créent — une situation unique. S'il est vrai que les questions relatives à ces deux délimitations auraient pu se présenter et être réglées à des moments différents, cela ne modifie en rien la nature du problème qui se pose en fait à la Cour, vu la façon dont les Parties elles-mêmes l'ont saisie (voir les deux paragraphes précédents).

12. Pour achever l'exposé des faits, il convient de rappeler que la République fédérale a formellement réservé sa position non seulement à l'égard de la délimitation dano-néerlandaise suivant la ligne E-F de la carte 3 comme il a été indiqué au paragraphe 9, mais également au sujet des délimitations entre le Royaume-Uni et le Danemark et entre le Royaume-Uni et les Pays-Bas mentionnées au paragraphe 4. Dans ces deux derniers cas, le Gouvernement de la République fédérale a attiré l'attention de tous les gouvernements intéressés sur le fait que la question de la délimitation latérale du plateau continental de la mer du Nord entre la République fédérale et les Royaumes du Danemark et des Pays-Bas n'était pas encore réglée et que les accords conclus entre ces deux pays et le Royaume-Uni ne pouvaient en préjuger la solution.

\* \* \*

13. Tels sont les événements et les faits géographiques au vu desquels la Cour doit déterminer quels sont les principes et les règles de droit international applicables à la délimitation des zones de plateau continental en cause. A ce sujet, les Parties ont adopté des positions fondamentalement différentes. Les Royaumes du Danemark et des Pays-Bas soutiennent que l'ensemble de la question est régi par une règle de droit obliga-

mandatory rule of law which, reflecting the language of Article 6 of the Convention on the Continental Shelf concluded at Geneva on 29 April 1958, was designated by them as the “equidistance-special circumstances” rule. According to this contention, “equidistance” is not merely a method of the cartographical construction of a boundary line, but the essential element in a rule of law which may be stated as follows,—namely that in the absence of agreement by the Parties to employ another method or to proceed to a delimitation on an *ad hoc* basis, all continental shelf boundaries must be drawn by means of an equidistance line, unless, or except to the extent to which, “special circumstances” are recognized to exist,—an equidistance line being, it will be recalled, a line every point on which is the same distance away from whatever point is nearest to it on the coast of each of the countries concerned—or rather, strictly, on the baseline of the territorial sea along that coast. As regards what constitutes “special circumstances”, all that need be said at this stage is that according to the view put forward on behalf of Denmark and the Netherlands, the configuration of the German North Sea coast, its recessive character, and the fact that it makes nearly a right-angled bend in mid-course, would not of itself constitute, for either of the two boundary lines concerned, a special circumstance calling for or warranting a departure from the equidistance method of delimitation: only the presence of some special feature, minor in itself—such as an islet or small protuberance—but so placed as to produce a disproportionately distorting effect on an otherwise acceptable boundary line would, so it was claimed, possess this character.

14. These various contentions, together with the view that a rule of equidistance-special circumstances is binding on the Federal Republic, are founded by Denmark and the Netherlands partly on the 1958 Geneva Convention on the Continental Shelf already mentioned (preceding paragraph), and partly on general considerations of law relating to the continental shelf, lying outside this Convention. Similar considerations are equally put forward to found the contention that the delimitation on an equidistance basis of the line E-F (Map 3) by the Netherlands-Danish agreement of 31 March 1966 (paragraph 5 above) is valid *erga omnes*, and must be respected by the Federal Republic unless it can demonstrate the existence of juridically relevant “special circumstances”.

15. The Federal Republic, for its part, while recognizing the utility of equidistance as a method of delimitation, and that this method can in many cases be employed appropriately and with advantage, denies its obligatory character for States not parties to the Geneva Convention, and contends that the correct rule to be applied, at any rate in such circumstances as those of the North Sea, is one according to which each of the States concerned should have a “just and equitable share” of the available continental shelf, in proportion to the length of its coastline or sea-frontage. It was also contended on behalf of the Federal Republic

toire qu'ils appellent règle «équidistance-circonstances spéciales», en s'inspirant des termes de l'article 6 de la Convention de Genève du 29 avril 1958 sur le plateau continental. Selon cette thèse, l'équidistance n'est pas simplement une méthode de construction cartographique, mais l'élément essentiel d'une règle de droit qui peut s'énoncer ainsi: à défaut d'un accord entre les parties en vue d'employer une autre méthode ou de se fonder sur les éléments de fait de l'espèce, toute délimitation de plateau continental doit suivre la ligne d'équidistance, sauf dans la mesure où l'existence de «circonstances spéciales» est reconnue — la ligne d'équidistance étant, comme l'on sait, une ligne dont chaque point est à égale distance du point le plus proche de la côte de chacun des pays intéressés ou, plus précisément, de la ligne de base de la mer territoriale bordant cette côte. Quant à ce qu'il faut entendre par «circonstances spéciales», il suffira de dire pour le moment que, d'après le Danemark et les Pays-Bas, la concavité de la côte allemande de la mer du Nord, qui change de direction en son milieu presque à angle droit, ne constitue en soi, ni pour l'une ni pour l'autre des deux lignes de délimitation en cause, une circonstance spéciale appelant ou justifiant une dérogation à la méthode de délimitation fondée sur l'équidistance. A leur avis, seule pourrait constituer une telle circonstance spéciale une particularité mineure en soi, comme un îlot ou un léger saillant, mais produisant sur une limite par ailleurs acceptable un effet de déviation disproportionné.

14. C'est en partie sur la Convention de Genève de 1958 sur le plateau continental, mentionnée au paragraphe précédent, et en partie sur des considérations juridiques de caractère général ayant trait au plateau continental mais extérieures à la Convention que le Danemark et les Pays-Bas font reposer ces diverses thèses et notamment leur opinion selon laquelle une règle équidistance-circonstances spéciales lierait la République fédérale. Ils se fondent sur des considérations analogues pour dire que la délimitation opérée d'après l'équidistance, suivant la ligne E-F de la carte 3, par l'accord du 31 mars 1966 entre les Pays-Bas et le Danemark (voir paragraphe 5 ci-dessus) est valable *erga omnes* et doit être respectée par la République fédérale, à moins que celle-ci puisse démontrer l'existence de «circonstances spéciales» juridiquement admissibles.

15. Sans méconnaître l'utilité de l'équidistance comme méthode de délimitation ni le fait que cette méthode puisse être appropriée et présenter des avantages dans de nombreux cas, la République fédérale lui refuse pour sa part tout caractère obligatoire à l'égard des Etats qui ne sont pas parties à la Convention de Genève. Elle affirme que la véritable règle à appliquer, au moins dans les circonstances propres à la mer du Nord, est la règle suivant laquelle chacun des Etats en cause devrait obtenir une «part juste et équitable» du plateau continental disponible, proportionnellement à la longueur de son littoral ou de son front de mer. Elle

that in a sea shaped as is the North Sea, the whole bed of which, except for the Norwegian Trough, consists of continental shelf at a depth of less than 200 metres, and where the situation of the circumjacent States causes a natural convergence of their respective continental shelf areas, towards a central point situated on the median line of the whole seabed—or at any rate in those localities where this is the case—each of the States concerned is entitled to a continental shelf area extending up to this central point (in effect a sector), or at least extending to the median line at some point or other. In this way the “cut-off” effect, of which the Federal Republic complains, caused, as explained in paragraph 8, by the drawing of equidistance lines at the two ends of an inward curving or recessed coast, would be avoided. As a means of giving effect to these ideas, the Federal Republic proposed the method of the “coastal front”, or façade, constituted by a straight baseline joining these ends, upon which the necessary geometrical constructions would be erected.

16. Alternatively, the Federal Republic claimed that if, contrary to its main contention, the equidistance method was held to be applicable, then the configuration of the German North Sea coast constituted a “special circumstance” such as to justify a departure from that method of delimitation in this particular case.

17. In putting forward these contentions, it was stressed on behalf of the Federal Republic that the claim for a just and equitable share did not in any way involve asking the Court to give a decision *ex aequo et bono* (which, having regard to the terms of paragraph 2 of Article 38 of the Court’s Statute, would not be possible without the consent of the Parties),—for the principle of the just and equitable share was one of the recognized general principles of law which, by virtue of paragraph 1 (c) of the same Article, the Court was entitled to apply as a matter of the *justitia distributiva* which entered into all legal systems. It appeared, moreover, that whatever its underlying motivation, the claim of the Federal Republic was, at least ostensibly, to a just and equitable share of the space involved, rather than to a share of the natural resources as such, mineral or other, to be found in it, the location of which could not in any case be fully ascertained at present. On the subject of location the Court has in fact received some, though not complete information, but has not thought it necessary to pursue the matter, since the question of natural resources is less one of delimitation than of eventual exploitation.

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18. It will be convenient to consider first the contentions put forward on behalf of the Federal Republic. The Court does not feel able to accept them—at least in the particular form they have taken. It considers



soutient également qu'étant donné la forme de la mer du Nord, dont le lit est entièrement constitué, à l'exception de la fosse norvégienne, par un plateau continental à une profondeur de moins de deux cents mètres et où la situation des Etats circonvoisins a pour conséquence naturelle de faire converger leurs zones de plateau continental vers un point central situé sur la ligne médiane divisant tout le lit de la mer, chacun des Etats intéressés peut, au moins dans la partie où cette convergence existe, prétendre à ce que sa zone aille jusqu'à ce point central (formant ainsi un secteur) ou atteigne en tout cas un point quelconque de la ligne médiane. Ainsi disparaîtrait l'effet d'«amputation» dont se plaint la République fédérale et qui résulte, comme on l'a vu au paragraphe 8, du tracé de lignes d'équidistance aux deux extrémités d'une côte concave ou rentrante. Pour mettre ces idées en pratique, la République fédérale propose la méthode de la «façade maritime», qui serait constituée par la ligne de base droite réunissant les extrémités de la côte et à partir de laquelle s'effectueraient les constructions géométriques nécessaires.

16. Subsidiairement la République fédérale soutient que, dans le cas où, contrairement à sa thèse principale, la méthode de l'équidistance serait considérée comme applicable, la configuration de la côte allemande de la mer du Nord constituerait une circonstance spéciale justifiant que l'on s'écarte de cette méthode en l'espèce.

17. Dans l'exposé de ces thèses, la République fédérale a souligné qu'en revendiquant une part juste et équitable elle n'invitait nullement la Cour à statuer *ex aequo et bono*, ce qui, vu l'article 38, paragraphe 2, du Statut de la Cour, ne serait possible qu'avec l'assentiment des Parties; elle considère en effet que le principe de la part juste et équitable est l'un des principes généraux de droit reconnus qu'en vertu du paragraphe 1 c) du même article de son Statut la Cour est habilitée à appliquer au titre de la justice distributive, partie intégrante de tous les systèmes juridiques. Il semble en outre que la demande de la République fédérale, quels qu'en soient les motifs réels, porte, du moins dans sa présentation, sur une part juste et équitable de l'espace en cause plutôt que sur une part des ressources minérales ou autres ressources naturelles que l'on pourrait y trouver et dont l'emplacement ne saurait de toute manière être exactement déterminé pour le moment. La Cour a obtenu certains renseignements, encore qu'incomplets, sur cette dernière question mais elle n'a pas jugé nécessaire d'insister, car cela concerne l'exploitation éventuelle des ressources du plateau continental plus encore que sa délimitation.

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18. Pour la commodité de l'exposé, il est préférable d'examiner en premier lieu les thèses présentées au nom de la République fédérale. La Cour n'estime pas pouvoir les accepter, du moins sous la forme qui

that, having regard both to the language of the Special Agreements and to more general considerations of law relating to the régime of the continental shelf, its task in the present proceedings relates essentially to the delimitation and not the apportionment of the areas concerned, or their division into converging sectors. Delimitation is a process which involves establishing the boundaries of an area already, in principle, appertaining to the coastal State and not the determination *de novo* of such an area. Delimitation in an equitable manner is one thing, but not the same thing as awarding a just and equitable share of a previously undelimited area, even though in a number of cases the results may be comparable, or even identical.

19. More important is the fact that the doctrine of the just and equitable share appears to be wholly at variance with what the Court entertains no doubt is the most fundamental of all the rules of law relating to the continental shelf, enshrined in Article 2 of the 1958 Geneva Convention, though quite independent of it,—namely that the rights of the coastal State in respect of the area of continental shelf that constitutes a natural prolongation of its land territory into and under the sea exist *ipso facto* and *ab initio*, by virtue of its sovereignty over the land, and as an extension of it in an exercise of sovereign rights for the purpose of exploring the seabed and exploiting its natural resources. In short, there is here an inherent right. In order to exercise it, no special legal process has to be gone through, nor have any special legal acts to be performed. Its existence can be declared (and many States have done this) but does not need to be constituted. Furthermore, the right does not depend on its being exercised. To echo the language of the Geneva Convention, it is “exclusive” in the sense that if the coastal State does not choose to explore or exploit the areas of shelf appertaining to it, that is its own affair, but no one else may do so without its express consent.

20. It follows that even in such a situation as that of the North Sea, the notion of apportioning an as yet undelimited area, considered as a whole (which underlies the doctrine of the just and equitable share), is quite foreign to, and inconsistent with, the basic concept of continental shelf entitlement, according to which the process of delimitation is essentially one of drawing a boundary line between areas which already appertain to one or other of the States affected. The delimitation itself must indeed be equitably effected, but it cannot have as its object the awarding of an equitable share, or indeed of a share, as such, at all,—for the fundamental concept involved does not admit of there being anything undivided to share out. Evidently any dispute about boundaries must involve that there is a disputed marginal or fringe area, to which both parties are laying claim, so that any delimitation of it which does not leave it wholly to one of the parties will in practice divide it between them in certain shares, or operate as if such a division had been made.

leur a été donnée. Compte tenu du texte des compromis et de considérations plus générales touchant le régime juridique du plateau continental, elle est d'avis que sa tâche en l'espèce concerne essentiellement la délimitation et non point la répartition des espaces visés ou leur division en secteurs convergents. La délimitation est une opération qui consiste à déterminer les limites d'une zone relevant déjà en principe de l'Etat riverain et non à définir cette zone *de novo*. Délimiter d'une manière équitable est une chose, mais c'en est une autre que d'attribuer une part juste et équitable d'une zone non encore délimitée, quand bien même le résultat des deux opérations serait dans certains cas comparable, voire identique.

19. Ce qui est plus important encore, c'est que la doctrine de la part juste et équitable semble s'écarter totalement de la règle qui constitue sans aucun doute possible pour la Cour la plus fondamentale de toutes les règles de droit relatives au plateau continental et qui est consacrée par l'article 2 de la Convention de Genève de 1958, bien qu'elle en soit tout à fait indépendante: les droits de l'Etat riverain concernant la zone de plateau continental qui constitue un prolongement naturel de son territoire sous la mer existent *ipso facto et ab initio* en vertu de la souveraineté de l'Etat sur ce territoire et par une extension de cette souveraineté sous la forme de l'exercice de droits souverains aux fins de l'exploration du lit de la mer et de l'exploitation de ses ressources naturelles. Il y a là un droit inhérent. Point n'est besoin pour l'exercer de suivre un processus juridique particulier ni d'accomplir des actes juridiques spéciaux. Son existence peut être constatée, comme cela a été fait par de nombreux Etats, mais elle ne suppose aucun acte constitutif. Qui plus est, ce droit est indépendant de son exercice effectif. Pour reprendre le terme de la Convention de Genève, il est «exclusif» en ce sens que, si un Etat riverain choisit de ne pas explorer ou de ne pas exploiter les zones de plateau continental lui revenant, cela ne concerne que lui et nul ne peut le faire sans son consentement exprès

20. Il en découle que, même dans la situation de la mer du Nord, l'idée de répartir une zone non encore délimitée considérée comme un tout, idée sous-jacente à la doctrine de la part juste et équitable, est absolument étrangère et opposée à la conception fondamentale du régime du plateau continental, suivant laquelle l'opération de délimitation consiste essentiellement à tracer une ligne de démarcation entre des zones relevant déjà de l'un ou de l'autre des Etats intéressés. Certes la délimitation doit s'effectuer équitablement, mais elle ne saurait avoir pour objet d'attribuer une part équitable ni même simplement une part, car la conception fondamentale en la matière exclut qu'il y ait quoi que ce soit d'indivis à partager. Il est évident qu'un différend sur des limites implique nécessairement l'existence d'une zone marginale litigieuse réclamée par les deux parties et que toute délimitation n'attribuant pas entièrement cette zone à l'une des parties aboutit en pratique à la partager ou à faire comme s'il y avait partage. Mais cela ne signifie pas qu'il y ait répartition de

But this does not mean that there has been an apportionment of something that previously consisted of an integral, still less an undivided whole.

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21. The Court will now turn to the contentions advanced on behalf of Denmark and the Netherlands. Their general character has already been indicated in paragraphs 13 and 14: the most convenient way of dealing with them will be on the basis of the following question—namely, does the equidistance-special circumstances principle constitute a mandatory rule, either on a conventional or on a customary international law basis, in such a way as to govern any delimitation of the North Sea continental shelf areas between the Federal Republic and the Kingdoms of Denmark and the Netherlands respectively? Another and shorter way of formulating the question would be to ask whether, in any delimitation of these areas, the Federal Republic is under a legal obligation to accept the application of the equidistance-special circumstances principle.

22. Particular attention is directed to the use, in the foregoing formulations, of the terms “mandatory” and “obligation”. It has never been doubted that the equidistance method of delimitation is a very convenient one, the use of which is indicated in a considerable number of cases. It constitutes a method capable of being employed in almost all circumstances, however singular the results might sometimes be, and has the virtue that if necessary,—if for instance, the Parties are unable to enter into negotiations,—any cartographer can *de facto* trace such a boundary on the appropriate maps and charts, and those traced by competent cartographers will for all practical purposes agree.

23. In short, it would probably be true to say that no other method of delimitation has the same combination of practical convenience and certainty of application. Yet these factors do not suffice of themselves to convert what is a method into a rule of law, making the acceptance of the results of using that method obligatory in all cases in which the parties do not agree otherwise, or in which “special circumstances” cannot be shown to exist. Juridically, if there is such a rule, it must draw its legal force from other factors than the existence of these advantages, important though they may be. It should also be noticed that the counterpart of this conclusion is no less valid, and that the practical advantages of the equidistance method would continue to exist whether its employment were obligatory or not.

24. It would however be ignoring realities if it were not noted at the same time that the use of this method, partly for the reasons given in paragraph 8 above and partly for reasons that are best appreciated by reference to the many maps and diagrams furnished by both sides in the course of the written and oral proceedings, can under certain circumstances produce results that appear on the face of them to be extraordinary, unnatural or unreasonable. It is basically this fact which un-

quelque chose qui constituait auparavant un tout, et encore moins de quelque chose d'indivis.

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21. La Cour en vient maintenant aux thèses avancées au nom du Danemark et des Pays-Bas. Leur caractère général a déjà été indiqué aux paragraphes 13 et 14; pour en faciliter l'examen, on peut partir de la question suivante: le principe équidistance-circonstances spéciales constitue-t-il, en vertu d'une convention ou du droit international coutumier, une règle obligatoire applicable à toute délimitation du plateau continental de la mer du Nord entre la République fédérale et les Royaumes du Danemark et des Pays-Bas respectivement? En bref la République fédérale a-t-elle l'obligation juridique d'accepter en la matière l'application du principe équidistance-circonstances spéciales?

22. Il convient de noter l'emploi des termes *obligatoire* et *obligation* dans les formules qui précèdent. On n'a jamais douté que la méthode de délimitation fondée sur l'équidistance soit une méthode extrêmement pratique dont l'emploi est indiqué dans un très grand nombre de cas. Elle peut être utilisée dans presque toutes les circonstances, pour singulier que soit parfois le résultat; elle présente l'avantage qu'en cas de besoin, par exemple si une raison quelconque empêche les parties d'entreprendre des négociations, tout cartographe peut tracer sur la carte une ligne d'équidistance *de facto* et que les lignes dessinées par des cartographes qualifiés coïncideront pratiquement.

23. En somme il est probablement exact qu'aucune autre méthode de délimitation ne combine au même degré les avantages de la commodité pratique et de la certitude dans l'application. Toutefois cela ne suffit pas à transformer une méthode en règle de droit et à rendre obligatoire l'acceptation de ses résultats chaque fois que les parties ne se sont pas mises d'accord sur d'autres dispositions ou que l'existence de «circonstances spéciales» ne peut être établie. Juridiquement, si une telle règle existe, sa valeur en droit doit tenir à autre chose qu'à ces avantages, si importants soient-ils. La réciproque n'est pas moins vraie: que l'application de la méthode de l'équidistance soit obligatoire ou non, ses avantages pratiques resteront les mêmes.

24. Ce serait cependant méconnaître les réalités que de ne pas noter en même temps que, pour les raisons indiquées au paragraphe 8 ci-dessus et pour d'autres raisons qui apparaissent clairement si l'on se reporte aux cartes et croquis fournis en grand nombre par les Parties au cours des procédures écrite et orale, l'emploi de cette méthode peut dans certains cas aboutir à des résultats de prime abord extraordinaires, anormaux ou déraisonnables. C'est ce fait, fondamentalement, qui est à

derlies the present proceedings. The plea that, however this may be, the results can never be inequitable, because the equidistance principle is by definition an equitable principle of delimitation, involves a postulate that clearly begs the whole question at issue.

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25. The Court now turns to the legal position regarding the equidistance method. The first question to be considered is whether the 1958 Geneva Convention on the Continental Shelf is binding for all the Parties in this case—that is to say whether, as contended by Denmark and the Netherlands, the use of this method is rendered obligatory for the present delimitations by virtue of the delimitations provision (Article 6) of that instrument, according to the conditions laid down in it. Clearly, if this is so, then the provisions of the Convention will prevail in the relations between the Parties, and would take precedence of any rules having a more general character, or derived from another source. On that basis the Court's reply to the question put to it in the Special Agreements would necessarily be to the effect that as between the Parties the relevant provisions of the Convention represented the applicable rules of law—that is to say constituted the law for the Parties—and its sole remaining task would be to interpret those provisions, in so far as their meaning was disputed or appeared to be uncertain, and to apply them to the particular circumstances involved.

26. The relevant provisions of Article 6 of the Geneva Convention, paragraph 2 of which Denmark and the Netherlands contend not only to be applicable as a conventional rule, but also to represent the accepted rule of general international law on the subject of continental shelf delimitation, as it exists independently of the Convention, read as follows:

“1. Where the same continental shelf is adjacent to the territories of two or more States whose coasts are opposite each other, the boundary of the continental shelf appertaining to such States shall be determined by agreement between them. In the absence of agreement, and unless another boundary line is justified by special circumstances, the boundary is the median line, every point of which is equidistant from the nearest point of the baselines from which the breadth of the territorial sea of each State is measured.

2. Where the same continental shelf is adjacent to the territories of two adjacent States, the boundary of the continental shelf shall be determined by agreement between them. In the absence of agreement, and unless another boundary line is justified by special circumstances, the boundary shall be determined by application of the principle of equidistance from the nearest points of the baselines from which the breadth of the territorial sea of each State is measured.”

l'origine de la présente instance. Affirmer que de toute façon les résultats ne peuvent jamais être inéquitables parce que l'équidistance est par définition un principe de délimitation équitable revient de toute évidence à une pétition de principe.

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25. La Cour étudiera à présent quelle est la situation juridique en ce qui concerne la méthode de l'équidistance. Il convient d'examiner d'abord si la Convention de Genève de 1958 sur le plateau continental lie toutes les Parties à la présente affaire, c'est-à-dire si, comme le Danemark et les Pays-Bas le soutiennent, l'article 6 de cette Convention relatif à la délimitation rend l'application de la méthode de l'équidistance obligatoire en l'espèce, dans les conditions qu'il prévoit. Si tel était le cas, les dispositions de la Convention régiraient manifestement les relations entre les Parties et prendraient le pas sur toute règle d'un caractère plus général ou découlant d'une autre source. A la question posée dans les compromis, la Cour devrait alors nécessairement répondre que les dispositions pertinentes de la Convention représentent les règles de droit applicables entre les Parties, autrement dit qu'elles constituent le droit pour les Parties, et il ne lui resterait plus qu'à interpréter ces dispositions, dans la mesure où leur sens serait contesté ou paraîtrait incertain, et à les appliquer aux faits de l'espèce.

26. Les dispositions pertinentes de l'article 6 de la Convention de Genève, dont le paragraphe 2, selon le Danemark et les Pays-Bas, ne serait pas seulement applicable en tant que règle conventionnelle mais représenterait en outre la règle consacrée par le droit international général en matière de délimitation du plateau continental, indépendamment de la Convention, se lisent comme suit:

«1. Dans le cas où un même plateau continental est adjacent aux territoires de deux ou plusieurs Etats dont les côtes se font face, la délimitation du plateau continental entre ces Etats est déterminée par accord entre ces Etats. A défaut d'accord, et à moins que des circonstances spéciales ne justifient une autre délimitation, celle-ci est constituée par la ligne médiane dont tous les points sont équidistants des points les plus proches des lignes de base à partir desquelles est mesurée la largeur de la mer territoriale de chacun de ces Etats.

2. Dans le cas où un même plateau continental est adjacent aux territoires de deux Etats limitrophes, la délimitation du plateau continental est déterminée par accord entre ces Etats. A défaut d'accord, et à moins que des circonstances spéciales ne justifient une autre délimitation, celle-ci s'opère par application du principe de l'équidistance des points les plus proches des lignes de base à partir desquelles est mesurée la largeur de la mer territoriale de chacun de ces Etats.»

The Convention received 46 signatures and, up-to-date, there have been 39 ratifications or accessions. It came into force on 10 June 1964, having received the 22 ratifications or accessions required for that purpose (Article 11), and was therefore in force at the time when the various delimitations of continental shelf boundaries described earlier (paragraphs 1 and 5) took place between the Parties. But, under the formal provisions of the Convention, it is in force for any individual State only in so far as, having signed it within the time-limit provided for that purpose, that State has also subsequently ratified it; or, not having signed within that time-limit, has subsequently acceded to the Convention. Denmark and the Netherlands have both signed and ratified the Convention, and are parties to it, the former since 10 June 1964, the latter since 20 March 1966. The Federal Republic was one of the signatories of the Convention, but has never ratified it, and is consequently not a party.

27. It is admitted on behalf of Denmark and the Netherlands that in these circumstances the Convention cannot, as such, be binding on the Federal Republic, in the sense of the Republic being contractually bound by it. But it is contended that the Convention, or the régime of the Convention, and in particular of Article 6, has become binding on the Federal Republic in another way,—namely because, by conduct, by public statements and proclamations, and in other ways, the Republic has unilaterally assumed the obligations of the Convention; or has manifested its acceptance of the conventional régime; or has recognized it as being generally applicable to the delimitation of continental shelf areas. It has also been suggested that the Federal Republic had held itself out as so assuming, accepting or recognizing, in such a manner as to cause other States, and in particular Denmark and the Netherlands, to rely on the attitude thus taken up.

28. As regards these contentions, it is clear that only a very definite, very consistent course of conduct on the part of a State in the situation of the Federal Republic could justify the Court in upholding them; and, if this had existed—that is to say if there had been a real intention to manifest acceptance or recognition of the applicability of the conventional régime—then it must be asked why it was that the Federal Republic did not take the obvious step of giving expression to this readiness by simply ratifying the Convention. In principle, when a number of States, including the one whose conduct is invoked, and those invoking it, have drawn up a convention specifically providing for a particular method by which the intention to become bound by the régime of the convention is to be manifested—namely by the carrying out of certain prescribed formalities (ratification, accession), it is not lightly to be presumed that a State which has not carried out these formalities, though at all times fully able and entitled to do so, has nevertheless somehow become bound in another way. Indeed if it were a question not of obligation but of rights,—if, that is to say, a State which, though entitled



La Convention a été signée par quarante-six Etats et elle a reçu à ce jour trente-neuf ratifications ou adhésions. Elle est entrée en vigueur le 10 juin 1964, ayant obtenu les vingt-deux ratifications ou adhésions exigées (article 11); elle était donc en vigueur au moment où les Parties ont effectué les diverses délimitations du plateau continental évoquées aux paragraphes 1 et 5 ci-dessus. Toutefois, selon ses clauses finales, la Convention n'est en vigueur à l'égard d'un Etat que si celui-ci, après l'avoir signée dans les délais prévus, l'a ratifiée ou, sans l'avoir signée dans les délais, y a adhéré ultérieurement. Le Danemark et les Pays-Bas ont signé et ratifié la Convention et y sont parties depuis le 10 juin 1964 et le 20 mars 1966 respectivement. La République fédérale a signé la Convention mais elle ne l'a jamais ratifiée et n'y est donc pas partie.

27. Le Danemark et les Pays-Bas admettent que dans ces conditions la Convention ne saurait en tant que telle être obligatoire pour la République fédérale, c'est-à-dire la lier contractuellement. Ils soutiennent que la Convention, ou le régime de la Convention et de son article 6 en particulier, est néanmoins devenue obligatoire pour la République fédérale d'une autre manière: en raison notamment de son comportement, de ses déclarations publiques et de ses proclamations, la République fédérale aurait assumé unilatéralement les obligations de la Convention, ou manifesté son acceptation du régime conventionnel, ou reconnu ce régime comme généralement applicable en matière de délimitation du plateau continental. Il a été avancé aussi que la République fédérale se serait présentée comme assumant les obligations de la Convention, comme acceptant le régime conventionnel ou comme reconnaissant l'applicabilité de ce régime, d'une façon qui aurait amené d'autres Etats, en particulier le Danemark et les Pays-Bas, à tabler sur cette attitude.

28. Il est clair que la Cour ne serait justifiée à accepter pareilles thèses que dans le cas où le comportement de la République fédérale aurait été absolument net et constant; et même dans cette hypothèse, c'est-à-dire si elle avait eu vraiment l'intention de manifester qu'elle acceptait le régime conventionnel ou en reconnaissait l'applicabilité, on devrait se demander pourquoi la République fédérale n'a pas pris la mesure qui s'imposait, à savoir exprimer sa volonté en ratifiant purement et simplement la Convention. En principe, lorsque plusieurs Etats, y compris celui dont le comportement est invoqué et ceux qui l'invoquent, ont conclu une convention où il est spécifié que l'intention d'être lié par le régime conventionnel doit se manifester d'une manière déterminée, c'est-à-dire par l'accomplissement de certaines formalités prescrites (ratification, adhésion), on ne saurait présumer à la légère qu'un Etat n'ayant pas accompli ces formalités, alors qu'il était à tout moment en mesure et en droit de le faire, n'en est pas moins tenu d'une autre façon. D'ailleurs, s'il s'agissait de droits et non d'obligations, en d'autres termes si un Etat essayait de revendiquer des droits en vertu d'une convention à

to do so, had not ratified or acceded, attempted to claim rights under the convention, on the basis of a declared willingness to be bound by it, or of conduct evincing acceptance of the conventional régime, it would simply be told that, not having become a party to the convention it could not claim any rights under it until the professed willingness and acceptance had been manifested in the prescribed form.

29. A further point, not in itself conclusive, but to be noted, is that if the Federal Republic had ratified the Geneva Convention, it could have entered—and could, if it ratified now, enter—a reservation to Article 6, by reason of the faculty to do so conferred by Article 12 of the Convention. This faculty would remain, whatever the previous conduct of the Federal Republic might have been—a fact which at least adds to the difficulties involved by the Danish-Netherlands contention.

30. Having regard to these considerations of principle, it appears to the Court that only the existence of a situation of estoppel could suffice to lend substance to this contention,—that is to say if the Federal Republic were now precluded from denying the applicability of the conventional régime, by reason of past conduct, declarations, etc., which not only clearly and consistently evinced acceptance of that régime, but also had caused Denmark or the Netherlands, in reliance on such conduct, detrimentally to change position or suffer some prejudice. Of this there is no evidence whatever in the present case.

31. In these circumstances it seems to the Court that little useful purpose would be served by passing in review and subjecting to detailed scrutiny the various acts relied on by Denmark and the Netherlands as being indicative of the Federal Republic's acceptance of the régime of Article 6;—for instance that at the Geneva Conference the Federal Republic did not take formal objection to Article 6 and eventually signed the Convention without entering any reservation in respect of that provision; that it at one time announced its intention to ratify the Convention; that in its public declarations concerning its continental shelf rights it appeared to rely on, or at least cited, certain provisions of the Geneva Convention. In this last connection a good deal has been made of the joint Minute signed in Bonn, on 4 August 1964, between the then-negotiating delegations of the Federal Republic and the Netherlands. But this minute made it clear that what the Federal Republic was seeking was an agreed division, rather than a delimitation of the central North Sea continental shelf areas, and the reference it made to Article 6 was specifically to the first sentence of paragraphs 1 and 2 of that Article, which speaks exclusively of delimitation by agreement and not at all of the use of the equidistance method.

32. In the result it appears to the Court that none of the elements invoked is decisive; each is ultimately negative or inconclusive; all are capable of varying interpretations or explanations. It would be one

laquelle il n'aurait donné ni sa ratification ni son adhésion alors qu'il était habilité à le faire, et s'il alléguait à cette fin qu'il a proclamé sa volonté d'être lié par la convention ou a manifesté par son comportement son acceptation du régime conventionnel, on lui répondrait simplement que, n'étant pas devenu partie à la convention il ne peut revendiquer aucun droit à ce titre tant qu'il n'a pas exprimé sa volonté ou son acceptation dans les formes prescrites.

29. Un autre point, qui n'est pas en soi décisif, vaut d'être relevé: si la République fédérale avait ratifié la Convention de Genève, elle aurait pu formuler une réserve à l'égard de l'article 6, en usant de la faculté offerte par l'article 12, et elle pourrait encore le faire aujourd'hui si elle ratifiait la Convention. Cette possibilité subsisterait indépendamment du comportement antérieur de la République fédérale, ce qui ne fait qu'ajouter aux difficultés soulevées par la thèse du Danemark et des Pays-Bas.

30. Eu égard à ces considérations de principe, la Cour est d'avis que seule l'existence d'une situation d'*estoppel* pourrait étayer pareille thèse: il faudrait que la République fédérale ne puisse plus contester l'applicabilité du régime conventionnel, en raison d'un comportement, de déclarations, etc., qui n'auraient pas seulement attesté d'une manière claire et constante son acceptation de ce régime mais auraient également amené le Danemark ou les Pays-Bas, se fondant sur cette attitude, à modifier leur position à leur détriment ou à subir un préjudice quelconque. Rien n'indique qu'il en soit ainsi en l'espèce.

31. Dans ces conditions, il ne semble guère utile à la Cour d'examiner en détail les divers actes de la République fédérale qui, selon le Danemark et les Pays-Bas, traduiraient une acceptation du régime de l'article 6: ainsi, lors de la conférence de Genève, elle n'a pas opposé d'objection formelle à l'article 6 et elle a, pour finir, signé la Convention sans formuler de réserve à l'égard de cet article; elle a annoncé à un certain moment son intention de ratifier la Convention; dans ses déclarations publiques concernant ses droits sur le plateau continental, elle a paru se fonder sur certaines dispositions de la Convention ou elle les a en tout cas citées. A ce sujet on a tiré argument du procès-verbal commun signé à Bonn le 4 août 1964 par les délégations de la République fédérale et des Pays-Bas lors des négociations entre ces deux pays. Mais le texte fait bien ressortir que la République fédérale cherchait un accord sur un partage plutôt que sur une délimitation des zones centrales du plateau continental de la mer du Nord et la mention qu'il fait de l'article 6 vise expressément la première phrase des paragraphes 1 et 2 de cet article, laquelle concerne uniquement la délimitation par voie d'accord et nullement l'emploi de la méthode de l'équidistance.

32. Somme toute, il semble à la Cour qu'aucun des faits invoqués n'est décisif; tous sont en fin de compte négatifs ou non concluants, tous se prêtent à des interprétations ou explications variées. Autre chose

thing to infer from the declarations of the Federal Republic an admission accepting the fundamental concept of coastal State rights in respect of the continental shelf: it would be quite another matter to see in this an acceptance of the rules of delimitation contained in the Convention. The declarations of the Federal Republic, taken in the aggregate, might at most justify the view that to begin with, and before becoming fully aware of what the probable effects in the North Sea would be, the Federal Republic was not specifically opposed to the equidistance principle as embodied in Article 6 of the Convention. But from a purely negative conclusion such as this, it would certainly not be possible to draw the positive inference that the Federal Republic, though not a party to the Convention, had accepted the régime of Article 6 in a manner binding upon itself.

33. The dangers of the doctrine here advanced by Denmark and the Netherlands, if it had to be given general application in the international law field, hardly need stressing. Moreover, in the present case, any such inference would immediately be nullified by the fact that, as soon as concrete delimitations of North Sea continental shelf areas began to be carried out, the Federal Republic, as described earlier (paragraphs 9 and 12), at once reserved its position with regard to those delimitations which (effected on an equidistance basis) might be prejudicial to the delimitation of its own continental shelf areas.

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34. Since, accordingly, the foregoing considerations must lead the Court to hold that Article 6 of the Geneva Convention is not, as such, applicable to the delimitations involved in the present proceedings, it becomes unnecessary for it to go into certain questions relating to the interpretation or application of that provision which would otherwise arise. One should be mentioned however, namely what is the relationship between the requirement of Article 6 for delimitation by agreement, and the requirements relating to equidistance and special circumstances that are to be applied in "the absence of" such agreement,—i.e., in the absence of agreement on the matter, is there a presumption that the continental shelf boundary between any two adjacent States consists automatically of an equidistance line,—or must negotiations for an agreed boundary prove finally abortive before the acceptance of a boundary drawn on an equidistance basis becomes obligatory in terms of Article 6, if no special circumstances exist?

35. Without attempting to resolve this question, the determination of which is not necessary for the purposes of the present case, the Court draws attention to the fact that the delimitation of the line E-F, as shown on Map 3, which was effected by Denmark and the Netherlands under the agreement of 31 March 1966 already mentioned (paragraphs 5 and 9), to which the Federal Republic was not a party, must have been based on

est de déduire des déclarations de la République fédérale qu'elle a admis la conception fondamentale des droits de l'Etat riverain sur le plateau continental; autre chose est d'y voir une acceptation des règles de délimitation prévues par la Convention. Considérées globalement, les déclarations de la République fédérale permettraient tout au plus de penser qu'au début, avant d'être pleinement consciente des effets probables du principe de l'équidistance dans le cas de la mer du Nord, la République fédérale n'était pas expressément opposée au principe énoncé à l'article 6 de la Convention. Or une constatation d'un caractère aussi négatif ne permet certainement pas de tirer la conclusion positive que, sans être partie à la Convention, la République fédérale avait accepté le régime de l'article 6 de façon à se lier.

33. Il est à peine besoin de souligner les dangers que présenterait la thèse ainsi soutenue par le Danemark et les Pays-Bas si on devait lui donner une portée générale en droit international. Au surplus, dans la présente affaire, cette conclusion serait immédiatement démentie par le fait que, sitôt effectuées les premières délimitations du plateau continental de la mer du Nord, la République fédérale a, comme on l'a vu aux paragraphes 9 et 12 ci-dessus, réservé sa position à l'égard de tracés qui, fondés sur l'équidistance, pouvaient nuire à la délimitation de sa propre zone de plateau continental.

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34. Les considérations qui précèdent amènent nécessairement la Cour à conclure que l'article 6 de la Convention de Genève n'est pas applicable en tant que tel aux délimitations visées en l'espèce; il devient donc superflu de traiter de certaines questions d'interprétation ou d'application qui pourraient se poser s'il en allait autrement. On peut néanmoins en mentionner une, celle de la relation entre la prescription de l'article 6 relative à la délimitation par voie d'accord et les prescriptions relatives à l'équidistance et aux circonstances spéciales qui sont applicables «à défaut d'accord»: existe-t-il une présomption suivant laquelle, en l'absence d'accord sur la question, toute délimitation d'un plateau continental entre deux Etats limitrophes est automatiquement fondée sur l'équidistance, ou bien des négociations sur les limites doivent-elles avoir définitivement échoué pour que l'acceptation de la délimitation fondée sur l'équidistance devienne obligatoire en vertu de l'article 6 s'il n'y a pas de circonstances spéciales?

35. Sans vouloir trancher cette question, ce qui n'est pas nécessaire aux fins de la présente affaire, la Cour souligne que la délimitation effectuée par le Danemark et les Pays-Bas suivant la ligne E-F de la carte 3, en vertu de l'accord du 31 mars 1966 auquel la République fédérale n'était pas partie (voir paragraphes 5 et 9 ci-dessus), doit avoir reposé tacitement sur l'idée que, puisqu'il n'en avait pas été convenu

the tacit assumption that, no agreement to the contrary having been reached in the negotiations between the Federal Republic and Denmark and the Netherlands respectively (paragraph 7), the boundary between the continental shelf areas of the Republic and those of the other two countries must be deemed to be an equidistance one;—or in other words the delimitation of the line E-F, and its validity *erga omnes* including the Federal Republic, as contended for by Denmark and the Netherlands, presupposes both the delimitation and the validity on an equidistance basis, of the lines B-E and D-E on Map 3, considered by Denmark and the Netherlands to represent the boundaries between their continental shelf areas and those of the Federal Republic.

36. Since, however, Article 6 of the Geneva Convention provides only for delimitation between “adjacent” States, which Denmark and the Netherlands clearly are not, or between “opposite” States which, despite suggestions to the contrary, the Court thinks they equally are not, the delimitation of the line E-F on Map 3 could not in any case find its validity in Article 6, even if that provision were opposable to the Federal Republic. The validity of this delimitation must therefore be sought in some other source of law. It is a main contention of Denmark and the Netherlands that there does in fact exist such another source, furnishing a rule that validates not only this particular delimitation, but all delimitations effected on an equidistance basis,—and indeed requiring delimitation on that basis unless the States concerned otherwise agree, and whether or not the Geneva Convention is applicable. This contention must now be examined.

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37. It is maintained by Denmark and the Netherlands that the Federal Republic, whatever its position may be in relation to the Geneva Convention, considered as such, is in any event bound to accept delimitation on an equidistance-special circumstances basis, because the use of this method is not in the nature of a merely conventional obligation, but is, or must now be regarded as involving, a rule that is part of the *corpus* of general international law;—and, like other rules of general or customary international law, is binding on the Federal Republic automatically and independently of any specific assent, direct or indirect, given by the latter. This contention has both a positive law and a more fundamentalist aspect. As a matter of positive law, it is based on the work done in this field by international legal bodies, on State practice and on the influence attributed to the Geneva Convention itself,—the claim being that these various factors have cumulatively evidenced or been creative of the *opinio juris sive necessitatis*, requisite for the formation of new rules of customary international law. In its fundamentalist aspect, the view put forward derives from what might be called the natural law of the con-

autrement lors des négociations de la République fédérale avec le Danemark et avec les Pays-Bas (voir paragraphe 7 ci-dessus), la délimitation du plateau continental entre la République fédérale et les deux autres pays devait se fonder sur l'équidistance; autrement dit, la délimitation de la ligne E-F et la validité à l'égard de tous, y compris la République fédérale, que lui attribuent le Danemark et les Pays-Bas présupposent à la fois le tracé et la validité, sur la base de l'équidistance, des lignes B-E et D-E de la carte 3, considérées par le Danemark et les Pays-Bas comme représentant les limites entre leurs zones de plateau continental et celle de la République fédérale.

36. D'autre part, l'article 6 de la Convention de Genève se rapporte uniquement à la délimitation entre Etats «limitrophes» — ce qui n'est manifestement pas le cas du Danemark et des Pays-Bas — ou entre Etats «se faisant face» — ce qui, de l'avis de la Cour, n'est pas non plus applicable à ces deux pays, bien que l'on ait avancé le contraire; la délimitation matérialisée par la ligne E-F sur la carte 3 ne saurait donc de toute manière se justifier par l'article 6, même s'il était opposable à la République fédérale. Cette délimitation devrait donc tirer sa validité d'une autre source de droit. L'une des thèses principales du Danemark et des Pays-Bas est qu'il existe bien une autre source de droit, d'où se dégage une règle justifiant la délimitation dont il s'agit, ainsi que toute autre délimitation effectuée selon l'équidistance, et imposant même cette méthode à moins que les Etats intéressés ne conviennent d'une autre, et cela que la Convention de Genève soit ou ne soit pas applicable. Il convient maintenant d'examiner cette thèse.

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37. Le Danemark et les Pays-Bas soutiennent que, quelle que soit sa situation par rapport à la Convention de Genève en tant que telle, la République fédérale est de toute façon tenue d'accepter la méthode équidistance-circonstances spéciales en matière de délimitation car, si l'emploi de cette méthode ne s'impose pas à titre conventionnel, il relève — ou doit désormais être considéré comme relevant — d'une règle de droit international général qui, de même que les autres règles de droit international général ou coutumier, lie la République fédérale automatiquement et indépendamment de tout consentement spécial direct ou indirect. Cette thèse présente deux aspects, l'un de droit positif, l'autre plus fondamentaliste. En ce qui concerne le droit positif, elle se fonde sur les travaux d'organismes juridiques internationaux, sur la pratique des Etats et sur l'effet attribué à la Convention de Genève elle-même: l'ensemble de ces facteurs attesterait ou engendrerait l'*opinio juris sive necessitatis* indispensable à la formation de règles nouvelles de droit international coutumier. Sous son aspect fondamentaliste, la thèse en question découle de ce qu'on pourrait appeler le droit naturel du plateau

tinental shelf, in the sense that the equidistance principle is seen as a necessary expression in the field of delimitation of the accepted doctrine of the exclusive appurtenance of the continental shelf to the nearby coastal State, and therefore as having an *a priori* character of so to speak juristic inevitability.

38. The Court will begin by examining this latter aspect, both because it is the more fundamental, and was so presented on behalf of Denmark and the Netherlands—i.e., as something governing the whole case; and because, if it is correct that the equidistance principle is, as the point was put in the course of the argument, to be regarded as inherent in the whole basic concept of continental shelf rights, then equidistance should constitute the rule according to positive law tests also. On the other hand, if equidistance should not possess any *a priori* character of necessity or inherency, this would not be any bar to its having become a rule of positive law through influences such as those of the Geneva Convention and State practice,—and that aspect of the matter would remain for later examination.

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39. The *a priori* argument starts from the position described in paragraph 19, according to which the right of the coastal State to its continental shelf areas is based on its sovereignty over the land domain, of which the shelf area is the natural prolongation into and under the sea. From this notion of appurtenance is derived the view which, as has already been indicated, the Court accepts, that the coastal State's rights exist *ipso facto* and *ab initio* without there being any question of having to make good a claim to the areas concerned, or of any apportionment of the continental shelf between different States. This was one reason why the Court felt bound to reject the claim of the Federal Republic (in the particular form which it took) to be awarded a "just and equitable share" of the shelf areas involved in the present proceedings. Denmark and the Netherlands, for their part, claim that the test of appurtenance must be "proximity", or more accurately "closer proximity": all those parts of the shelf being considered as appurtenant to a particular coastal State which are (but only if they are) closer to it than they are to any point on the coast of another State. Hence delimitation must be effected by a method which will leave to each one of the States concerned all those areas that are nearest to its own coast. Only a line drawn on equidistance principles will do this. Therefore, it is contended, only such a line can be valid (unless the Parties, for reasons of their own, agree on another), because only such a line can be thus consistent with basic continental shelf doctrine.

40. This view clearly has much force; for there can be no doubt that as a matter of normal topography, the greater part of a State's continental



continental, en ce sens que le principe de l'équidistance serait une expression nécessaire, pour ce qui est de la délimitation, de la doctrine établie d'après laquelle le plateau continental relève exclusivement de l'Etat riverain voisin et aurait donc à priori un caractère en quelque sorte inéluctable sur le plan juridique.

38. La Cour étudiera d'abord ce dernier aspect. Il est en effet plus fondamental et a été présenté comme tel par le Danemark et les Pays-Bas, qui y ont vu un élément dont toute l'affaire dépend. Au surplus, s'il était exact que l'équidistance soit, ainsi qu'on l'a dit en plaidoirie, un principe inhérent à la conception fondamentale du régime juridique du plateau continental, elle devrait aussi constituer la règle applicable d'après les critères du droit positif. En revanche, si l'équidistance n'avait pas à priori un caractère nécessaire ou inhérent, cela n'empêcherait nullement qu'elle soit devenue une règle de droit positif par l'effet d'éléments tels que la Convention de Genève ou la pratique des Etats; il faudrait donc encore examiner cet aspect du problème.

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39. L'argument du caractère à priori procède d'une constatation déjà faite au paragraphe 19: le droit de l'Etat riverain sur son plateau continental a pour fondement la souveraineté qu'il exerce sur le territoire dont ce plateau continental est le prolongement naturel sous la mer. De cette notion de rattachement découle l'idée, acceptée par la Cour comme on l'a déjà vu, que les droits de l'Etat riverain existent *ipso facto* et *ab initio* sans que la validité de ses revendications doive être établie ou sans qu'il soit besoin de procéder à une répartition du plateau continental entre Etats intéressés. C'est l'un des motifs pour lesquels la Cour a estimé devoir rejeter, sous la forme qui lui a été donnée, la demande de la République fédérale tendant à obtenir une «part juste et équitable» des zones de plateau continental en cause. Le Danemark et les Pays-Bas prétendent quant à eux que le critère du rattachement doit être la «proximité» ou plus exactement la «plus grande proximité»: ils considèrent que toutes les parties du plateau continental plus proches d'un Etat riverain déterminé que de tout point situé sur la côte d'un autre Etat — mais ces parties-là seulement — relèvent du premier Etat. En conséquence la délimitation doit s'opérer selon une méthode attribuant à chacun des Etats intéressés toutes les zones qui sont plus proches de sa propre côte que d'aucune autre. Seule une ligne tracée selon le principe de l'équidistance permet d'y parvenir. Seule donc, prétend-on, une telle ligne peut être valable, à moins que les parties n'en choisissent une autre pour des raisons qui leur sont propres, car seule elle est compatible avec la conception fondamentale du plateau continental.

40. Cet argument a incontestablement du poids; il ne fait pas de doute que, dans des conditions géographiques normales, la plus grande partie

shelf areas will in fact, and without the necessity for any delimitation at all, be nearer to its coasts than to any other. It could not well be otherwise: but *post hoc* is not *propter hoc*, and this situation may only serve to obscure the real issue, which is whether it follows that every part of the area concerned must be placed in this way, and that it should be as it were prohibited that any part should not be so placed. The Court does not consider that it does follow, either from the notion of proximity itself, or from the more fundamental concept of the continental shelf as being the natural prolongation of the land domain—a concept repeatedly appealed to by both sides throughout the case, although quite differently interpreted by them.

41. As regards the notion of proximity, the idea of absolute proximity is certainly not implied by the rather vague and general terminology employed in the literature of the subject, and in most State proclamations and international conventions and other instruments—terms such as “near”, “close to its shores”, “off its coast”, “opposite”, “in front of the coast”, “in the vicinity of”, “neighbouring the coast”, “adjacent to”, “contiguous”, etc.,—all of them terms of a somewhat imprecise character which, although they convey a reasonably clear general idea, are capable of a considerable fluidity of meaning. To take what is perhaps the most frequently employed of these terms, namely “adjacent to”, it is evident that by no stretch of imagination can a point on the continental shelf situated say a hundred miles, or even much less, from a given coast, be regarded as “adjacent” to it, or to any coast at all, in the normal sense of adjacency, even if the point concerned is nearer to some one coast than to any other. This would be even truer of localities where, physically, the continental shelf begins to merge with the ocean depths. Equally, a point inshore situated near the meeting place of the coasts of two States can often properly be said to be adjacent to both coasts, even though it may be fractionally closer to the one than the other. Indeed, local geographical configuration may sometimes cause it to have a closer physical connection with the coast to which it is not in fact closest.

42. There seems in consequence to be no necessary, and certainly no complete, identity between the notions of adjacency and proximity; and therefore the question of which parts of the continental shelf “adjacent to” a coastline bordering more than one State fall within the appurtenance of which of them, remains to this extent an open one, not to be determined on a basis exclusively of proximity. Even if proximity may afford one of the tests to be applied and an important one in the right conditions, it may not necessarily be the only, nor in all circumstances, the most appropriate one. Hence it would seem that the notion of adjacency, so constantly employed in continental shelf doctrine from the start, only implies proximity in a general sense, and does not imply any fundamental or inherent rule the ultimate effect of which would be to

des zones de plateau continental relevant d'un Etat seront en fait, et indépendamment de toute délimitation, plus proches de la côte de cet Etat que d'aucune autre. Le contraire serait étonnant, mais *post hoc* n'est pas *propter hoc* et tout cela ne fait qu'obscurcir la véritable question : faut-il réellement que toute partie de la zone relevant d'un Etat soit plus proche de sa côte que d'aucune autre et y a-t-il en quelque sorte un empêchement à ce qu'une partie de cette zone fasse exception? De l'avis de la Cour, cela ne résulte nécessairement ni de la notion même de proximité, ni de la conception plus fondamentale du plateau continental envisagé comme prolongement naturel du territoire, conception invoquée à maintes reprises des deux côtés pendant toute la procédure mais avec des interprétations très différentes.

41. En ce qui concerne la notion de proximité, on peut dire que l'idée d'une proximité absolue ne découle certes pas implicitement de la terminologie plutôt vague et générale employée dans les ouvrages consacrés à la question et dans la plupart des proclamations d'Etats, conventions internationales et autres instruments; on y trouve des termes comme *près, proche de ses côtes, au large de ses côtes, faisant face, devant la côte, au voisinage de, avoisinant la côte, adjacent, contigu, etc.*, qui sont tous assez imprécis et qui, tout en donnant une idée générale suffisamment claire, peuvent avoir un sens très difficile à cerner. Pour prendre l'exemple du terme *adjacent*, qui est peut-être le plus fréquemment utilisé, il est évident que, même avec beaucoup d'imagination, un point du plateau continental situé à une centaine de milles d'une côte déterminée ou même beaucoup moins loin ne saurait être considéré comme adjacent à cette côte ou à aucune autre côte au sens normal du mot *adjacent*, bien qu'il soit en fait plus proche d'un littoral que d'un autre. Cela est encore plus vrai des zones où le plateau continental proprement dit commence à faire place aux grands fonds. De même, un point situé plus près de la terre, non loin du lieu où les côtes de deux Etats se rejoignent, peut souvent et à juste titre être qualifié d'adjacent aux deux côtes bien qu'il soit légèrement plus proche de l'une que de l'autre. En fait, la configuration géographique locale peut parfois lui donner un lien physique plus étroit avec la côte dont il n'est pas le plus rapproché.

42. Il ne paraît donc pas y avoir d'identité nécessaire, et en tout cas pas d'identité complète, entre les notions d'adjacence et de proximité; dans ces conditions, la question de savoir quelles parties du plateau continental « adjacent à » un littoral bordant plusieurs Etats relèvent de l'un ou de l'autre reste entière et ne saurait être résolue d'après la seule proximité. Même si la proximité peut être l'un des critères applicables — et un critère important quand les conditions s'y prêtent —, ce n'est pas nécessairement le seul ni toujours le plus approprié. Il semblerait donc que la notion d'adjacence, employée si constamment au sujet de la doctrine du plateau continental et cela dès le début, n'implique la proximité qu'en un sens général, sans postuler une règle fondamentale ou inhérente dont l'effet serait en définitive d'interdire à tout Etat d'exercer, sauf par voie

prohibit any State (otherwise than by agreement) from exercising continental shelf rights in respect of areas closer to the coast of another State.

43. More fundamental than the notion of proximity appears to be the principle—constantly relied upon by all the Parties—of the natural prolongation or continuation of the land territory or domain, or land sovereignty of the coastal State, into and under the high seas, via the bed of its territorial sea which is under the full sovereignty of that State. There are various ways of formulating this principle, but the underlying idea, namely of an extension of something already possessed, is the same, and it is this idea of extension which is, in the Court's opinion, determinant. Submarine areas do not really appertain to the coastal State because—or not only because—they are near it. They are near it of course; but this would not suffice to confer title, any more than, according to a well-established principle of law recognized by both sides in the present case, mere proximity confers *per se* title to land territory. What confers the *ipso jure* title which international law attributes to the coastal State in respect of its continental shelf, is the fact that the submarine areas concerned may be deemed to be actually part of the territory over which the coastal State already has dominion,—in the sense that, although covered with water, they are a prolongation or continuation of that territory, an extension of it under the sea. From this it would follow that whenever a given submarine area does not constitute a natural—or the most natural—extension of the land territory of a coastal State, even though that area may be closer to it than it is to the territory of any other State, it cannot be regarded as appertaining to that State;—or at least it cannot be so regarded in the face of a competing claim by a State of whose land territory the submarine area concerned is to be regarded as a natural extension, even if it is less close to it.

44. In the present case, although both sides relied on the prolongation principle and regarded it as fundamental, they interpreted it quite differently. Both interpretations appear to the Court to be incorrect. Denmark and the Netherlands identified natural prolongation with closest proximity and therefrom argued that it called for an equidistance line: the Federal Republic seemed to think it implied the notion of the just and equitable share, although the connection is distinctly remote. (The Federal Republic did however invoke another idea, namely that of the proportionality of a State's continental shelf area to the length of its coastline, which obviously does have an intimate connection with the prolongation principle, and will be considered in its place.) As regards equidistance, it clearly cannot be identified with the notion of natural prolongation or extension, since, as has already been stated (paragraph 8), the use of the equidistance method would frequently cause areas which are the natural prolongation or extension of the territory of one State to be attributed to another, when the configuration of the latter's coast makes the equidistance line swing out laterally across the former's

d'accord, ses droits relatifs au plateau continental sur des zones plus proches de la côte d'un autre Etat que de la sienne.

43. Plus fondamental que la notion de proximité semble être le principe, que les Parties n'ont cessé d'invoquer, du prolongement naturel ou de l'extension du territoire ou de la souveraineté territoriale de l'Etat riverain sous la haute mer, au-delà du lit de la mer territoriale qui relève de la pleine souveraineté de cet Etat. Il y a plusieurs manières de formuler ce principe mais l'idée de base, celle d'une extension de quelque chose que l'on possède déjà, est la même et c'est cette idée d'extension qui est décisive selon la Cour. Ce n'est pas vraiment ou pas seulement parce qu'elles sont proches de son territoire que des zones sous-marines relèvent d'un Etat riverain. Elles en sont proches certes, mais cela ne suffit pas pour conférer un titre — pas plus que la simple proximité ne constitue en soi un titre au domaine terrestre, ce qui est un principe de droit bien établi et admis par les Parties en l'espèce. En réalité le titre que le droit international attribue *ipso jure* à l'Etat riverain sur son plateau continental procède de ce que les zones sous-marines en cause peuvent être considérées comme faisant véritablement partie du territoire sur lequel l'Etat riverain exerce déjà son autorité: on peut dire que, tout en étant recouvertes d'eau, elles sont un prolongement, une continuation, une extension de ce territoire sous la mer. Par suite, même si une zone sous-marine est plus proche du territoire d'un Etat que de tout autre, on ne saurait considérer qu'elle relève de cet Etat dès lors qu'elle ne constitue pas une extension naturelle, ou l'extension la plus naturelle, de son domaine terrestre et qu'une revendication rivale est formulée par un autre Etat dont il est possible d'admettre que la zone sous-marine en question prolonge de façon naturelle le territoire, tout en étant moins proche.

44. Dans la présente affaire, on a invoqué des deux côtés le principe du prolongement en le considérant comme fondamental mais on l'a interprété de façons très différentes. Les deux interprétations paraissent inexactes à la Cour. Le Danemark et les Pays-Bas ont assimilé le concept de prolongement naturel à celui de plus grande proximité et ils en ont déduit que le premier exige le tracé d'une ligne d'équidistance; la République fédérale paraît avoir pensé qu'il implique la notion de la part juste et équitable, bien que le rapport soit très lointain. (La République fédérale a cependant invoqué une autre idée, celle de la proportionnalité entre la zone de plateau continental revenant à un Etat et la longueur de son littoral; cette idée, qui a évidemment un lien étroit avec le principe du prolongement, sera examinée le moment venu.) La notion d'équidistance ne peut manifestement pas être identifiée à celle d'extension ou de prolongement naturel car, comme on l'a déjà vu au paragraphe 8, l'emploi de la méthode de l'équidistance aurait souvent pour résultat d'attribuer à un Etat des zones prolongeant naturellement le territoire d'un autre Etat lorsque la configuration côtière du premier fait dévier latéralement la

coastal front, cutting it off from areas situated directly before that front.

45. The fluidity of all these notions is well illustrated by the case of the Norwegian Trough (paragraph 4 above). Without attempting to pronounce on the status of that feature, the Court notes that the shelf areas in the North Sea separated from the Norwegian coast by the 80-100 kilometres of the Trough cannot in any physical sense be said to be adjacent to it, nor to be its natural prolongation. They are nevertheless considered by the States parties to the relevant delimitations, as described in paragraph 4, to appertain to Norway up to the median lines shown on Map 1. True these median lines are themselves drawn on equidistance principles; but it was only by first ignoring the existence of the Trough that these median lines fell to be drawn at all.

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46. The conclusion drawn by the Court from the foregoing analysis is that the notion of equidistance as being logically necessary, in the sense of being an inescapable *a priori* accompaniment of basic continental shelf doctrine, is incorrect. It is said not to be possible to maintain that there is a rule of law ascribing certain areas to a State as a matter of inherent and original right (see paragraphs 19 and 20), without also admitting the existence of some rule by which those areas can be obligatorily delimited. The Court cannot accept the logic of this view. The problem arises only where there is a dispute and only in respect of the marginal areas involved. The appurtenance of a given area, considered as an entity, in no way governs the precise delimitation of its boundaries, any more than uncertainty as to boundaries can affect territorial rights. There is for instance no rule that the land frontiers of a State must be fully delimited and defined, and often in various places and for long periods they are not, as is shown by the case of the entry of Albania into the League of Nations (*Monastery of Saint Naoum, Advisory Opinion, 1924, P.C.I.J., Series B, No. 9*, at p. 10).

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47. A review of the genesis and development of the equidistance method of delimitation can only serve to confirm the foregoing conclusion. Such a review may appropriately start with the instrument, generally known as the "Truman Proclamation", issued by the Government of the United States on 28 September 1945. Although this instrument was not the first or only one to have appeared, it has in the opinion of the Court a special status. Previously, various theories as to the nature and extent of the rights relative to or exercisable over the continental shelf had been advanced by jurists, publicists and technicians. The Truman Proclamation however, soon came to be regarded as the starting point of the posi-

ligne d'équidistance et ampute le second de zones situées juste devant sa façade maritime.

45. Le cas de la fosse norvégienne (voir paragraphe 4 ci-dessus) illustre bien le caractère incertain de toutes ces notions. Sans se prononcer sur le statut de la fosse, la Cour constate que les zones du plateau continental de la mer du Nord séparées de la côte norvégienne par une fosse de quatre-vingts à cent kilomètres de large ne sauraient être considérées au point de vue géographique comme étant adjacentes à cette côte ou comme constituant son prolongement naturel. Elles n'en sont pas moins considérées par les Etats parties aux délimitations décrites au paragraphe 4 comme relevant de la Norvège jusqu'aux lignes médianes portées sur la carte 1. Certes ces lignes médianes ont été tracées selon le principe de l'équidistance, mais c'est uniquement parce que l'on n'a pas tenu compte de l'existence de la fosse norvégienne.

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46. La Cour conclut de l'analyse qui précède qu'il est inexact de considérer la notion d'équidistance comme logiquement nécessaire, en ce sens qu'elle serait liée de façon inévitable et à priori à la conception fondamentale du plateau continental. On a dit qu'il n'est pas possible de soutenir qu'une règle juridique attribue certaines zones à un Etat au titre d'un droit inhérent et originaire (voir paragraphes 19 et 20) sans admettre en même temps l'existence d'une règle obligatoire quant à la délimitation de ces zones. La Cour ne voit pas la logique de cette thèse. Le problème ne se pose qu'en cas de litige et uniquement à l'égard des zones qui forment les confins. Le fait qu'une zone, prise comme une entité, relève de tel ou tel Etat est sans conséquence sur la délimitation exacte des frontières de cette zone, de même que l'incertitude des frontières ne saurait affecter les droits territoriaux. Aucune règle ne dispose par exemple que les frontières terrestres d'un Etat doivent être complètement délimitées et définies et il est fréquent qu'elles ne le soient pas en certains endroits et pendant de longues périodes, comme le montre la question de l'admission de l'Albanie à la Société des Nations (*Monastère de Saint-Naoum, avis consultatif, 1924, C.P.J.I. série B n° 9, p. 10*).

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47. Un examen de la genèse et de l'évolution de la méthode de délimitation fondée sur l'équidistance ne fait que confirmer la conclusion ci-dessus. Il convient de rappeler tout d'abord l'acte, généralement connu sous le nom de *proclamation Truman*, que le Gouvernement des Etats-Unis a publié le 28 septembre 1945. Bien que cet acte n'ait été ni le premier ni le seul, il a, selon la Cour, une importance particulière. Auparavant, des juristes, des publicistes et des techniciens avaient avancé diverses théories sur la nature et l'étendue des droits existant à l'égard du plateau continental ou pouvant être exercés sur lui. La proclamation Truman devait cependant être bientôt considérée comme le point de

tive law on the subject, and the chief doctrine it enunciated, namely that of the coastal State as having an original, natural, and exclusive (in short a vested) right to the continental shelf off its shores, came to prevail over all others, being now reflected in Article 2 of the 1958 Geneva Convention on the Continental Shelf. With regard to the delimitation of lateral boundaries between the continental shelves of adjacent States, a matter which had given rise to some consideration on the technical, but very little on the juristic level, the Truman Proclamation stated that such boundaries "shall be determined by the United States and the State concerned in accordance with equitable principles". These two concepts, of delimitation by mutual agreement and delimitation in accordance with equitable principles, have underlain all the subsequent history of the subject. They were reflected in various other State proclamations of the period, and after, and in the later work on the subject.

48. It was in the International Law Commission of the United Nations that the question of delimitation as between adjacent States was first taken up seriously as part of a general juridical project; for outside the ranks of the hydrographers and cartographers, questions of delimitation were not much thought about in earlier continental shelf doctrine. Juridical interest and speculation was focussed mainly on such questions as what was the legal basis on which any rights at all in respect of the continental shelf could be claimed, and what was the nature of those rights. As regards boundaries, the main issue was not that of boundaries between States but of the seaward limit of the area in respect of which the coastal State could claim exclusive rights of exploitation. As was pointed out in the course of the written proceedings, States in most cases had not found it necessary to conclude treaties or legislate about their lateral sea boundaries with adjacent States before the question of exploiting the natural resources of the seabed and subsoil arose;—practice was therefore sparse.

49. In the records of the International Law Commission, which had the matter under consideration from 1950 to 1956, there is no indication at all that any of its members supposed that it was incumbent on the Commission to adopt a rule of equidistance because this gave expression to, and translated into linear terms, a principle of proximity inherent in the basic concept of the continental shelf, causing every part of the shelf to appertain to the nearest coastal State and to no other, and because such a rule must therefore be mandatory as a matter of customary international law. Such an idea does not seem ever to have been propounded. Had it been, and had it had the self-evident character contended for by Denmark and the Netherlands, the Commission would have had no alternative but to adopt it, and its long continued hesitations over this matter would be incomprehensible.



départ dans l'élaboration du droit positif en ce domaine et la doctrine principale qu'elle énonçait, à savoir que l'Etat riverain possède un droit originaire, naturel et exclusif, en somme un droit acquis, sur le plateau continental situé devant ses côtes, l'a finalement emporté sur toutes les autres et trouve aujourd'hui son expression dans l'article 2 de la Convention de Genève de 1958 sur le plateau continental. En ce qui concerne la délimitation latérale des plateaux continentaux d'Etats limitrophes, problème qui avait été étudié dans une certaine mesure sur le plan technique mais avait fort peu retenu l'attention sur le plan juridique, la proclamation Truman énonçait que la ligne de délimitation serait « déterminée par les Etats-Unis et l'Etat intéressé conformément à des principes équitables ». De ces deux notions de délimitation par voie d'accord et de délimitation conforme à des principes équitables a procédé toute l'évolution historique postérieure. On en trouve la trace dans des proclamations faites à partir de cette époque par divers autres Etats, ainsi que dans les travaux consacrés depuis lors au problème.

48. C'est à la Commission du droit international des Nations Unies que la question de la délimitation entre Etats limitrophes a été abordée sérieusement pour la première fois dans une étude juridique de caractère général; jusqu'alors en effet les problèmes de délimitation dans le cadre de la doctrine du plateau continental n'avaient guère retenu que l'attention des hydrographes et des cartographes. L'intérêt et la réflexion des juristes s'étaient principalement portés sur des questions comme le fondement juridique et la nature des droits pouvant être éventuellement revendiqués sur le plateau continental. S'agissant de la délimitation, le grand problème n'était pas celui des limites entre Etats mais celui de la limite vers le large de l'étendue sur laquelle l'Etat riverain peut revendiquer des droits d'exploitation exclusifs. Comme il a été observé au cours de la procédure écrite, les Etats n'ont pas jugé nécessaire, dans la plupart des cas, de conclure des traités ou de légiférer pour fixer leurs limites maritimes latérales avec des Etats limitrophes avant que se pose la question de l'exploitation des ressources naturelles du lit de la mer et de son sous-sol. La pratique dans ce domaine était donc peu abondante.

49. A lire les documents de la Commission du droit international, qui s'est occupée de la question de 1950 à 1956, rien n'indique qu'il soit venu à l'esprit d'aucun de ses membres qu'elle dût adopter une règle fondée sur l'équidistance pour le motif qu'une telle règle constituait l'expression linéaire d'un principe de proximité inhérent à la conception fondamentale du plateau continental — d'après lequel toute partie du plateau relèverait de l'Etat riverain le plus proche à l'exclusion de tout autre Etat — et était en conséquence obligatoire en droit international coutumier. Cette idée ne semble jamais avoir été avancée. Si elle l'avait été et si elle avait eu le caractère évident que le Danemark et les Pays-Bas lui prêtent, la Commission n'aurait pu faire autrement que de l'adopter et ses hésitations prolongées à ce sujet seraient incompréhensibles.

50. It is moreover, in the present context, a striking feature of the Commission's discussions that during the early and middle stages, not only was the notion of equidistance never considered from the standpoint of its having *a priori* a character of inherent necessity: it was never given any special prominence at all, and certainly no priority. The Commission discussed various other possibilities as having equal if not superior status such as delimitation by agreement, by reference to arbitration, by drawing lines perpendicular to the coast, by prolonging the dividing line of adjacent territorial waters (the principle of which was itself not as yet settled), and on occasion the Commission seriously considered adopting one or other of these solutions. It was not in fact until after the matter had been referred to a committee of hydrographical experts, which reported in 1953, that the equidistance principle began to take precedence over other possibilities: the Report of the Commission for that year (its principal report on the topic of delimitation as such) makes it clear that before this reference to the experts the Commission had felt unable to formulate any definite rule at all, the previous trend of opinion having been mainly in favour of delimitation by agreement or by reference to arbitration.

51. It was largely because of these difficulties that it was decided to consult the Committee of Experts. It is therefore instructive in the context (i.e., of an alleged inherent necessity for the equidistance principle) to see on what basis the matter was put to the experts, and how they dealt with it. Equidistance was in fact only one of four methods suggested to them, the other three being the continuation in the seaward direction of the land frontier between the two adjacent States concerned; the drawing of a perpendicular to the coast at the point of its intersection with this land frontier; and the drawing of a line perpendicular to the line of the "general direction" of the coast. Furthermore the matter was not even put to the experts directly as a question of continental shelf delimitation, but in the context of the delimitation of the lateral boundary between adjacent territorial waters, no account being taken of the possibility that the situation respecting territorial waters might be different.

52. The Committee of Experts simply reported that after a thorough discussion of the different methods—(there are no official records of this discussion)—they had decided that "the (lateral) boundary through the territorial sea—if not already fixed otherwise—should be drawn according to the principle of equidistance from the respective coastlines". They added, however, significantly, that in "a number of cases this may not lead to an equitable solution, which should be then arrived at by negotiation". Only after that did they add, as a rider to this conclusion, that they had considered it "important to find a formula for drawing the international boundaries in the territorial waters of States, which could also be used for the delimitation of the respective continental shelves of two States bordering the same continental shelf".

50. Au surplus il est frappant de constater à cet égard que, dans les discussions qui se sont déroulées à la Commission au début et vers le milieu de ses travaux, non seulement on n'a jamais considéré que la notion d'équidistance ait à priori un caractère de nécessité inhérente mais encore on ne lui a jamais reconnu une importance spéciale et certainement aucune priorité. La Commission a examiné diverses autres possibilités en leur accordant une valeur égale sinon supérieure: délimitation par voie d'accord, délimitation par voie d'arbitrage, délimitation selon une ligne perpendiculaire à la côte, délimitation par prolongement de la ligne divisant les eaux territoriales adjacentes, dont le principe n'était pas encore établi, et d'autres encore; la Commission a même sérieusement envisagé d'adopter l'une ou l'autre de ces solutions. En fait, c'est seulement après que la question eut été renvoyée à un comité d'experts-hydrographes, dont le rapport a été présenté en 1953, que le principe de l'équidistance a commencé à l'emporter sur les autres possibilités: il ressort nettement du rapport de la Commission pour 1953 (son principal rapport sur le problème de la délimitation proprement dit) qu'avant d'en référer aux experts la Commission ne s'était pas jugée en mesure de formuler une règle précise et qu'elle s'était jusque-là surtout montrée favorable à une délimitation par voie d'accord ou d'arbitrage.

51. Si la Commission a décidé de consulter le comité d'experts, c'est en grande partie à cause de ces difficultés. Il est donc instructif, du point de vue d'une prétendue nécessité inhérente du principe de l'équidistance, d'examiner sur quelle base le problème a été soumis aux experts et comment ils l'ont traité. L'équidistance n'était en réalité que l'une des quatre méthodes qui leur étaient suggérées. Les trois autres étaient les suivantes: prolongement vers le large de la frontière terrestre entre les deux Etats limitrophes intéressés; tracé d'une ligne perpendiculaire à la côte à l'endroit où la frontière entre les deux territoires atteint la mer; tracé d'une ligne perpendiculaire à la «direction générale» de la côte. En outre le problème n'a pas été posé directement aux experts à propos de la délimitation du plateau continental: il l'a été à propos de la délimitation latérale des eaux territoriales de deux Etats limitrophes, sans que l'on se demande si la situation n'était pas différente.

52. Le comité d'experts a simplement signalé dans son rapport qu'après une discussion approfondie des diverses méthodes — qui n'a pas fait l'objet de procès-verbaux officiels — il avait été d'avis que «la frontière (latérale) entre les mers territoriales respectives de deux Etats adjacents, là où elle n'a pas déjà été fixée d'une autre manière, devrait être tracée selon le principe d'équidistance de la côte de part et d'autre de l'aboutissement de la frontière». Il a cependant ajouté, et cela est significatif: «Dans certains cas, cette méthode ne permettra pas d'aboutir à une solution équitable, laquelle devra alors être recherchée dans des négociations.» C'est seulement après cette conclusion que les experts ont précisé, dans une observation annexe, qu'ils s'étaient efforcés «de trouver des formules pour tracer les frontières internationales dans les mers territoriales qui

53. In this almost impromptu, and certainly contingent manner was the principle of equidistance for the delimitation of continental shelf boundaries propounded. It is clear from the Report of the Commission for 1953 already referred to (paragraph 50) that the latter adopted it largely on the basis of the recommendation of the Committee of Experts, and even so in a text that gave priority to delimitation by agreement and also introduced an exception in favour of "special circumstances" which the Committee had not formally proposed. The Court moreover thinks it to be a legitimate supposition that the experts were actuated by considerations not of legal theory but of practical convenience and cartography of the kind mentioned in paragraph 22 above. Although there are no official records of their discussions, there is warrant for this view in correspondence passing between certain of them and the Commission's Special Rapporteur on the subject, which was deposited by one of the Parties during the oral hearing at the request of the Court. Nor, even after this, when a decision in principle had been taken in favour of an equidistance rule, was there an end to the Commission's hesitations, for as late as three years after the adoption of the report of the Committee of Experts, when the Commission was finalizing the whole complex of drafts comprised under the topic of the Law of the Sea, various doubts about the equidistance principle were still being voiced in the Commission, on such grounds for instance as that its strict application would be open, in certain cases, to the objection that the geographical configuration of the coast would render a boundary drawn on this basis inequitable.

54. A further point of some significance is that neither in the Committee of Experts, nor in the Commission itself, nor subsequently at the Geneva Conference, does there appear to have been any discussion of delimitation in the context, not merely of two adjacent States, but of three or more States on the same coast, or in the same vicinity,—from which it can reasonably be inferred that the possible resulting situations, some of which have been described in paragraph 8 above, were never really envisaged or taken into account. This view finds some confirmation in the fact that the relevant part of paragraph 2 of Article 6 of the Geneva Convention speaks of delimiting the continental shelf of "two" adjacent States (although a reference simply to "adjacent States" would have sufficed), whereas in respect of median lines the reference in paragraph 1 of that Article is to "two or more" opposite States.

55. In the light of this history, and of the record generally, it is clear that at no time was the notion of equidistance as an inherent necessity of continental shelf doctrine entertained. Quite a different outlook was indeed manifested from the start in current legal thinking. It was, and

pourraient en même temps servir pour délimiter les frontières respectives de «plateau continental» concernant les Etats devant les côtes desquels s'étend ce plateau».

53. C'est de cette manière presque improvisée et purement contingente que le principe de l'équidistance a été envisagé pour la délimitation du plateau continental. Il ressort nettement du rapport de la Commission du droit international pour 1953 (voir paragraphe 50 ci-dessus) que la Commission a adopté ce principe essentiellement sur la recommandation du comité d'experts mais que, ce faisant, elle a dans le même texte donné priorité à la délimitation par voie d'accord et a introduit une exception dans le cas de «circonstances spéciales» que le comité n'avait pas formellement proposée. La Cour estime en outre légitime de supposer que les experts ont été mus par le genre de considérations d'ordre pratique et cartographique dont il est fait état au paragraphe 22 ci-dessus et non par des considérations d'ordre juridique et doctrinal. Bien que leurs discussions n'aient pas fait l'objet de procès-verbaux officiels, cette opinion trouve confirmation dans une correspondance échangée entre certains d'entre eux et le rapporteur spécial de la Commission, correspondance déposée au cours de la procédure orale par l'une des Parties sur la demande de la Cour. D'autre part, même après avoir pris une décision de principe en faveur d'une règle fondée sur l'équidistance, la Commission a continué à faire preuve d'hésitation: trois ans après l'adoption du rapport du comité d'experts, au moment où elle mettait la dernière main à l'ensemble des projets concernant le droit de la mer, le principe de l'équidistance suscitait encore des doutes parmi ses membres, motif pris par exemple de ce que son application stricte pourrait prêter à critique dans des cas où la configuration géographique de la côte rendrait inéquitable une limite tracée sur cette base.

54. Un autre élément significatif est à considérer: il semble que ni au comité d'experts, ni à la Commission elle-même, ni ultérieurement à la conférence de Genève la discussion n'ait porté sur les délimitations à effectuer non pas simplement entre deux Etats limitrophes, mais entre trois ou plusieurs Etats bordant la même côte ou situés dans le voisinage les uns des autres; il est raisonnable d'en déduire que les situations pouvant résulter de cet état de choses, et dont certaines ont été décrites au paragraphe 8 ci-dessus, n'ont jamais été véritablement envisagées ou prises en considération. Cette déduction est confirmée par le fait qu'à l'article 6, paragraphe 2, de la Convention de Genève le passage pertinent parle de la délimitation du plateau continental entre «deux» Etats limitrophes — il aurait suffi de dire «des» Etats limitrophes —, alors qu'en ce qui concerne les lignes médianes entre Etats dont les côtes se font face l'article 6, paragraphe 1, dit «deux ou plusieurs» Etats.

55. Compte tenu de ces antécédents et d'une manière plus générale du dossier, il est clair qu'à aucun moment on n'a considéré que la notion d'équidistance soit liée de façon inhérente et nécessaire à la doctrine du plateau continental. L'opinion des juristes s'est même, dès le début, mani-

it really remained to the end, governed by two beliefs;—namely, first, that no one single method of delimitation was likely to prove satisfactory in all circumstances, and that delimitation should, therefore, be carried out by agreement (or by reference to arbitration); and secondly, that it should be effected on equitable principles. It was in pursuance of the first of these beliefs that in the draft that emerged as Article 6 of the Geneva Convention, the Commission gave priority to delimitation by agreement,—and in pursuance of the second that it introduced the exception in favour of “special circumstances”. Yet the record shows that, even with these mitigations, doubts persisted, particularly as to whether the equidistance principle would in all cases prove equitable.

56. In these circumstances, it seems to the Court that the inherency contention as now put forward by Denmark and the Netherlands inverts the true order of things in point of time and that, so far from an equidistance rule having been generated by an antecedent principle of proximity inherent in the whole concept of continental shelf appurtenance, the latter is rather a rationalization of the former—an *ex post facto* construct directed to providing a logical juristic basis for a method of delimitation propounded largely for different reasons, cartographical and other. Given also that for the reasons already set out (paragraphs 40-46) the theory cannot be said to be endowed with any quality of logical necessity either, the Court is unable to accept it.

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57. Before going further it will be convenient to deal briefly with two subsidiary matters. Most of the difficulties felt in the International Law Commission related, as here, to the case of the lateral boundary between adjacent States. Less difficulty was felt over that of the median line boundary between opposite States, although it too is an equidistance line. For this there seems to the Court to be good reason. The continental shelf area off, and dividing, opposite States, can be claimed by each of them to be a natural prolongation of its territory. These prolongations meet and overlap, and can therefore only be delimited by means of a median line; and, ignoring the presence of islets, rocks and minor coastal projections, the disproportionately distorting effect of which can be eliminated by other means, such a line must effect an equal division of the particular area involved. If there is a third State on one of the coasts concerned, the area of mutual natural prolongation with that of the same or another opposite State will be a separate and distinct one, to be treated in the same way. This type of case is therefore different from that of laterally adjacent States on the same coast with no immediately opposite coast in front of it, and does not give rise to the same kind of problem—a conclusion which also finds some confirmation in the dif-

festée en un tout autre sens. Elle a procédé, et elle n'a cessé de procéder, de deux convictions: en premier lieu il était peu probable qu'une méthode de délimitation unique donne satisfaction dans toutes les circonstances et la délimitation devait donc s'opérer par voie d'accord ou d'arbitrage; en second lieu la délimitation devait s'effectuer selon des principes équitables. C'est en raison de la première conviction que la Commission a donné priorité à la délimitation par voie d'accord dans le projet qui est devenu l'article 6 de la Convention de Genève et c'est en raison de la seconde conviction qu'elle a introduit l'exception des «circonstances spéciales». Les documents montrent cependant que, même avec ces atténuations, les doutes ont persisté, en particulier sur le point de savoir si le principe de l'équidistance se révélerait équitable dans tous les cas.

56. Dans ces conditions, il semble à la Cour que la thèse du caractère inhérent, telle qu'elle est formulée maintenant par le Danemark et les Pays-Bas, renverse l'ordre réel des choses dans le temps. Loin qu'une règle d'équidistance ait été engendrée par un principe antérieur de proximité inhérent à la conception fondamentale du plateau continental, c'est plutôt ce principe qui est une rationalisation de la règle, une construction à posteriori destinée à fournir une base juridique logique à une méthode de délimitation proposée pour des raisons surtout extra-juridiques, cartographiques en particulier. Etant donné en outre que, pour les motifs déjà exposés aux paragraphes 40 à 46, on ne saurait non plus dire que la théorie présente un caractère de nécessité logique, la Cour n'est pas en mesure de l'accepter.

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57. Avant d'aller plus loin, il convient d'examiner brièvement deux questions incidentes. La plus grande partie des difficultés éprouvées par la Commission du droit international concernaient comme ici le cas de la ligne latérale de délimitation entre Etats limitrophes. Les difficultés ont été moindres pour ce qui est de la ligne médiane de délimitation entre Etats dont les côtes se font face, bien qu'il s'agisse là aussi d'une ligne d'équidistance. Il semble à la Cour qu'il y a une bonne raison à cela. En effet les zones de plateau continental se trouvant au large d'Etats dont les côtes se font face et séparant ces Etats peuvent être réclamées par chacun d'eux à titre de prolongement naturel de son territoire. Ces zones se rencontrent, se chevauchent et ne peuvent donc être délimitées que par une ligne médiane; si l'on ne tient pas compte des îlots, des rochers ou des légers saillants de la côte, dont on peut éliminer l'effet exagéré de déviation par d'autres moyens, une telle ligne doit diviser également l'espace dont il s'agit. Si un troisième Etat borde l'une des côtes, la zone où le prolongement naturel de son territoire recoupe celui de l'Etat déjà considéré lui faisant face, ou celui d'un autre Etat lui faisant face, sera distincte et séparée mais devra être traitée de la même manière. Tout différent est le cas d'Etats limitrophes se trouvant sur la

ference of language to be observed in the two paragraphs of Article 6 of the Geneva Convention (reproduced in paragraph 26 above) as respects recourse in the one case to median lines and in the other to lateral equidistance lines, in the event of absence of agreement.

58. If on the other hand, contrary to the view expressed in the preceding paragraph, it were correct to say that there is no essential difference in the process of delimiting the continental shelf areas between opposite States and that of delimitations between adjacent States, then the results ought in principle to be the same or at least comparable. But in fact, whereas a median line divides equally between the two opposite countries areas that can be regarded as being the natural prolongation of the territory of each of them, a lateral equidistance line often leaves to one of the States concerned areas that are a natural prolongation of the territory of the other.

59. Equally distinct in the opinion of the Court is the case of the lateral boundary between adjacent territorial waters to be drawn on an equidistance basis. As was convincingly demonstrated in the maps and diagrams furnished by the Parties, and as has been noted in paragraph 8, the distorting effects of lateral equidistance lines under certain conditions of coastal configuration are nevertheless comparatively small within the limits of territorial waters, but produce their maximum effect in the localities where the main continental shelf areas lie further out. There is also a direct correlation between the notion of closest proximity to the coast and the sovereign jurisdiction which the coastal State is entitled to exercise and must exercise, not only over the seabed underneath the territorial waters but over the waters themselves, which does not exist in respect of continental shelf areas where there is no jurisdiction over the superjacent waters, and over the seabed only for purposes of exploration and exploitation.

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60. The conclusions so far reached leave open, and still to be considered, the question whether on some basis other than that of an *a priori* logical necessity, i.e., through positive law processes, the equidistance principle has come to be regarded as a rule of customary international law, so that it would be obligatory for the Federal Republic in that way, even though Article 6 of the Geneva Convention is not, as such, opposable to it. For this purpose it is necessary to examine the status of the principle as it stood when the Convention was drawn up, as it resulted from the effect of the Convention, and in the light of State practice subsequent to the Convention; but it should be clearly understood that in the pronouncements the Court makes on these matters it has in view solely the delimitation provisions (Article 6) of the Convention, not other parts of it, nor the Convention as such.



même côte et n'ayant pas de vis-à-vis immédiat; les problèmes soulevés ne sont pas du même ordre: cette conclusion est confirmée par la rédaction différente des deux paragraphes de l'article 6 de la Convention de Genève reproduits au paragraphe 26 ci-dessus quant à l'utilisation, à défaut d'accord, de lignes médianes ou de lignes latérales d'équidistance selon le cas.

58. En revanche si, contrairement à l'opinion émise au paragraphe précédent, il était exact de dire qu'il n'y a pas de différence essentielle pour la délimitation du plateau continental entre le cas d'Etats se faisant face et le cas d'Etats limitrophes, les résultats devraient être en principe sinon identiques du moins comparables. Or en fait, alors qu'une ligne médiane tracée entre deux pays se faisant face divise également des zones qui peuvent être considérées comme le prolongement naturel du territoire de chacun d'eux, il est fréquent qu'une ligne latérale d'équidistance laisse à l'un des Etats intéressés des zones qui sont le prolongement naturel du territoire de l'autre.

59. Tout différent aussi est, de l'avis de la Cour, le problème de la délimitation latérale entre les eaux territoriales d'Etats limitrophes faite selon l'équidistance. Ainsi que l'ont démontré de façon convaincante les cartes et croquis fournis par les Parties et ainsi qu'on l'a vu au paragraphe 8, les effets de déviation que produisent certaines configurations côtières sur les lignes latérales d'équidistance sont relativement faibles dans les limites des eaux territoriales mais jouent au maximum à l'emplacement des zones de plateau continental au large. Il existe aussi une corrélation directe entre la notion de proximité par rapport à la côte et la juridiction souveraine que l'Etat riverain a le droit et le devoir d'exercer non seulement sur le lit de la mer au-dessous de ses eaux territoriales mais aussi sur ces eaux mêmes, corrélation qui n'existe pas en ce qui concerne le plateau continental car l'Etat n'a aucune juridiction sur les eaux surjacentes et n'a de juridiction sur le lit de la mer qu'à des fins d'exploration et d'exploitation.

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60. Les conclusions précédentes laissent encore sans réponse la question de savoir si le principe de l'équidistance en est venu à être considéré comme une règle de droit international coutumier pour une autre raison que la nécessité logique et à priori, c'est-à-dire par les moyens du droit positif, de sorte qu'il s'imposerait à la République fédérale à ce titre bien que l'article 6 de la Convention de Genève ne lui soit pas opposable en tant que tel. Il faut à cette fin étudier la place qu'occupait ce principe lors de la rédaction de la Convention et celle qui lui a été conférée par la Convention elle-même et par la pratique des Etats postérieure à la Convention; mais il doit être nettement entendu que, dans ses énonciations en la matière, la Cour envisage uniquement la clause sur la délimitation (article 6) et nullement d'autres dispositions de la Convention ni la Convention en tant que telle.

61. The first of these questions can conveniently be considered in the form suggested on behalf of Denmark and the Netherlands themselves in the course of the oral hearing, when it was stated that they had not in fact contended that the delimitation article (Article 6) of the Convention “embodied already received rules of customary law in the sense that the Convention was merely declaratory of existing rules”. Their contention was, rather, that although prior to the Conference, continental shelf law was only in the formative stage, and State practice lacked uniformity, yet “the process of the definition and consolidation of the emerging customary law took place through the work of the International Law Commission, the reaction of governments to that work and the proceedings of the Geneva Conference”; and this emerging customary law became “crystallized in the adoption of the Continental Shelf Convention by the Conference”.

62. Whatever validity this contention may have in respect of at least certain parts of the Convention, the Court cannot accept it as regards the delimitation provision (Article 6), the relevant parts of which were adopted almost unchanged from the draft of the International Law Commission that formed the basis of discussion at the Conference. The status of the rule in the Convention therefore depends mainly on the processes that led the Commission to propose it. These processes have already been reviewed in connection with the Danish-Netherlands contention of an *a priori* necessity for equidistance, and the Court considers this review sufficient for present purposes also, in order to show that the principle of equidistance, as it now figures in Article 6 of the Convention, was proposed by the Commission with considerable hesitation, somewhat on an experimental basis, at most *de lege ferenda*, and not at all *de lege lata* or as an emerging rule of customary international law. This is clearly not the sort of foundation on which Article 6 of the Convention could be said to have reflected or crystallized such a rule.

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63. The foregoing conclusion receives significant confirmation from the fact that Article 6 is one of those in respect of which, under the reservations article of the Convention (Article 12) reservations may be made by any State on signing, ratifying or acceding,—for, speaking generally, it is a characteristic of purely conventional rules and obligations that, in regard to them, some faculty of making unilateral reservations may, within certain limits, be admitted;—whereas this cannot be so in the case of general or customary law rules and obligations which, by their very nature, must have equal force for all members of the international community, and cannot therefore be the subject of any right of unilateral exclusion exercisable at will by any one of them in its own

61. Il peut être commode d'examiner la première de ces questions sous la forme que lui ont donnée le Danemark et les Pays-Bas dans leurs plaidoiries: ces deux Etats ont alors indiqué qu'en fait ils n'avaient pas soutenu que l'article de la Convention relatif à la délimitation (article 6) « consacrait des règles déjà reçues de droit coutumier, en ce sens que la Convention était simplement déclaratoire des règles existantes ». Leur thèse était plutôt la suivante: si avant la conférence le droit du plateau continental n'était qu'embryonnaire et si la pratique des Etats manquait d'uniformité, il n'en restait pas moins que « la définition et la consolidation du droit coutumier en voie de formation s'étaient effectuées grâce aux travaux de la Commission du droit international, aux réactions des gouvernements devant l'œuvre de la Commission et aux débats de la conférence de Genève » et que ce droit coutumier en voie de formation s'était « cristallisé du fait de l'adoption de la Convention sur le plateau continental par la conférence ».

62. Si juste que soit cette thèse en ce qui concerne du moins certaines parties de la Convention, la Cour ne saurait la retenir pour ce qui est de la clause sur la délimitation (article 6) dont les dispositions pertinentes sont reprises presque sans changement du projet de la Commission du droit international ayant servi de base de discussion à la conférence. La valeur de la règle dans la Convention doit donc surtout être jugée par rapport aux conditions dans lesquelles la Commission a été amenée à la proposer et qui ont déjà été examinées au sujet de la thèse du Danemark et des Pays-Bas sur le caractère nécessaire et à priori de l'équidistance. La Cour considère que cet examen suffit, aux fins du présent raisonnement, à montrer que le principe de l'équidistance, tel qu'il est actuellement énoncé à l'article 6 de la Convention, a été proposé par la Commission avec beaucoup d'hésitation, à titre plutôt expérimental et tout au plus *de lege ferenda*, donc certainement pas *de lege lata* ni même à titre de règle de droit international coutumier en voie de formation. Tel n'est manifestement pas le genre de fondement que l'on pourrait invoquer pour prétendre que l'article 6 de la Convention a consacré ou cristallisé la règle de l'équidistance.

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63. La conclusion précédente trouve une confirmation significative dans le fait que l'article 6 est l'un des articles à l'égard desquels tout Etat peut formuler des réserves au moment de la signature, de la ratification ou de l'adhésion, en vertu de l'article de la Convention relatif aux réserves (article 12). Il est en général caractéristique d'une règle ou d'une obligation purement conventionnelle que la faculté d'y apporter des réserves unilatérales soit admise dans certaines limites; mais il ne saurait en être ainsi dans le cas de règles et d'obligations de droit général ou coutumier qui par nature doivent s'appliquer dans des conditions égales à tous les membres de la communauté internationale et ne peuvent donc être subordonnées à un droit d'exclusion exercé unilatéralement et à

favour. Consequently, it is to be expected that when, for whatever reason, rules or obligations of this order are embodied, or are intended to be reflected in certain provisions of a convention, such provisions will figure amongst those in respect of which a right of unilateral reservation is not conferred, or is excluded. This expectation is, in principle, fulfilled by Article 12 of the Geneva Continental Shelf Convention, which permits reservations to be made to all the articles of the Convention "other than to Articles 1 to 3 inclusive"—these three Articles being the ones which, it is clear, were then regarded as reflecting, or as crystallizing, received or at least emergent rules of customary international law relative to the continental shelf, amongst them the question of the seaward extent of the shelf; the juridical character of the coastal State's entitlement; the nature of the rights exercisable; the kind of natural resources to which these relate; and the preservation intact of the legal status as high seas of the waters over the shelf, and the legal status of the superjacent air-space.

64. The normal inference would therefore be that any articles that do not figure among those excluded from the faculty of reservation under Article 12, were not regarded as declaratory of previously existing or emergent rules of law; and this is the inference the Court in fact draws in respect of Article 6 (delimitation), having regard also to the attitude of the International Law Commission to this provision, as already described in general terms. Naturally this would not of itself prevent this provision from eventually passing into the general *corpus* of customary international law by one of the processes considered in paragraphs 70-81 below. But that is not here the issue. What is now under consideration is whether it originally figured in the Convention as such a rule.

65. It has however been suggested that the inference drawn at the beginning of the preceding paragraph is not necessarily warranted, seeing that there are certain other provisions of the Convention, also not excluded from the faculty of reservation, but which do undoubtedly in principle relate to matters that lie within the field of received customary law, such as the obligation not to impede the laying or maintenance of submarine cables or pipelines on the continental shelf seabed (Article 4), and the general obligation not unjustifiably to interfere with freedom of navigation, fishing, and so on (Article 5, paragraphs 1 and 6). These matters however, all relate to or are consequential upon principles or rules of general maritime law, very considerably ante-dating the Convention, and not directly connected with but only incidental to continental shelf rights as such. They were mentioned in the Convention, not in order to declare or confirm their existence, which was not necessary, but simply to ensure that they were not prejudiced by the exercise of continental shelf rights as provided for in the Convention. Another method of

volonté par l'un quelconque des membres de la communauté à son propre avantage. Par conséquent, il paraît probable que, si pour une raison quelconque l'on consacre ou l'on entend traduire des règles ou des obligations de cet ordre dans certaines dispositions d'une convention, ces dispositions figureront parmi celles au sujet desquelles le droit de formuler des réserves unilatérales n'est pas accordé ou est exclu. C'est ainsi que l'article 12 de la Convention de Genève sur le plateau continental autorise des réserves « aux articles de la Convention autres que les articles 1 à 3 inclus »; ces trois articles sont ceux que l'on a alors manifestement considérés comme consacrant ou cristallisant des règles de droit international coutumier relatives au plateau continental, règles établies ou du moins en voie de formation et visant notamment la question de l'étendue du plateau continental vers le large, le caractère juridique du titre de l'Etat riverain, la nature des droits pouvant être exercés, le genre de ressources naturelles sur lesquelles portent ces droits, le maintien du régime juridique des eaux surjacentes au plateau continental en tant que haute mer, et le maintien du régime juridique de l'espace aérien situé au-dessus de ces eaux.

64. Il semble donc normal de conclure que les articles à propos desquels la faculté de formuler des réserves n'est pas exclue par l'article 12 n'ont pas été considérés comme déclaratoires de règles de droit pré-existantes ou en voie de formation. Telle est bien, en ce qui concerne l'article 6 sur la délimitation, la déduction tirée par la Cour, qui tient également compte de l'attitude, déjà exposée en termes généraux, de la Commission du droit international à l'égard de cette disposition. Cela ne suffirait évidemment pas à empêcher cette disposition de s'intégrer au droit international coutumier par l'un des moyens considérés aux paragraphes 70 à 81 ci-après. Mais là n'est pas la question. Il s'agit pour l'instant de savoir si la disposition a figuré dès l'origine dans la Convention à titre de règle coutumière.

65. On soutient néanmoins que la déduction dont il est fait état au début du paragraphe précédent n'est pas nécessairement fondée car il ne fait pas de doute que certaines autres dispositions de la Convention, à propos desquelles la faculté de faire des réserves n'est pas exclue non plus, se rapportent en principe à des questions relevant du droit coutumier établi; telles sont notamment l'obligation de ne pas entraver la pose ou l'entretien de câbles ou pipe-lines sous-marins sur le plateau continental (article 4), l'obligation générale de ne pas gêner d'une manière injustifiable la navigation, la pêche, etc. (article 5, paragraphes 1 et 6). Mais ces questions concernent toutes, directement ou indirectement, des principes ou des règles de droit maritime général qui sont très antérieurs à la Convention et se rattachent non pas directement mais de manière incidente au régime juridique du plateau continental en tant que tel. Si on les a mentionnées dans la Convention, ce n'était pas pour déclarer ou confirmer leur existence, ce qui n'était pas nécessaire, mais simplement pour faire en sorte que l'exercice des droits relatifs au plateau continental

prévus dans la Convention n'y porte pas atteinte. Une autre rédaction aurait pu éviter l'ambiguïté; il n'en reste pas moins qu'un Etat ayant formulé une réserve ne serait pas dégagé pour autant des obligations imposées par le droit maritime général en dehors et indépendamment de la Convention sur le plateau continental, et notamment des obligations énoncées à l'article 2 de la convention sur la haute mer conclue au même moment et définie par son préambule comme déclaratoire de principes établis du droit international.

66. L'article 6 relatif à la délimitation paraît à la Cour se présenter de manière différente. Il se rattache directement au régime juridique du plateau continental en tant que tel et non à des questions incidentes: puisque la faculté de formuler des réserves n'a pas été exclue à son sujet, comme elle l'a été pour les articles 1 à 3, il est légitime d'en déduire qu'on lui a attribué une valeur différente et moins fondamentale et que, contrairement à ces articles, il ne traduisait pas le droit coutumier préexistant ou en voie de formation. Le Danemark et les Pays-Bas ont pourtant soutenu que le droit d'apporter des réserves à l'article 6 n'était pas censé être illimité et qu'en particulier il n'allait pas jusqu'à exclure totalement le principe de délimitation fondé sur l'équidistance, car les articles 1 et 2 de la Convention, à propos desquels aucune réserve n'est autorisée, impliqueraient la délimitation sur la base de l'équidistance. Il en résulterait que le droit de faire des réserves à l'article 6 ne pourrait être exercé que d'une manière compatible avec, au moins, le maintien du principe fondamental de l'équidistance. On a souligné à cet égard que, sur les quatre seules réserves formulées jusqu'à présent au sujet de l'article 6 et dont l'une au moins a une portée assez large, aucune ne vise une exclusion ou un rejet aussi total.

67. La Cour ne juge pas cet argument convaincant pour plusieurs motifs. En premier lieu, il ne semble pas que les articles 1 et 2 de la Convention de Genève aient un rapport direct avec une délimitation entre Etats en tant que telle. L'article 1 ne vise que la limite extérieure du plateau continental du côté du large et non pas sa délimitation entre Etats se faisant face ou entre Etats limitrophes. L'article 2 ne concerne pas davantage ce dernier point. Or il a été suggéré, semble-t-il, que la notion d'équidistance résulte implicitement du caractère « exclusif » attribué par l'article 2, paragraphe 2, aux droits de l'Etat riverain sur le plateau continental. A s'en tenir au texte, cette interprétation est manifestement inexacte. Le véritable sens de ce passage est que, dans toute zone de plateau continental où un Etat riverain a des droits, ces droits sont exclusifs et aucun autre Etat ne peut les exercer. Mais aucune précision n'y est donnée quant aux zones mêmes sur lesquelles chaque Etat riverain possède des droits exclusifs. Cette question, qui ne peut se poser qu'en ce qui concerne les confins du plateau continental d'un Etat, est exactement, comme on l'a vu au paragraphe 20 ci-dessus *in fine*, celle que le processus de délimitation doit permettre de résoudre et elle relève de l'article 6, non de l'article 2.

drafting might have clarified the point, but this cannot alter the fact that no reservation could release the reserving party from obligations of general maritime law existing outside and independently of the Convention, and especially obligations formalized in Article 2 of the contemporaneous Convention on the High Seas, expressed by its preamble to be declaratory of established principles of international law.

66. Article 6 (delimitation) appears to the Court to be in a different position. It does directly relate to continental shelf rights as such, rather than to matters incidental to these; and since it was not, as were Articles 1 to 3, excluded from the faculty of reservation, it is a legitimate inference that it was considered to have a different and less fundamental status and not, like those Articles, to reflect pre-existing or emergent customary law. It was however contended on behalf of Denmark and the Netherlands that the right of reservation given in respect of Article 6 was not intended to be an unfettered right, and that in particular it does not extend to effecting a total exclusion of the equidistance principle of delimitation,—for, so it was claimed, delimitation on the basis of that principle is implicit in Articles 1 and 2 of the Convention, in respect of which no reservations are permitted. Hence the right of reservation under Article 6 could only be exercised in a manner consistent with the preservation of at least the basic principle of equidistance. In this connection it was pointed out that, of the no more than four reservations so far entered in respect of Article 6, one at least of which was somewhat far-reaching, none has purported to effect such a total exclusion or denial.

67. The Court finds this argument unconvincing for a number of reasons. In the first place, Articles 1 and 2 of the Geneva Convention do not appear to have any direct connection with inter-State delimitation as such. Article 1 is concerned only with the outer, seaward, limit of the shelf generally, not with boundaries between the shelf areas of opposite or adjacent States. Article 2 is equally not concerned with such boundaries. The suggestion seems to be that the notion of equidistance is implicit in the reference in paragraph 2 of Article 2 to the rights of the coastal State over its continental shelf being “exclusive”. So far as actual language is concerned this interpretation is clearly incorrect. The true sense of the passage is that in whatever areas of the continental shelf a coastal State has rights, those rights are exclusive rights, not exercisable by any other State. But this says nothing as to what in fact are the precise areas in respect of which each coastal State possesses these exclusive rights. This question, which can arise only as regards the fringes of a coastal State’s shelf area is, as explained at the end of paragraph 20 above, exactly what falls to be settled through the process of delimitation, and this is the sphere of Article 6, not Article 2.

68. Secondly, it must be observed that no valid conclusions can be drawn from the fact that the faculty of entering reservations to Article 6 has been exercised only sparingly and within certain limits. This is the affair exclusively of those States which have not wished to exercise the faculty, or which have been content to do so only to a limited extent. Their action or inaction cannot affect the right of other States to enter reservations to whatever is the legitimate extent of the right.

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69. In the light of these various considerations, the Court reaches the conclusion that the Geneva Convention did not embody or crystallize any pre-existing or emergent rule of customary law, according to which the delimitation of continental shelf areas between adjacent States must, unless the Parties otherwise agree, be carried out on an equidistance-special circumstances basis. A rule was of course embodied in Article 6 of the Convention, but as a purely conventional rule. Whether it has since acquired a broader basis remains to be seen: *qua* conventional rule however, as has already been concluded, it is not opposable to the Federal Republic.

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70. The Court must now proceed to the last stage in the argument put forward on behalf of Denmark and the Netherlands. This is to the effect that even if there was at the date of the Geneva Convention no rule of customary international law in favour of the equidistance principle, and no such rule was crystallized in Article 6 of the Convention, nevertheless such a rule has come into being since the Convention, partly because of its own impact, partly on the basis of subsequent State practice,—and that this rule, being now a rule of customary international law binding on all States, including therefore the Federal Republic, should be declared applicable to the delimitation of the boundaries between the Parties' respective continental shelf areas in the North Sea.

71. In so far as this contention is based on the view that Article 6 of the Convention has had the influence, and has produced the effect, described, it clearly involves treating that Article as a norm-creating provision which has constituted the foundation of, or has generated a rule which, while only conventional or contractual in its origin, has since passed into the general *corpus* of international law, and is now accepted as such by the *opinio juris*, so as to have become binding even for countries which have never, and do not, become parties to the Convention. There is no doubt that this process is a perfectly possible one and does from time to time occur: it constitutes indeed one of the recognized methods by which new rules of customary international law may be formed. At the same time this result is not lightly to be regarded as having been attained.

72. It would in the first place be necessary that the provision con-



68. En second lieu il convient de souligner que l'on ne peut tirer aucune conclusion valable du fait que la faculté d'apporter des réserves à l'article 6 n'a été utilisée que fort peu et sans dépasser certaines limites. Cela intéresse uniquement les Etats qui n'ont pas voulu exercer cette faculté ou qui se sont bornés à l'exercer modérément. Leur action ou leur inaction ne saurait influencer sur le droit des autres Etats à formuler des réserves dans toute la mesure légitime.

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69. Eu égard aux considérations qui précèdent, la Cour conclut que la Convention de Genève n'a ni consacré ni cristallisé une règle de droit coutumier préexistante ou en voie de formation selon laquelle la délimitation du plateau continental entre Etats limitrophes devrait s'opérer, sauf si les Parties en décident autrement, sur la base d'un principe équidistance-circonstances spéciales. Une règle a bien été établie par l'article 6 de la Convention, mais uniquement en tant que règle conventionnelle. Il reste à voir si elle a acquis depuis lors un fondement plus large car, comme règle conventionnelle, elle n'est pas opposable à la République fédérale, ainsi que la Cour l'a déjà constaté.

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70. La Cour doit maintenant aborder la dernière phase de l'argumentation du Danemark et des Pays-Bas. Leur thèse est celle-ci: même si à la date de la Convention de Genève il n'existait aucune règle de droit international coutumier consacrant le principe de l'équidistance et si l'article 6 de la Convention ne cristallisait aucune règle de ce genre, une telle règle est apparue depuis la Convention, du fait pour une part de l'influence exercée par celle-ci et pour une autre de la pratique ultérieure des Etats: cette règle, devenue règle de droit international coutumier liant tous les Etats, y compris par conséquent la République fédérale, devrait être déclarée applicable à la délimitation des zones de plateau continental relevant de chacune des Parties dans la mer du Nord.

71. En attribuant à l'article 6 de la Convention l'influence et l'effet indiqués, cette thèse revient manifestement à le considérer comme une disposition normative ayant servi de base ou de point de départ à une règle qui, purement conventionnelle ou contractuelle à l'origine, se serait depuis lors intégrée à l'ensemble du droit international général et serait maintenant acceptée à ce titre par l'*opinio juris*, de telle sorte que désormais elle s'imposerait même aux pays qui ne sont pas et n'ont jamais été parties à la Convention. Certes cette situation est du domaine des possibilités et elle se présente de temps à autre: c'est même l'une des méthodes reconnues par lesquelles des règles nouvelles de droit international coutumier peuvent se former. Mais on ne considère pas facilement ce résultat comme atteint.

72. Il faut d'abord que la disposition en cause ait, en tout cas virtuelle-

cerned should, at all events potentially, be of a fundamentally norm-creating character such as could be regarded as forming the basis of a general rule of law. Considered *in abstracto* the equidistance principle might be said to fulfil this requirement. Yet in the particular form in which it is embodied in Article 6 of the Geneva Convention, and having regard to the relationship of that Article to other provisions of the Convention, this must be open to some doubt. In the first place, Article 6 is so framed as to put second the obligation to make use of the equidistance method, causing it to come after a primary obligation to effect delimitation by agreement. Such a primary obligation constitutes an unusual preface to what is claimed to be a potential general rule of law. Without attempting to enter into, still less pronounce upon any question of *jus cogens*, it is well understood that, in practice, rules of international law can, by agreement, be derogated from in particular cases, or as between particular parties,—but this is not normally the subject of any express provision, as it is in Article 6 of the Geneva Convention. Secondly the part played by the notion of special circumstances relative to the principle of equidistance as embodied in Article 6, and the very considerable, still unresolved controversies as to the exact meaning and scope of this notion, must raise further doubts as to the potentially norm-creating character of the rule. Finally, the faculty of making reservations to Article 6, while it might not of itself prevent the equidistance principle being eventually received as general law, does add considerably to the difficulty of regarding this result as having been brought about (or being potentially possible) on the basis of the Convention: for so long as this faculty continues to exist, and is not the subject of any revision brought about in consequence of a request made under Article 13 of the Convention—of which there is at present no official indication—it is the Convention itself which would, for the reasons already indicated, seem to deny to the provisions of Article 6 the same norm-creating character as, for instance, Articles 1 and 2 possess.

73. With respect to the other elements usually regarded as necessary before a conventional rule can be considered to have become a general rule of international law, it might be that, even without the passage of any considerable period of time, a very widespread and representative participation in the convention might suffice of itself, provided it included that of States whose interests were specially affected. In the present case however, the Court notes that, even if allowance is made for the existence of a number of States to whom participation in the Geneva Convention is not open, or which, by reason for instance of being land-locked States, would have no interest in becoming parties to it, the number of ratifications and accessions so far secured is, though respectable, hardly sufficient. That non-ratification may sometimes be due to factors other than active disapproval of the convention concerned can hardly constitute a basis on which positive acceptance of its principles can be implied: the reasons are speculative, but the facts remain.

ment, un caractère fondamentalement normatif et puisse ainsi constituer la base d'une règle générale de droit. On peut dire que le principe de l'équidistance, envisagé dans l'abstrait, satisfait à cette condition. Néanmoins, vu la forme particulière qu'il revêt à l'article 6 de la Convention et étant donné le rapport entre cet article et d'autres dispositions de la Convention, on ne peut manquer d'avoir des doutes. En premier lieu, l'article 6 est rédigé de telle sorte qu'il fait passer l'obligation de recourir à la méthode de l'équidistance après l'obligation primordiale d'effectuer la délimitation par voie d'accord. Cette obligation primordiale précéderait de manière bien inusitée ce que l'on prétend être virtuellement une règle de droit général. Sans chercher à aborder la question du *jus cogens* et encore moins à se prononcer sur elle, on doit admettre qu'en pratique il est possible de déroger par voie d'accord aux règles de droit international dans des cas particuliers ou entre certaines parties, mais cela ne fait pas normalement l'objet d'une disposition expresse comme dans l'article 6 de la Convention de Genève. En second lieu, le rôle que joue la notion de circonstances spéciales par rapport au principe de l'équidistance consacré à l'article 6 et les controverses très importantes, non encore résolues, auxquelles ont donné lieu la portée et le sens de cette notion ne peuvent que susciter d'autres doutes quant au caractère virtuellement normatif de la règle. Enfin, si la faculté d'apporter des réserves à l'article 6 ne suffit peut-être pas à empêcher le principe de l'équidistance de s'intégrer finalement au droit général, elle fait du moins qu'il est beaucoup plus difficile de soutenir que ce résultat a été ou pourrait être atteint sur la base de la Convention: tant que cette faculté demeure et qu'elle n'est pas modifiée à la suite d'une demande de révision formulée en vertu de l'article 13 — demande qu'aucune indication officielle ne laisse présager pour l'instant —, il semble que ce soit la Convention elle-même qui, pour les raisons déjà énoncées, prive les dispositions de l'article 6 du caractère normatif qu'ont par exemple les dispositions des articles 1 et 2.

73. En ce qui concerne les autres éléments généralement tenus pour nécessaires afin qu'une règle conventionnelle soit considérée comme étant devenue une règle générale de droit international, il se peut que, sans même qu'une longue période se soit écoulée, une participation très large et représentative à la convention suffise, à condition toutefois qu'elle comprenne les Etats particulièrement intéressés. S'agissant de la présente affaire, la Cour constate que, même si l'on tient compte du fait que certains des Etats ne peuvent participer à la Convention de Genève ou, faute de littoral par exemple, n'ont pas d'intérêt à y devenir parties, le nombre des ratifications et adhésions obtenues jusqu'ici est important mais n'est pas suffisant. On ne saurait s'appuyer sur le fait que la non-ratification puisse être due parfois à des facteurs autres qu'une désapprobation active de la convention en cause pour en déduire l'acceptation positive de ces principes: les raisons sont conjecturales mais les faits demeurent.

74. As regards the time element, the Court notes that it is over ten years since the Convention was signed, but that it is even now less than five since it came into force in June 1964, and that when the present proceedings were brought it was less than three years, while less than one had elapsed at the time when the respective negotiations between the Federal Republic and the other two Parties for a complete delimitation broke down on the question of the application of the equidistance principle. Although the passage of only a short period of time is not necessarily, or of itself, a bar to the formation of a new rule of customary international law on the basis of what was originally a purely conventional rule, an indispensable requirement would be that within the period in question, short though it might be, State practice, including that of States whose interests are specially affected, should have been both extensive and virtually uniform in the sense of the provision invoked;— and should moreover have occurred in such a way as to show a general recognition that a rule of law or legal obligation is involved.

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75. The Court must now consider whether State practice in the matter of continental shelf delimitation has, subsequent to the Geneva Convention, been of such a kind as to satisfy this requirement. Leaving aside cases which, for various reasons, the Court does not consider to be reliable guides as precedents, such as delimitations effected between the present Parties themselves, or not relating to international boundaries, some fifteen cases have been cited in the course of the present proceedings, occurring mostly since the signature of the 1958 Geneva Convention, in which continental shelf boundaries have been delimited according to the equidistance principle—in the majority of the cases by agreement, in a few others unilaterally—or else the delimitation was foreshadowed but has not yet been carried out. Amongst these fifteen are the four North Sea delimitations United Kingdom/Norway-Denmark-Netherlands, and Norway/Denmark already mentioned in paragraph 4 of this Judgment. But even if these various cases constituted more than a very small proportion of those potentially calling for delimitation in the world as a whole, the Court would not think it necessary to enumerate or evaluate them separately, since there are, *a priori*, several grounds which deprive them of weight as precedents in the present context.

76. To begin with, over half the States concerned, whether acting unilaterally or conjointly, were or shortly became parties to the Geneva Convention, and were therefore presumably, so far as they were concerned, acting actually or potentially in the application of the Convention. From their action no inference could legitimately be drawn as to the existence of a rule of customary international law in favour of the equidistance principle. As regards those States, on the other hand, which were not, and have not become parties to the Convention, the basis of

74. En ce qui concerne l'élément de temps, la Cour constate qu'il y a actuellement plus de dix ans que la Convention a été signée et moins de cinq ans qu'elle est entrée en vigueur (juin 1964); lorsque la présente affaire a été introduite, il y en avait moins de trois; enfin moins d'un an s'était écoulé lorsque les négociations bilatérales tendant à une délimitation complète entre la République fédérale et les deux autres Parties ont échoué sur la question de l'application du principe de l'équidistance. Bien que le fait qu'il ne se soit écoulé qu'un bref laps de temps ne constitue pas nécessairement en soi un empêchement à la formation d'une règle nouvelle de droit international coutumier à partir d'une règle purement conventionnelle à l'origine, il demeure indispensable que dans ce laps de temps, aussi bref qu'il ait été, la pratique des Etats, y compris ceux qui sont particulièrement intéressés, ait été fréquente et pratiquement uniforme dans le sens de la disposition invoquée et se soit manifestée de manière à établir une reconnaissance générale du fait qu'une règle de droit ou une obligation juridique est en jeu.

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75. La Cour doit maintenant rechercher si, depuis la Convention de Genève, la pratique des Etats en matière de délimitation du plateau continental a été de nature à satisfaire à cette condition. Abstraction faite des cas que la Cour, pour divers motifs, ne considère pas comme des précédents sur lesquels on puisse se fonder, notamment les délimitations effectuées entre les Parties à la présente affaire ou ne concernant pas des limites internationales, on a cité au cours de la procédure une quinzaine de cas où des limites de plateau continental ont été déterminées selon le principe de l'équidistance; la plupart sont postérieurs à la signature de la Convention de Genève de 1958; le plus souvent la délimitation a été opérée par voie d'accord, parfois elle l'a été unilatéralement, parfois aussi elle est prévue mais n'a pas encore été réalisée. Parmi ces quelque quinze exemples, on relève les quatre délimitations concernant la mer du Nord déjà mentionnées au paragraphe 4 du présent arrêt: Royaume-Uni/Norvège-Danemark-Pays-Bas et Norvège/Danemark. Même s'ils représentaient plus qu'une très faible proportion des cas possibles de délimitation dans le monde, la Cour n'estimerait pas nécessaire de les énumérer ou de les examiner séparément car plusieurs raisons leur enlèvent à priori la valeur de précédents en l'espèce.

76. Tout d'abord plus de la moitié des Etats intéressés, qu'ils aient agi unilatéralement ou conjointement, étaient, ou sont bientôt devenus, parties à la Convention de Genève et il est donc permis de supposer que leur action s'inscrivait en fait ou virtuellement dans le cadre de l'application de la Convention. On ne saurait donc légitimement en déduire qu'il existe une règle de droit international coutumier consacrant le principe de l'équidistance. Pour les Etats qui n'étaient pas et ne sont pas devenus depuis lors parties à la Convention, les raisons de leur action ne

their action can only be problematical and must remain entirely speculative. Clearly, they were not applying the Convention. But from that no inference could justifiably be drawn that they believed themselves to be applying a mandatory rule of customary international law. There is not a shred of evidence that they did and, as has been seen (paragraphs 22 and 23), there is no lack of other reasons for using the equidistance method, so that acting, or agreeing to act in a certain way, does not of itself demonstrate anything of a juridical nature.

77. The essential point in this connection—and it seems necessary to stress it—is that even if these instances of action by non-parties to the Convention were much more numerous than they in fact are, they would not, even in the aggregate, suffice in themselves to constitute the *opinio juris*;—for, in order to achieve this result, two conditions must be fulfilled. Not only must the acts concerned amount to a settled practice, but they must also be such, or be carried out in such a way, as to be evidence of a belief that this practice is rendered obligatory by the existence of a rule of law requiring it. The need for such a belief, i.e., the existence of a subjective element, is implicit in the very notion of the *opinio juris sive necessitatis*. The States concerned must therefore feel that they are conforming to what amounts to a legal obligation. The frequency, or even habitual character of the acts is not in itself enough. There are many international acts, e.g., in the field of ceremonial and protocol, which are performed almost invariably, but which are motivated only by considerations of courtesy, convenience or tradition, and not by any sense of legal duty.

78. In this respect the Court follows the view adopted by the Permanent Court of International Justice in the *Lotus* case, as stated in the following passage, the principle of which is, by analogy, applicable almost word for word, *mutatis mutandis*, to the present case (*P.C.I.J., Series A, No. 10, 1927*, at p. 28):

“Even if the rarity of the judicial decisions to be found . . . were sufficient to prove . . . the circumstance alleged . . ., it would merely show that States had often, in practice, abstained from instituting criminal proceedings, and not that they recognized themselves as being obliged to do so; for only if such abstention were based on their being conscious of having a duty to abstain would it be possible to speak of an international custom. The alleged fact does not allow one to infer that States have been conscious of having such a duty; on the other hand, . . . there are other circumstances calculated to show that the contrary is true.”

Applying this dictum to the present case, the position is simply that in certain cases—not a great number—the States concerned agreed to draw or did draw the boundaries concerned according to the principle of equidistance. There is no evidence that they so acted because they felt

peuvent être que problématiques et restent entièrement du domaine de la conjecture. Il est clair que ces Etats n'appliquaient pas la Convention, mais il serait excessif d'en conclure qu'ils croyaient appliquer une règle de droit international coutumier à caractère obligatoire. Il n'existe pas le moindre indice en ce sens et, comme on l'a vu aux paragraphes 22 et 23, il ne manquait pas d'autres raisons de recourir à la méthode de l'équidistance, de sorte que le fait d'avoir agi ou de s'être engagé à agir d'une certaine façon ne prouve rien sur le plan juridique.

77. L'élément essentiel à cet égard — il semble nécessaire de le souligner — est que, même si pareille attitude avait été beaucoup plus fréquente de la part des Etats non parties à la Convention, ces actes, même considérés globalement, ne suffiraient pas en eux-mêmes à constituer l'*opinio juris* car, pour parvenir à ce résultat, deux conditions doivent être remplies. Non seulement les actes considérés doivent représenter une pratique constante, mais en outre ils doivent témoigner, par leur nature ou la manière dont ils sont accomplis, de la conviction que cette pratique est rendue obligatoire par l'existence d'une règle de droit. La nécessité de pareille conviction, c'est-à-dire l'existence d'un élément subjectif, est implicite dans la notion même d'*opinio juris sive necessitatis*. Les Etats intéressés doivent donc avoir le sentiment de se conformer à ce qui équivaut à une obligation juridique. Ni la fréquence ni même le caractère habituel des actes ne suffisent. Il existe nombre d'actes internationaux, dans le domaine du protocole par exemple, qui sont accomplis presque invariablement mais sont motivés par de simples considérations de courtoisie, d'opportunité ou de tradition et non par le sentiment d'une obligation juridique.

78. A cet égard la Cour fait sienne l'opinion de la Cour permanente de Justice internationale dans l'affaire du *Lotus*, telle qu'elle est énoncée dans le passage suivant, et dont le principe est applicable par analogie à la présente espèce presque mot pour mot *mutatis mutandis* (C.P.J.I. série A n° 10, 1927, p. 28):

« Même si la rareté des décisions judiciaires que l'on peut trouver... était une preuve suffisante du fait invoqué..., il en résulterait simplement que les Etats se sont abstenus, en fait, d'exercer des poursuites pénales, et non qu'ils se reconnaissent obligés de ce faire; or, c'est seulement si l'abstention était motivée par la conscience d'un devoir de s'abstenir que l'on pourrait parler de coutume internationale. Le fait allégué ne permet pas de conclure que les Etats aient été conscients de pareil devoir; par contre, ... il y a d'autres circonstances qui sont de nature à persuader du contraire. »

Si l'on applique ce prononcé à la présente affaire, on doit simplement constater que dans certains cas peu nombreux des Etats sont convenus de tracer, ou ont tracé, les limites qui les concernent suivant le principe de l'équidistance. Rien ne prouve qu'ils aient agi ainsi parce qu'ils s'y

legally compelled to draw them in this way by reason of a rule of customary law obliging them to do so—especially considering that they might have been motivated by other obvious factors.

79. Finally, it appears that in almost all of the cases cited, the delimitations concerned were median-line delimitations between opposite States, not lateral delimitations between adjacent States. For reasons which have already been given (paragraph 57) the Court regards the case of median-line delimitations between opposite States as different in various respects, and as being sufficiently distinct not to constitute a precedent for the delimitation of lateral boundaries. In only one situation discussed by the Parties does there appear to have been a geographical configuration which to some extent resembles the present one, in the sense that a number of States on the same coastline are grouped around a sharp curve or bend of it. No complete delimitation in this area has however yet been carried out. But the Court is not concerned to deny to this case, or any other of those cited, all evidential value in favour of the thesis of Denmark and the Netherlands. It simply considers that they are inconclusive, and insufficient to bear the weight sought to be put upon them as evidence of such a settled practice, manifested in such circumstances, as would justify the inference that delimitation according to the principle of equidistance amounts to a mandatory rule of customary international law,—more particularly where lateral delimitations are concerned.

80. There are of course plenty of cases (and a considerable number were cited) of delimitations of waters, as opposed to seabed, being carried out on the basis of equidistance—mostly of internal waters (lakes, rivers, etc.), and mostly median-line cases. The nearest analogy is that of adjacent territorial waters, but as already explained (paragraph 59) the Court does not consider this case to be analogous to that of the continental shelf.

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81. The Court accordingly concludes that if the Geneva Convention was not in its origins or inception declaratory of a mandatory rule of customary international law enjoining the use of the equidistance principle for the delimitation of continental shelf areas between adjacent States, neither has its subsequent effect been constitutive of such a rule; and that State practice up-to-date has equally been insufficient for the purpose.

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82. The immediately foregoing conclusion, coupled with that reached earlier (paragraph 56) to the effect that the equidistance principle could not be regarded as being a rule of law on any *a priori* basis of logical



sentaient juridiquement tenus par une règle obligatoire de droit coutumier, surtout si l'on songe que d'autres facteurs ont pu motiver leur action.

79. Enfin il semble que, dans presque tous les cas de délimitation invoqués, il s'est agi de tracer des lignes médianes entre Etats se faisant face et non des limites latérales entre Etats limitrophes. Pour les motifs déjà indiqués au paragraphe 57, la Cour considère que les délimitations effectuées selon des lignes médianes entre Etats se faisant face sont à divers égards différentes des délimitations latérales et qu'elles s'en distinguent suffisamment pour ne pas constituer un précédent pour la fixation de limites latérales. Il semble qu'une seule des situations évoquées par les Parties se rapporte à une configuration géographique ressemblant dans une certaine mesure à celle de la présente espèce, en ce sens que plusieurs Etats sont groupés le long d'une côte fortement incurvée. Or, jusqu'à présent, il n'a pas été effectué de délimitation complète dans la région dont il s'agit. Ce n'est pas que la Cour refuse aux exemples cités toute valeur probante à l'appui de la thèse du Danemark et des Pays-Bas; elle estime simplement qu'ils ne sont pas décisifs et ne suffisent pas à établir, comme on le voudrait, une pratique constante manifestée dans des circonstances permettant de conclure que la délimitation suivant le principe de l'équidistance constitue une règle obligatoire de droit international coutumier, en particulier en matière de délimitation latérale.

80. Bien entendu, dans de nombreux cas dont beaucoup ont été mentionnés, l'équidistance a été appliquée pour délimiter des eaux, par opposition à des fonds marins: il s'est agi surtout d'eaux intérieures (lacs, fleuves, etc.) et de délimitations suivant les lignes médianes. Le cas le plus voisin est celui des eaux territoriales adjacentes mais, ainsi qu'on l'a déjà vu au paragraphe 59, la Cour ne le considère pas comme analogue à celui du plateau continental.

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81. La Cour conclut donc que, si la Convention de Genève n'était ni dans ses origines ni dans ses prémices déclaratoire d'une règle obligatoire de droit international coutumier imposant l'emploi du principe de l'équidistance pour la délimitation du plateau continental entre Etats limitrophes, elle n'a pas non plus par ses effets ultérieurs abouti à la formation d'une telle règle; et que la pratique des Etats jusqu'à ce jour a également été insuffisante à cet égard.

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82. La conclusion qui précède, jointe à celle qui a déjà été formulée au paragraphe 56 et suivant laquelle le principe de l'équidistance ne saurait être considéré comme constituant a priori une règle de droit découlant

necessity deriving from the fundamental theory of the continental shelf, leads to the final conclusion on this part of the case that the use of the equidistance method is not obligatory for the delimitation of the areas concerned in the present proceedings. In these circumstances, it becomes unnecessary for the Court to determine whether or not the configuration of the German North Sea coast constitutes a "special circumstance" for the purposes either of Article 6 of the Geneva Convention or of any rule of customary international law,—since once the use of the equidistance method of delimitation is determined not to be obligatory in any event, it ceases to be legally necessary to prove the existence of special circumstances in order to justify not using that method.

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83. The legal situation therefore is that the Parties are under no obligation to apply either the 1958 Convention, which is not opposable to the Federal Republic, or the equidistance method as a mandatory rule of customary law, which it is not. But as between States faced with an issue concerning the lateral delimitation of adjacent continental shelves, there are still rules and principles of law to be applied; and in the present case it is not the fact either that rules are lacking, or that the situation is one for the unfettered appreciation of the Parties. Equally, it is not the case that if the equidistance principle is not a rule of law, there has to be as an alternative some other single equivalent rule.

84. As already indicated, the Court is not called upon itself to delimit the areas of continental shelf appertaining respectively to each Party, and in consequence is not bound to prescribe the methods to be employed for the purposes of such a delimitation. The Court has to indicate to the Parties the principles and rules of law in the light of which the methods for eventually effecting the delimitation will have to be chosen. The Court will discharge this task in such a way as to provide the Parties with the requisite directions, without substituting itself for them by means of a detailed indication of the methods to be followed and the factors to be taken into account for the purposes of a delimitation the carrying out of which the Parties have expressly reserved to themselves.

85. It emerges from the history of the development of the legal régime of the continental shelf, which has been reviewed earlier, that the essential reason why the equidistance method is not to be regarded as a rule of law is that, if it were to be compulsorily applied in all situations, this would not be consonant with certain basic legal notions which, as has been observed in paragraphs 48 and 55, have from the beginning reflected the *opinio juris* in the matter of delimitation; those principles being that delimitation must be the object of agreement between the States concerned, and that such agreement must be arrived at in accordance with equitable principles. On a foundation of very general precepts of justice and good faith, actual rules of law are here involved which govern the

logiquement de la conception fondamentale du plateau continental, amène à conclure sur cet aspect de l'affaire que l'emploi de la méthode de l'équidistance n'est pas obligatoire pour la délimitation des zones en cause. Dans ces conditions, la Cour n'a pas à déterminer si la configuration de la côte allemande de la mer du Nord constitue ou non une « circonstance spéciale » aux fins de l'article 6 de la Convention de Genève ou de toute règle de droit international coutumier; en effet, dès lors qu'il est établi que la méthode de délimitation fondée sur l'équidistance n'est en aucune façon obligatoire, il cesse d'être juridiquement nécessaire de prouver l'existence de circonstances spéciales pour en justifier la non-application.

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83. La situation juridique est donc que les Parties ne sont tenues d'appliquer ni la Convention de 1958 qui n'est pas opposable à la République fédérale, ni la méthode de l'équidistance en tant que règle obligatoire de droit coutumier, ce qu'elle n'est pas. Mais entre Etats qui ont un problème de délimitation latérale de plateaux continentaux limitrophes il demeure des règles et principes de droit à appliquer et il ne s'agit, en l'espèce, ni d'une absence de règles, ni d'une appréciation entièrement libre de la situation par les Parties. Il ne s'agit pas non plus, si le principe de l'équidistance n'est pas la règle de droit, d'avoir à titre subsidiaire une autre règle unique équivalente.

84. Comme il a été indiqué plus haut, la Cour n'a pas à faire elle-même une délimitation des zones de plateau continental relevant respectivement de chaque Partie et elle n'est par conséquent pas tenue de prescrire les méthodes à utiliser pour procéder à cette délimitation. La Cour doit indiquer aux Parties les principes et règles de droit en fonction desquels devra se faire le choix des méthodes pour effectuer finalement la délimitation. La Cour s'acquittera de cette tâche de manière à fournir aux Parties les directions nécessaires, sans se substituer à elles par une indication détaillée des méthodes à suivre et des éléments à prendre en considération aux fins d'une délimitation que les Parties se sont formellement réservé de faire elles-mêmes.

85. Il ressort de l'histoire du développement du régime juridique du plateau continental, qui a été rappelée ci-dessus, que la raison essentielle pour laquelle la méthode de l'équidistance ne peut être tenue pour une règle de droit est que, si elle devait être appliquée obligatoirement en toutes situations, cette méthode ne correspondrait pas à certaines notions juridiques de base qui, comme on l'a constaté aux paragraphes 48 et 55, reflètent depuis l'origine l'*opinio juris* en matière de délimitation; ces principes sont que la délimitation doit être l'objet d'un accord entre les Etats intéressés et que cet accord doit se réaliser selon des principes équitables. Il s'agit là, sur la base de préceptes très généraux de justice et de bonne foi, de véritables règles de droit en matière de délimitation des

delimitation of adjacent continental shelves—that is to say, rules binding upon States for all delimitations;—in short, it is not a question of applying equity simply as a matter of abstract justice, but of applying a rule of law which itself requires the application of equitable principles, in accordance with the ideas which have always underlain the development of the legal régime of the continental shelf in this field, namely:

- (a) the parties are under an obligation to enter into negotiations with a view to arriving at an agreement, and not merely to go through a formal process of negotiation as a sort of prior condition for the automatic application of a certain method of delimitation in the absence of agreement; they are under an obligation so to conduct themselves that the negotiations are meaningful, which will not be the case when either of them insists upon its own position without contemplating any modification of it;
- (b) the parties are under an obligation to act in such a way that, in the particular case, and taking all the circumstances into account, equitable principles are applied,—for this purpose the equidistance method can be used, but other methods exist and may be employed, alone or in combination, according to the areas involved;
- (c) for the reasons given in paragraphs 43 and 44, the continental shelf of any State must be the natural prolongation of its land territory and must not encroach upon what is the natural prolongation of the territory of another State.

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86. It is now necessary to examine these rules more closely, as also certain problems relative to their application. So far as the first rule is concerned, the Court would recall not only that the obligation to negotiate which the Parties assumed by Article I, paragraph 2, of the Special Agreements arises out of the Truman Proclamation, which, for the reasons given in paragraph 47, must be considered as having propounded the rules of law in this field, but also that this obligation merely constitutes a special application of a principle which underlies all international relations, and which is moreover recognized in Article 33 of the Charter of the United Nations as one of the methods for the peaceful settlement of international disputes. There is no need to insist upon the fundamental character of this method of settlement, except to point out that it is emphasized by the observable fact that judicial or arbitral settlement is not universally accepted.

87. As the Permanent Court of International Justice said in its Order of 19 August 1929 in the case of the *Free Zones of Upper Savoy and the District of Gex*, the judicial settlement of international disputes “is simply an alternative to the direct and friendly settlement of such disputes between the parties” (*P.C.I.J., Series A, No. 22*, at p. 13). Defining the content of the obligation to negotiate, the Permanent Court, in its

plateaux continentaux limitrophes, c'est-à-dire, de règles obligatoires pour les Etats pour toute délimitation; en d'autres termes, il ne s'agit pas d'appliquer l'équité simplement comme une représentation de la justice abstraite, mais d'appliquer une règle de droit prescrivant le recours à des principes équitables conformément aux idées qui ont toujours inspiré le développement du régime juridique du plateau continental en la matière, à savoir:

- a) les parties sont tenues d'engager une négociation en vue de réaliser un accord et non pas simplement de procéder à une négociation formelle comme une sorte de condition préalable à l'application automatique d'une certaine méthode de délimitation faute d'accord; les parties ont l'obligation de se comporter de telle manière que la négociation ait un sens, ce qui n'est pas le cas lorsque l'une d'elles insiste sur sa propre position sans envisager aucune modification;
- b) les parties sont tenues d'agir de telle sorte que, dans le cas d'espèce et compte tenu de toutes les circonstances, des principes équitables soient appliqués; à cet effet la méthode de l'équidistance peut être appliquée; d'autres aussi existent et peuvent être utilisées exclusivement ou conjointement selon les secteurs envisagés;
- c) pour les raisons exposées aux paragraphes 43 et 44, le plateau continental de tout Etat doit être le prolongement naturel de son territoire et ne doit pas empiéter sur ce qui est le prolongement naturel du territoire d'un autre Etat.

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86. Il convient maintenant d'examiner ces règles de plus près, ainsi que certains problèmes relatifs à leur application. En ce qui concerne la première règle, la Cour rappelle que l'obligation de négocier assumée par les Parties dans l'article 1, paragraphe 2, des compromis, non seulement découle de la proclamation Truman qui, pour les motifs énoncés au paragraphe 47, doit être considérée comme ayant posé les règles de droit en la matière, mais encore ne constitue qu'une application particulière d'un principe, qui est à la base de toutes relations internationales et qui est d'ailleurs reconnu dans l'article 33 de la Charte des Nations Unies comme l'une des méthodes de règlement pacifique des différends internationaux; il est inutile d'insister sur le caractère fondamental de cette forme de règlement sinon pour remarquer qu'il est renforcé par la constatation que le règlement judiciaire ou arbitral n'est pas généralement accepté.

87. Comme l'a dit la Cour permanente de Justice internationale dans son ordonnance du 19 août 1929 en l'affaire des *Zones franches de la Haute-Savoie et du Pays de Gex*, le règlement judiciaire des conflits internationaux « n'est qu'un succédané au règlement direct et amiable de ces conflits entre les parties » (*C.P.J.I. série A n° 22*, p. 13). Définissant dans son avis consultatif sur le *Trafic ferroviaire entre la Lituanie et la*

Advisory Opinion in the case of *Railway Traffic between Lithuania and Poland*, said that the obligation was “not only to enter into negotiations but also to pursue them as far as possible with a view to concluding agreements”, even if an obligation to negotiate did not imply an obligation to reach agreement (*P.C.I.J., Series A/B, No. 42, 1931, at p. 116*). In the present case, it needs to be observed that whatever the details of the negotiations carried on in 1965 and 1966, they failed of their purpose because the Kingdoms of Denmark and the Netherlands, convinced that the equidistance principle alone was applicable, in consequence of a rule binding upon the Federal Republic, saw no reason to depart from that rule; and equally, given the geographical considerations stated in the last sentence of paragraph 7 above, the Federal Republic could not accept the situation resulting from the application of that rule. So far therefore the negotiations have not satisfied the conditions indicated in paragraph 85 (a), but fresh negotiations are to take place on the basis of the present Judgment.

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88. The Court comes next to the rule of equity. The legal basis of that rule in the particular case of the delimitation of the continental shelf as between adjoining States has already been stated. It must however be noted that the rule rests also on a broader basis. Whatever the legal reasoning of a court of justice, its decisions must by definition be just, and therefore in that sense equitable. Nevertheless, when mention is made of a court dispensing justice or declaring the law, what is meant is that the decision finds its objective justification in considerations lying not outside but within the rules, and in this field it is precisely a rule of law that calls for the application of equitable principles. There is consequently no question in this case of any decision *ex aequo et bono*, such as would only be possible under the conditions prescribed by Article 38, paragraph 2, of the Court’s Statute. Nor would this be the first time that the Court has adopted such an attitude, as is shown by the following passage from the Advisory Opinion given in the case of *Judgments of the Administrative Tribunal of the I.L.O. upon Complaints Made against Unesco (I.C.J. Reports 1956, at p. 100)*:

“In view of this the Court need not examine the allegation that the validity of the judgments of the Tribunal is vitiated by excess of jurisdiction on the ground that it awarded compensation *ex aequo et bono*. It will confine itself to stating that, in the reasons given by the Tribunal in support of its decision on the merits, the Tribunal said: ‘That redress will be ensured *ex aequo et bono* by the granting to the complainant of the sum set forth below.’ It does not appear from the context of the judgment that the Tribunal thereby intended to depart from principles of law. The apparent intention was to say

Pologne la teneur de l'obligation de négocier, la Cour permanente a dit que cette obligation « n'est pas seulement d'entamer des négociations, mais encore de les poursuivre autant que possible, en vue d'arriver à des accords », même si l'engagement de négocier n'impliquait pas celui de s'entendre (*C.P.J.I. série A/B n° 42*, 1931, p. 116). Dans la présente affaire on doit noter que, quels qu'en aient été les détails, les négociations menées en 1965 et 1966 n'ont pas atteint leur but parce que les Royaumes du Danemark et des Pays-Bas, convaincus que le principe de l'équidistance était seul applicable et cela par l'effet d'une règle obligatoire pour la République fédérale, ne voyaient aucun motif de s'écarter de cette règle, de même que, vu les considérations d'ordre géographique dont il est fait état au paragraphe 7 ci-dessus *in fine*, la République fédérale ne pouvait accepter la situation résultant de l'application de cette règle; les négociations menées jusqu'à présent n'ont donc pas satisfait aux conditions énoncées au paragraphe 85 a), mais de nouvelles négociations doivent se tenir sur la base du présent arrêt.

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88. La Cour en vient maintenant à la règle de l'équité. Le fondement juridique de cette règle dans le cas particulier de la délimitation du plateau continental entre Etats limitrophes a déjà été précisé. Il faut noter cependant que cette règle repose aussi sur une base plus large. Quel que soit le raisonnement juridique du juge, ses décisions doivent par définition être justes, donc en ce sens équitables. Néanmoins, lorsqu'on parle du juge qui rend la justice ou qui dit le droit, il s'agit de justification objective de ses décisions non pas au-delà des textes mais selon les textes et dans ce domaine c'est précisément une règle de droit qui appelle l'application de principes équitables. Il n'est par conséquent pas question en l'espèce d'une décision *ex aequo et bono*, ce qui ne serait possible que dans les conditions prescrites à l'article 38, paragraphe 2, du Statut de la Cour. Ce ne serait d'ailleurs pas la première fois que la Cour adopterait une telle position, ainsi que cela ressort de son avis consultatif en l'affaire des *Jugements du tribunal administratif de l'O.I.T. sur requête contre l'Unesco* (*C.I.J. Recueil 1956*, p. 100):

« Dans ces conditions, la Cour n'a pas à examiner la prétention selon laquelle la validité des jugements du tribunal serait viciée par un dépassement de compétence du fait qu'il a été accordé des indemnités *ex aequo et bono*. Elle se bornera à dire que si le tribunal, dans les motifs de sa décision sur le fond, a dit « que la réparation sera assurée *ex aequo et bono* par l'allocation au requérant du montant ci-après », le contexte ne fait nullement apparaître que le tribunal ait entendu par là se départir des principes du droit. Il a voulu seulement énoncer que, le calcul du montant de l'indemnité ne pouvant pas

that, as the precise determination of the actual amount to be awarded could not be based on any specific rule of law, the Tribunal fixed what the Court, in other circumstances, has described as the true measure of compensation and the reasonable figure of such compensation (*Corfu Channel* case, Judgment of December 15th, 1949, *I.C.J. Reports 1949*, p. 249).”

89. It must next be observed that, in certain geographical circumstances which are quite frequently met with, the equidistance method, despite its known advantages, leads unquestionably to inequity, in the following sense:

- (a) The slightest irregularity in a coastline is automatically magnified by the equidistance line as regards the consequences for the delimitation of the continental shelf. Thus it has been seen in the case of concave or convex coastlines that if the equidistance method is employed, then the greater the irregularity and the further from the coastline the area to be delimited, the more unreasonable are the results produced. So great an exaggeration of the consequences of a natural geographical feature must be remedied or compensated for as far as possible, being of itself creative of inequity.
- (b) In the case of the North Sea in particular, where there is no outer boundary to the continental shelf, it happens that the claims of several States converge, meet and intercross in localities where, despite their distance from the coast, the bed of the sea still unquestionably consists of continental shelf. A study of these convergences, as revealed by the maps, shows how inequitable would be the apparent simplification brought about by a delimitation which, ignoring such geographical circumstances, was based solely on the equidistance method.

90. If for the above reasons equity excludes the use of the equidistance method in the present instance, as the sole method of delimitation, the question arises whether there is any necessity to employ only one method for the purposes of a given delimitation. There is no logical basis for this, and no objection need be felt to the idea of effecting a delimitation of adjoining continental shelf areas by the concurrent use of various methods. The Court has already stated why it considers that the international law of continental shelf delimitation does not involve any imperative rule and permits resort to various principles or methods, as may be appropriate, or a combination of them, provided that, by the application of equitable principles, a reasonable result is arrived at.

91. Equity does not necessarily imply equality. There can never be any question of completely refashioning nature, and equity does not require that a State without access to the sea should be allotted an area of continental shelf, any more than there could be a question of rendering the situation of a State with an extensive coastline similar to that of a



être déduit de règles de droit posées à cet effet, il entendait fixer ce que la Cour a, en d'autres circonstances, appelé la juste mesure de la réparation, le chiffre raisonnable de celle-ci (affaire du *Détroit de Corfou*, arrêt du 15 décembre 1949, *C.I.J. Recueil 1949*, p. 249). »

89. Il faut ensuite constater que, malgré ses avantages reconnus, la méthode de l'équidistance aboutit dans certaines conditions géographiques assez fréquentes à créer une incontestable inéquité :

- a) La moindre déformation d'une côte est automatiquement amplifiée par la ligne d'équidistance dans ses conséquences pour la délimitation du plateau continental. C'est ainsi qu'on a vu dans le cas des côtes concaves ou convexes que, si l'on applique la méthode de l'équidistance, on aboutit à des résultats d'autant plus déraisonnables que la déformation est considérable et que la zone à délimiter est éloignée de la côte. Une exagération d'une telle importance des conséquences d'un accident géographique naturel doit être réparée ou compensée dans la mesure du possible parce qu'elle est en soi créatrice d'inéquité.
- b) Particulièrement dans le cas de la mer du Nord où le plateau continental ne rencontre aucune limite extérieure, il se trouve que les prétentions de plusieurs Etats convergent, se rencontrent et s'entrecroisent en des endroits où, en dépit de la distance des côtes, le lit de la mer consiste encore en un plateau continental. La constatation de ces convergences, manifestes sur la carte, révèle combien inéquitable serait la simplification apparente d'une délimitation qui ne serait fondée que sur la méthode de l'équidistance en ignorant cette circonstance géographique.

90. Si, pour les raisons indiquées ci-dessus, l'équité interdit l'emploi de l'équidistance dans le cas présent comme l'unique méthode de délimitation, la question se pose de savoir s'il existe une nécessité quelconque de n'employer pour une délimitation déterminée qu'une seule méthode. Il n'y a aucune base logique à cela et l'on ne voit aucune objection à l'idée qu'une délimitation de zones limitrophes du plateau continental puisse être faite par l'emploi concurrent de diverses méthodes. La Cour a déjà dit pourquoi elle considère que le droit international en matière de délimitation du plateau continental ne comporte pas de règle impérative et autorise le recours à divers principes ou méthodes, selon le cas, ainsi qu'à leur combinaison, pourvu qu'on aboutisse par application de principes équitables à un résultat raisonnable.

91. L'équité n'implique pas nécessairement l'égalité. Il n'est jamais question de refaire la nature entièrement et l'équité ne commande pas qu'un Etat sans accès à la mer se voie attribuer une zone de plateau continental, pas plus qu'il ne s'agit d'égaliser la situation d'un Etat dont les côtes sont étendues et celle d'un Etat dont les côtes sont réduites. L'égalité

State with a restricted coastline. Equality is to be reckoned within the same plane, and it is not such natural inequalities as these that equity could remedy. But in the present case there are three States whose North Sea coastlines are in fact comparable in length and which, therefore, have been given broadly equal treatment by nature except that the configuration of one of the coastlines would, if the equidistance method is used, deny to one of these States treatment equal or comparable to that given the other two. Here indeed is a case where, in a theoretical situation of equality within the same order, an inequity is created. What is unacceptable in this instance is that a State should enjoy continental shelf rights considerably different from those of its neighbours merely because in the one case the coastline is roughly convex in form and in the other it is markedly concave, although those coastlines are comparable in length. It is therefore not a question of totally refashioning geography whatever the facts of the situation but, given a geographical situation of quasi-equality as between a number of States, of abating the effects of an incidental special feature from which an unjustifiable difference of treatment could result.

92. It has however been maintained that no one method of delimitation can prevent such results and that all can lead to relative injustices. This argument has in effect already been dealt with. It can only strengthen the view that it is necessary to seek not one method of delimitation but one goal. It is in this spirit that the Court must examine the question of how the continental shelf can be delimited when it is in fact the case that the equidistance principle does not provide an equitable solution. As the operation of delimiting is a matter of determining areas appertaining to different jurisdictions, it is a truism to say that the determination must be equitable; rather is the problem above all one of defining the means whereby the delimitation can be carried out in such a way as to be recognized as equitable. Although the Parties have made it known that they intend to reserve for themselves the application of the principles and rules laid down by the Court, it would, even so, be insufficient simply to rely on the rule of equity without giving some degree of indication as to the possible ways in which it might be applied in the present case, it being understood that the Parties will be free to agree upon one method rather than another, or different methods if they so prefer.

93. In fact, there is no legal limit to the considerations which States may take account of for the purpose of making sure that they apply equitable procedures, and more often than not it is the balancing-up of all such considerations that will produce this result rather than reliance on one to the exclusion of all others. The problem of the relative weight to be accorded to different considerations naturally varies with the circumstances of the case.

94. In balancing the factors in question it would appear that various aspects must be taken into account. Some are related to the geological, others to the geographical aspect of the situation, others again to the

se mesure dans un même plan et ce n'est pas à de telles inégalités naturelles que l'équité pourrait porter remède. Mais en l'espèce il s'agit de trois Etats dont les côtes sur la mer du Nord sont justement d'une longueur comparable et qui par conséquent ont été traités à peu près également par la nature, sauf que l'une de ces côtes par sa configuration priverait l'un des Etats d'un traitement égal ou comparable à celui que recevraient les deux autres si l'on utilisait la méthode de l'équidistance. C'est bien un cas où, dans une situation théorique d'égalité dans le même plan, une inéquité est créée. Ce qui est inacceptable en l'espèce est qu'un Etat ait des droits considérablement différents de ses voisins sur le plateau continental du seul fait que l'un a une côte de configuration plutôt convexe et l'autre une côte de configuration fortement concave, même si la longueur de ces côtes est comparable. Il ne s'agit donc pas de refaire totalement la géographie dans n'importe quelle situation de fait mais, en présence d'une situation géographique de quasi-égalité entre plusieurs Etats, de remédier à une particularité non essentielle d'où pourrait résulter une injustifiable différence de traitement.

92. Il a été soutenu qu'aucune méthode de délimitation ne peut empêcher de tels résultats et que toutes peuvent éventuellement aboutir à une relative injustice. Une réponse a déjà été donnée à cet argument. Il renforce d'ailleurs l'opinion selon laquelle on doit rechercher non pas une méthode unique de délimitation mais un but unique. C'est dans cet esprit que la Cour doit rechercher comment une délimitation de plateau continental peut être assurée lorsque le principe de l'équidistance ne donne précisément pas une solution équitable. Délimiter étant une opération de détermination de zones relevant respectivement de compétences différentes, c'est une vérité première de dire que cette détermination doit être équitable; le problème est surtout de définir les moyens par lesquels la délimitation peut être fixée de manière à être reconnue comme équitable. Bien que les Parties aient manifesté leur intention de se réserver l'application des principes et règles établis par la Cour, il serait cependant insuffisant de s'en tenir à la règle de l'équité sans en préciser quelque peu les possibilités d'application en l'espèce, étant entendu que les Parties pourront choisir l'une plutôt que l'autre de ces méthodes ou qu'elles pourront en préférer de différentes.

93. En réalité il n'y a pas de limites juridiques aux considérations que les Etats peuvent examiner afin de s'assurer qu'ils vont appliquer des procédés équitables et c'est le plus souvent la balance entre toutes ces considérations qui créera l'équitable plutôt que l'adoption d'une seule considération en excluant toutes les autres. De tels problèmes d'équilibre entre diverses considérations varient naturellement selon les circonstances de l'espèce.

94. Dans la balance des éléments en cause divers facteurs semblent devoir être pris en considération. Les uns tiennent à l'aspect géologique, d'autres à l'aspect géographique de la situation, d'autres enfin à l'idée

idea of the unity of any deposits. These criteria, though not entirely precise, can provide adequate bases for decision adapted to the factual situation.

95. The institution of the continental shelf has arisen out of the recognition of a physical fact; and the link between this fact and the law, without which that institution would never have existed, remains an important element for the application of its legal régime. The continental shelf is, by definition, an area physically extending the territory of most coastal States into a species of platform which has attracted the attention first of geographers and hydrographers and then of jurists. The importance of the geological aspect is emphasized by the care which, at the beginning of its investigation, the International Law Commission took to acquire exact information as to its characteristics, as can be seen in particular from the definitions to be found on page 131 of Volume I of the *Yearbook of the International Law Commission for 1956*. The appurtenance of the shelf to the countries in front of whose coastlines it lies, is therefore a fact, and it can be useful to consider the geology of that shelf in order to find out whether the direction taken by certain configurational features should influence delimitation because, in certain localities, they point-up the whole notion of the appurtenance of the continental shelf to the State whose territory it does in fact prolong.

96. The doctrine of the continental shelf is a recent instance of encroachment on maritime expanses which, during the greater part of history, appertained to no-one. The contiguous zone and the continental shelf are in this respect concepts of the same kind. In both instances the principle is applied that the land dominates the sea; it is consequently necessary to examine closely the geographical configuration of the coastlines of the countries whose continental shelves are to be delimited. This is one of the reasons why the Court does not consider that markedly pronounced configurations can be ignored; for, since the land is the legal source of the power which a State may exercise over territorial extensions to seaward, it must first be clearly established what features do in fact constitute such extensions. Above all is this the case when what is involved is no longer areas of sea, such as the contiguous zone, but stretches of submerged land; for the legal régime of the continental shelf is that of a soil and a subsoil, two words evocative of the land and not of the sea.

97. Another factor to be taken into consideration in the delimitation of areas of continental shelf as between adjacent States is the unity of any deposits. The natural resources of the subsoil of the sea in those parts which consist of continental shelf are the very object of the legal régime established subsequent to the Truman Proclamation. Yet it frequently occurs that the same deposit lies on both sides of the line dividing a continental shelf between two States, and since it is possible to exploit such a deposit from either side, a problem immediately arises on account of the risk of prejudicial or wasteful exploitation by one or other of the States concerned. To look no farther than the North Sea, the practice

d'unité de gisement. Ces critères, à défaut de précision rigoureuse, fournissent des bases de décision adaptées aux situations de fait.

95. L'institution du plateau continental est née de la constatation d'un fait naturel et le lien entre ce fait et le droit, sans lequel elle n'eût jamais existé, demeure un élément important dans l'application du régime juridique de l'institution. Le plateau continental est par définition une zone prolongeant physiquement le territoire de la plupart des Etats maritimes par cette espèce de socle qui a appelé en premier lieu l'attention des géographes et hydrographes, puis celle des juristes. L'importance de l'aspect géologique est marquée par le soin qu'a pris au début de ses études la Commission du droit international pour se documenter exactement sur ses caractéristiques, ainsi que cela ressort notamment des définitions contenues dans l'*Annuaire de la Commission du droit international*, 1956, volume I, page 141. L'appartenance géologique du plateau continental aux pays riverains devant leurs côtes est donc un fait et l'examen de la géologie de ce plateau peut être utile afin de savoir si quelques orientations ou mouvements influencent la délimitation en précisant en certains points la notion même d'appartenance du plateau continental à l'Etat dont il prolonge en fait le territoire.

96. La doctrine du plateau continental est l'un des cas récents d'empiètement sur des espaces maritimes qui, pendant la plus grande partie de l'histoire, ne relevaient de personne. Zone contiguë et plateau continental sont à cet égard du même ordre. Dans les deux hypothèses on applique le principe que la terre domine la mer; il est donc nécessaire de regarder de près la configuration géographique des côtes des pays dont on doit délimiter le plateau continental. C'est l'une des raisons pour lesquelles la Cour ne pense pas qu'on puisse négliger les configurations nettement excentriques, car puisque la terre est la source juridique du pouvoir qu'un Etat peut exercer dans les prolongements maritimes, encore faut-il bien établir en quoi consistent en fait ces prolongements. Et cela surtout lorsqu'il ne s'agit plus de zones aquatiques comme la zone contiguë mais d'espaces terrestres submergés, car le régime juridique du plateau continental est celui d'un sol et d'un sous-sol, deux mots qui évoquent la terre et non pas la mer.

97. Un autre élément à prendre en considération dans la délimitation des zones de plateau continental entre Etats limitrophes est l'unité de gisement. Les ressources naturelles du sous-sol de la mer dans la partie qui constitue le plateau continental sont l'objet même du régime juridique institué à la suite de la proclamation Truman. Or il est fréquent qu'un gisement s'étende des deux côtés de la limite du plateau continental entre deux Etats et, l'exploitation de ce gisement étant possible de chaque côté, un problème naît immédiatement en raison du danger d'une exploitation préjudiciable ou exagérée par l'un ou l'autre des Etats intéressés. Sans aller plus loin que la mer du Nord, la pratique des Etats montre

of States shows how this problem has been dealt with, and all that is needed is to refer to the undertakings entered into by the coastal States of that sea with a view to ensuring the most efficient exploitation or the apportionment of the products extracted—(see in particular the agreement of 10 March 1965 between the United Kingdom and Norway, Article 4; the agreement of 6 October 1965 between the Netherlands and the United Kingdom relating to “the exploitation of single geological structures extending across the dividing line on the continental shelf under the North Sea”; and the agreement of 14 May 1962 between the Federal Republic and the Netherlands concerning a joint plan for exploiting the natural resources underlying the area of the Ems Estuary where the frontier between the two States has not been finally delimited.) The Court does not consider that unity of deposit constitutes anything more than a factual element which it is reasonable to take into consideration in the course of the negotiations for a delimitation. The Parties are fully aware of the existence of the problem as also of the possible ways of solving it.

98. A final factor to be taken account of is the element of a reasonable degree of proportionality which a delimitation effected according to equitable principles ought to bring about between the extent of the continental shelf appertaining to the States concerned and the lengths of their respective coastlines,—these being measured according to their general direction in order to establish the necessary balance between States with straight, and those with markedly concave or convex coasts, or to reduce very irregular coastlines to their truer proportions. The choice and application of the appropriate technical methods would be a matter for the parties. One method discussed in the course of the proceedings, under the name of the principle of the coastal front, consists in drawing a straight baseline between the extreme points at either end of the coast concerned, or in some cases a series of such lines. Where the parties wish to employ in particular the equidistance method of delimitation, the establishment of one or more baselines of this kind can play a useful part in eliminating or diminishing the distortions that might result from the use of that method.

99. In a sea with the particular configuration of the North Sea, and in view of the particular geographical situation of the Parties' coastlines upon that sea, the methods chosen by them for the purpose of fixing the delimitation of their respective areas may happen in certain localities to lead to an overlapping of the areas appertaining to them. The Court considers that such a situation must be accepted as a given fact and resolved either by an agreed, or failing that by an equal division of the overlapping areas, or by agreements for joint exploitation, the latter solution appearing particularly appropriate when it is a question of preserving the unity of a deposit.

\* \* \*

comment ce problème a été traité et il suffira de relever les engagements pris par des Etats riverains de la mer du Nord pour assurer l'exploitation la plus efficace ou la répartition des produits extraits (cf. notamment l'accord du 10 mars 1965 entre le Royaume-Uni et la Norvège, article 4, l'accord du 6 octobre 1965 entre le Royaume-Uni et les Pays-Bas sur « l'exploitation de structures géologiques s'étendant de part et d'autre de la ligne de séparation du plateau continental situé sous la mer du Nord », et l'accord du 14 mai 1962 entre la République fédérale et les Pays-Bas sur un plan d'exploitation commune des richesses du sous-sol dans la zone de l'estuaire de l'Ems où la frontière entre les deux Etats n'a pas été délimitée de façon définitive). La Cour ne considère pas que l'unité de gisement constitue plus qu'un élément de fait qu'il est raisonnable de prendre en considération au cours d'une négociation sur une délimitation. Les Parties sont pleinement informées de l'existence du problème comme des possibilités de solution.

98. Un dernier élément à prendre en considération est le rapport raisonnable qu'une délimitation effectuée selon des principes équitables devrait faire apparaître entre l'étendue du plateau continental relevant des Etats intéressés et la longueur de leurs côtes; on mesurerait ces côtes d'après leur direction générale afin d'établir l'équilibre nécessaire entre les Etats ayant des côtes droites et les Etats ayant des côtes fortement concaves ou convexes ou afin de ramener des côtes très irrégulières à des proportions plus exactes. Le choix et l'application des méthodes techniques appropriées appartiendraient aux parties. L'une des méthodes examinées pendant la procédure, sous le nom de principe de la façade maritime, consiste à tracer une ligne de base droite ou, dans certains cas, une série de lignes de base droites entre les points extrêmes de la côte dont il s'agit. Lorsque les parties veulent recourir notamment à la méthode de délimitation fondée sur l'équidistance, le tracé d'une ou plusieurs lignes de base de ce genre peut contribuer utilement à éliminer ou à atténuer les distorsions que l'emploi de cette méthode risque d'entraîner.

99. Dans une mer qui a la configuration particulière de la mer du Nord et en raison de la situation géographique particulière des côtes des Parties dans cette mer, il peut se faire que les méthodes choisies pour fixer la délimitation des zones respectives conduisent en certains secteurs à des chevauchements entre les zones relevant des Parties. La Cour considère qu'il faut accepter cette situation comme une donnée de fait et la résoudre soit par une division des zones de chevauchement effectuée par voie d'accord ou, à défaut, par parts égales, soit par des accords d'exploitation en commun, cette dernière solution paraissant particulièrement appropriée lorsqu'il s'agit de préserver l'unité d'un gisement.

\* \* \*

100. The Court has examined the problems raised by the present case in its own context, which is strictly that of delimitation. Other questions relating to the general legal régime of the continental shelf, have been examined for that purpose only. This régime furnishes an example of a legal theory derived from a particular source that has secured a general following. As the Court has recalled in the first part of its Judgment, it was the Truman Proclamation of 28 September 1945 which was at the origin of the theory, whose special features reflect that origin. It would therefore not be in harmony with this history to over-systematize a pragmatic construct the developments of which have occurred within a relatively short space of time.

\* \* \* \* \*

101. For these reasons,

THE COURT,

by eleven votes to six,

finds that, in each case,

(A) the use of the equidistance method of delimitation not being obligatory as between the Parties; and

(B) there being no other single method of delimitation the use of which is in all circumstances obligatory;

(C) the principles and rules of international law applicable to the delimitation as between the Parties of the areas of the continental shelf in the North Sea which appertain to each of them beyond the partial boundary determined by the agreements of 1 December 1964 and 9 June 1965, respectively, are as follows:

- (1) delimitation is to be effected by agreement in accordance with equitable principles, and taking account of all the relevant circumstances, in such a way as to leave as much as possible to each Party all those parts of the continental shelf that constitute a natural prolongation of its land territory into and under the sea, without encroachment on the natural prolongation of the land territory of the other;
- (2) if, in the application of the preceding sub-paragraph, the delimitation leaves to the Parties areas that overlap, these are to be divided between them in agreed proportions or, failing agreement, equally, unless they decide on a régime of joint jurisdiction, user, or exploitation for the zones of overlap or any part of them;

(D) in the course of the negotiations, the factors to be taken into account are to include:



100. La Cour a examiné les problèmes soulevés par la présente affaire dans son contexte propre, c'est-à-dire aux seules fins de la délimitation. Si la Cour a abordé d'autres questions ayant trait au régime juridique général du plateau continental, elle ne l'a fait que dans ce cadre. Le régime du plateau continental est l'exemple d'une théorie juridique née d'une solution particulière qui a fait école. Comme la Cour l'a rappelé dans la première partie de l'arrêt, c'est la proclamation Truman du 28 septembre 1945 qui est à l'origine de la théorie et les particularités de celle-ci sont le reflet de cette origine. Il serait donc contraire à l'histoire de systématiser à l'excès une construction pragmatique dont les développements se sont présentés dans un délai relativement court.

\* \* \* \* \*

101. Par ces motifs,

LA COUR,

par onze voix contre six,

dit que, pour l'une et l'autre affaire,

A) l'application de la méthode de délimitation fondée sur l'équidistance n'est pas obligatoire entre les Parties;

B) il n'existe pas d'autre méthode unique de délimitation qui soit d'un emploi obligatoire en toutes circonstances;

C) les principes et les règles du droit international applicables à la délimitation entre les Parties des zones du plateau continental de la mer du Nord relevant de chacune d'elles, au-delà des lignes de délimitation partielle respectivement déterminées par les accords du 1<sup>er</sup> décembre 1964 et du 9 juin 1965, sont les suivants:

- 1) la délimitation doit s'opérer par voie d'accord conformément à des principes équitables et compte tenu de toutes les circonstances pertinentes, de manière à attribuer, dans toute la mesure du possible, à chaque Partie la totalité des zones du plateau continental qui constituent le prolongement naturel de son territoire sous la mer et n'empiètent pas sur le prolongement naturel du territoire de l'autre;
- 2) si, par suite de l'application de l'alinéa précédent, la délimitation attribue aux Parties des zones qui se chevauchent, celles-ci doivent être divisées entre les Parties par voie d'accord ou, à défaut, par parts égales, à moins que les Parties n'adoptent un régime de juridiction, d'utilisation ou d'exploitation commune pour tout ou partie des zones de chevauchement;

D) au cours des négociations, les facteurs à prendre en considération comprendront:

- (1) the general configuration of the coasts of the Parties, as well as the presence of any special or unusual features;
- (2) so far as known or readily ascertainable, the physical and geological structure, and natural resources, of the continental shelf areas involved;
- (3) the element of a reasonable degree of proportionality, which a delimitation carried out in accordance with equitable principles ought to bring about between the extent of the continental shelf areas appertaining to the coastal State and the length of its coast measured in the general direction of the coastline, account being taken for this purpose of the effects, actual or prospective, of any other continental shelf delimitations between adjacent States in the same region.

Done in English and in French, the English text being authoritative at the Peace Palace, The Hague, this twentieth day of February, one thousand nine hundred and sixty-nine, in four copies, one of which will be placed in the archives of the Court and the others transmitted to the Government of the Federal Republic of Germany, to the Government of the Kingdom of Denmark and to the Government of the Kingdom of the Netherlands, respectively.

*(Signed)* J. L. BUSTAMANTE R.,  
President.

*(Signed)* S. AQUARONE,  
Registrar.

Judge Sir Muhammad ZAFRULLA KHAN makes the following declaration:

I am in agreement with the Judgment throughout but would wish to add the following observations.

The essence of the dispute between the Parties is that the two Kingdoms claim that the delimitation effected between them under the Agreement of 31 March 1966 is binding upon the Federal Republic and that the Federal Republic is bound to accept the situation resulting therefrom, which would confine its continental shelf to the triangle formed by lines A-B-E and C-D-E in Map 3. The Federal Republic stoutly resists that claim.

Not only is Article 6 of the Geneva Convention of 1958 not opposable to the Federal Republic but the delimitation effected under the Agreement of 31 March 1966 does not derive from the provisions of that Article as Denmark and the Netherlands are neither States "whose coasts are opposite each other" within the meaning of the first paragraph of that Article nor are they "two adjacent States" within the meaning of the

- 1) la configuration générale des côtes des Parties et la présence de toute caractéristique spéciale ou inhabituelle;
- 2) pour autant que cela soit connu ou facile à déterminer, la structure physique et géologique et les ressources naturelles des zones de plateau continental en cause;
- 3) le rapport raisonnable qu'une délimitation opérée conformément à des principes équitables devrait faire apparaître entre l'étendue des zones de plateau continental relevant de l'Etat riverain et la longueur de son littoral mesurée suivant la direction générale de celui-ci, compte tenu à cette fin des effets actuels ou éventuels de toute autre délimitation du plateau continental effectuée entre Etats limitrophes dans la même région.

Fait en anglais et en français, le texte anglais faisant foi, au palais de la Paix, à La Haye, le vingt février mil neuf cent soixante-neuf, en quatre exemplaires, dont l'un restera déposé aux archives de la Cour et dont les autres seront transmis respectivement au Gouvernement de la République fédérale d'Allemagne, au Gouvernement du Royaume du Danemark et au Gouvernement du Royaume des Pays-Bas.

Le Président,

(Signé) J. L. BUSTAMANTE R.

Le Greffier,

(Signé) S. AQUARONE.

Sir Muhammad ZAFRULLA KHAN, juge, fait la déclaration suivante:

Je souscris à l'arrêt dans son intégralité mais voudrais ajouter les observations ci-après.

Le différend entre les Parties se ramène pour l'essentiel à ceci: le Danemark et les Pays-Bas soutiennent que la délimitation effectuée entre eux conformément à l'accord du 31 mars 1966 lie la République fédérale et que celle-ci est tenue d'accepter la situation ainsi créée, dans laquelle son plateau continental se trouverait limité au triangle formé par les lignes ABE et CDE de la carte 3. La République fédérale rejette catégoriquement cette thèse.

Or, non seulement l'article 6 de la Convention de Genève de 1958 n'est pas opposable à la République fédérale, mais la délimitation effectuée par l'accord du 31 mars 1966 ne procède pas des dispositions dudit article, puisque le Danemark et les Pays-Bas ne sont ni des Etats « dont les côtes se font face » au sens du premier paragraphe de cet article, ni des Etats « limitrophes » au sens du second paragraphe. La situation

second paragraph of that Article. The situation resulting from that delimitation, so far as it affects the Federal Republic is not, therefore, brought about by the application of the principle set out in either of the paragraphs of Article 6 of the Convention.

Had paragraph 2 of Article 6 been applicable to the delimitation of the continental shelf between the Parties to the dispute, a boundary line, determined by the application of the principle of equidistance, would have had to allow for the configuration of the coastline of the Federal Republic as a "special circumstance".

In the course of the oral pleadings the contention that the principle of equidistance *cum* special circumstances had crystallized into a rule of customary international law was not advanced on behalf of the two Kingdoms as an alternative to the claim that that principle was inherent in the very concept of the continental shelf. The Judgment has, in fairness, dealt with these two contentions as if they had been put forward in the alternative and were thus consistent with each other, and has rejected each of them on the merits. I am in agreement with the reasoning of the Judgment on both these points. But, I consider, it is worth mentioning that Counsel for the two Kingdoms summed up their position in regard to the effect of the 1958 Convention as follows:

"... They have not maintained that the Convention embodied already received rules of customary law in the sense that the Convention was merely declaratory of existing rules. Their position is rather that the doctrine of the coastal State's exclusive rights over the adjacent continental shelf was in process of formation between 1945 and 1958; that the State practice prior to 1958 showed fundamental variations in the nature and scope of the rights claimed; that, in consequence, in State practice the emerging doctrine was wholly lacking in any definition of these crucial elements as it was also of the legal régime applicable to the coastal State with respect to the continental shelf; that the process of the definition and consolidation of the emerging customary law took place through the work of the International Law Commission, the reaction of governments to that work and the proceedings of the Geneva Conference; that the emerging customary law, now become more defined, both as to the rights of the coastal State and the applicable régime, crystallized in the adoption of the Continental Shelf Convention by the Conference; and that the numerous signatures and ratifications of the Convention and the other State practice based on the principles set out in the Convention had the effect of consolidating those principles as customary law."

If it were correct that the doctrine of the coastal State's exclusive rights over the adjacent continental shelf was in process of formation

créée par cette délimitation, dans les effets qu'elle a pour la République fédérale, n'est par conséquent pas due à l'application du principe énoncé dans l'un ou l'autre de ces deux paragraphes de l'article 6 de la Convention.

Le paragraphe 2 de l'article 6 eût-il été applicable à la délimitation du plateau continental entre les Parties que la ligne de délimitation déterminée par application du principe de l'équidistance aurait dû tenir compte de la configuration de la côte de la République fédérale comme d'une « circonstance spéciale ».

Au cours de la procédure orale, le Danemark et les Pays-Bas n'ont pas présenté la thèse suivant laquelle le principe « équidistance-circonstances spéciales » se serait cristallisé en une règle de droit international coutumier comme l'un des termes d'une alternative, l'autre étant que ce principe serait inhérent à la notion même de plateau continental. Dans son arrêt la Cour a cru devoir examiner ces deux thèses comme si elles avaient été présentées sous la forme d'une alternative et étaient par conséquent compatibles l'une avec l'autre, et la Cour a rejeté chacune d'elles au fond. Je souscris dans les deux cas au raisonnement de l'arrêt. Mais je crois utile de signaler que l'agent du Danemark et des Pays-Bas a résumé la position des deux gouvernements quant à l'effet de la Convention de 1958 de la façon suivante :

« [Les deux gouvernements] n'ont pas soutenu que la Convention consacrait des règles déjà reçues de droit coutumier en ce sens qu'elle était simplement déclaratoire des règles existantes. Ils estiment plutôt que la doctrine des droits exclusifs d'un Etat riverain sur le plateau continental adjacent se trouvait en voie de formation entre 1945 et 1958; que la pratique des Etats antérieure à 1958 témoignait de variations fondamentales quant à la nature et à la portée des droits revendiqués; qu'en conséquence, dans la pratique des Etats, la doctrine en voie de formation ne définissait nullement ces éléments essentiels pas plus qu'elle ne définissait le régime juridique applicable aux Etats riverains en ce qui concerne le plateau continental; que la définition et la consolidation du droit coutumier en voie de formation s'étaient effectuées grâce aux travaux de la Commission du droit international, aux réactions des gouvernements devant l'œuvre de la Commission et aux débats de la conférence de Genève; que ce droit coutumier en formation, désormais plus précis sur la double question des droits des Etats riverains et du régime applicable, s'est cristallisé du fait de l'adoption de la Convention sur le plateau continental par la conférence; et que les nombreuses signatures et ratifications recueillies par la Convention, ainsi que la pratique des Etats s'inspirant des principes énoncés dans la Convention, ont eu pour effet de consolider ces principes en tant que droit coutumier. »

Si l'on admet que la doctrine des droits exclusifs de l'Etat riverain sur le plateau continental adjacent à sa côte était en voie de formation entre

between 1945 and 1958 and that in State practice prior to 1958 it was wholly lacking in any definition of crucial elements as it was also of the legal régime applicable to the coastal State with respect to the continental shelf, then it would seem to follow conclusively that the principle of equidistance was not inherent in the concept of the continental shelf.

Judge BENGZON makes the following declaration:

I regret my inability to concur with the main conclusions of the majority of the Court. I agree with my colleagues who maintain the view that Article 6 of the Geneva Convention is the applicable international law and that as between these Parties equidistance is the rule for delimitation, which rule may even be derived from the general principles of law.

President BUSTAMANTE Y RIVERO, Judges JESSUP, PADILLA NERVO and AMMOUN append Separate Opinions to the Judgment of the Court.

Vice-President KORETSKY, Judges TANAKA, MORELLI, LACHS and Judge *ad hoc* SØRENSEN append Dissenting Opinions to the Judgment of the Court.

*(Initialed)* J. L. B.-R.

*(Initialed)* S. A.

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1945 et 1958 et que la pratique des Etats antérieure à 1958 ne fournissait aucune définition, ni de certains éléments essentiels ni du régime juridique applicable à l'Etat riverain en ce qui concerne le plateau continental, on doit, semble-t-il, en tirer la conclusion que le principe de l'équidistance n'était pas inhérent à la notion de plateau continental.

M. BENGZON, juge, fait la déclaration suivante:

Je regrette de ne pouvoir souscrire aux conclusions principales émises par la majorité de la Cour. Je suis d'accord avec ceux de mes collègues qui soutiennent que l'article 6 de la Convention de Genève constitue le droit international applicable et qu'entre les Parties la règle de délimitation est l'équidistance, cette règle pouvant même être déduite des principes généraux de droit.

M. BUSTAMANTE Y RIVERO, Président, MM. JESSUP, PADILLA NERVO et AMMOUN, juges, joignent à l'arrêt les exposés de leur opinion individuelle.

M. KORETSKY, Vice-Président, MM. TANAKA, MORELLI, LACHS, juges, et M. SØRENSEN, juge *ad hoc*, joignent à l'arrêt les exposés de leur opinion dissidente.

(Paraphé) J. L. B.-R.

(Paraphé) S. A.

INTERNATIONAL COURT OF JUSTICE

REPORTS OF JUDGMENTS,  
ADVISORY OPINIONS AND ORDERS

INTERPRETATION OF THE AGREEMENT  
OF 25 MARCH 1951 BETWEEN  
THE WHO AND EGYPT

ADVISORY OPINION OF 20 DECEMBER 1980

**1980**

COUR INTERNATIONALE DE JUSTICE

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INTERPRÉTATION DE L'ACCORD  
DU 25 MARS 1951  
ENTRE L'OMS ET L'ÉGYPTE

AVIS CONSULTATIF DU 20 DÉCEMBRE 1980



Official citation :

*Interpretation of the Agreement of 25 March 1951 between the WHO and Egypt, Advisory Opinion, I.C.J. Reports 1980, p. 73.*

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## INTERNATIONAL COURT OF JUSTICE

YEAR 1980

20 December 1980

INTERPRETATION OF THE AGREEMENT  
OF 25 MARCH 1951 BETWEEN  
THE WHO AND EGYPT

*Determination by the Court of the meaning and implications of question submitted for advisory opinion – Need for Court to ascertain and formulate legal questions really in issue.*

*International organizations and host States – Respective powers of the organization and the host State with regard to seat of headquarters or regional offices of organization – Mutual obligations of co-operation and good faith resulting from a State's membership of organization as well as from relations between organization and host State – Legal principles and rules applicable on transfer of office of organization from territory of host State concerning conditions and modalities for effecting transfer – Duty to consult – Consideration of provisions of host agreements and of Vienna Convention on the Law of Treaties – Application of principles and rules of general international law – Mutual obligation to co-operate in good faith to promote the objectives and purposes of the Organization.*

## ADVISORY OPINION

*Present : President Sir Humphrey WALDOCK ; Vice-President ELIAS ; Judges FORSTER, GROS, LACHS, MOROZOV, NAGENDRA SINGH, RUDA, MOSLER, ODA, AGO, EL-ERIAN, SETTE-CAMARA ; Registrar TORRES BERNÁRDEZ.*

Concerning the interpretation of the Agreement signed on 25 March 1951 between the World Health Organization and the Government of Egypt,

THE COURT,

composed as above,

*gives the following Advisory Opinion :*

1. The questions upon which the advisory opinion of the Court has been requested were laid before the Court by a letter dated 21 May 1980, received in the Registry on 28 May 1980, addressed by the Director-General of the World

## COUR INTERNATIONALE DE JUSTICE

ANNÉE 1980

20 décembre 1980

1980  
20 décembre  
Rôle général  
n° 65INTERPRÉTATION DE L'ACCORD  
DU 25 MARS 1951  
ENTRE L'OMS ET L'ÉGYPTE

*Détermination par la Cour du sens et de la portée de la question soumise pour avis consultatif – Nécessité pour la Cour de rechercher et formuler les questions juridiques véritablement en jeu.*

*Organisations internationales et Etats hôtes – Pouvoirs respectifs de l'organisation et de l'Etat hôte en ce qui concerne le siège de l'organisation ou de ses bureaux régionaux – Obligations réciproques de coopération et de bonne foi résultant de l'appartenance d'un Etat membre à l'organisation ainsi que des relations entre l'organisation et l'Etat hôte – Principes et règles juridiques applicables au transfert du bureau de l'organisation hors du territoire de l'Etat hôte quant aux conditions et modalités du transfert – Obligation de consultation – Examen des dispositions des accords de siège et de la convention de Vienne sur le droit des traités – Application des principes et règles du droit international général – Obligation réciproque de coopérer de bonne foi pour servir les buts et objectifs de l'Organisation.*

## AVIS CONSULTATIF

*Présents : Sir Humphrey WALDOCK, Président ; M. ELIAS, Vice-Président ; MM. FORSTER, GROS, LACHS, MOROZOV, NAGENDRA SINGH, RUDA, MOSLER, ODA, AGO, EL-ERIAN, SETTE-CAMARA, juges ; M. TORRES BERNARDEZ, Greffier.*

Au sujet de l'interprétation de l'accord signé le 25 mars 1951 entre l'Organisation mondiale de la Santé et le Gouvernement de l'Égypte,

LA COUR,

ainsi composée,

donne l'avis consultatif suivant :

1. La Cour a été saisie des questions sur lesquelles un avis consultatif lui est demandé par une lettre du Directeur général de l'Organisation mondiale de la Santé au Greffier de la Cour datée du 21 mai 1980 et parvenue au Greffe le

Health Organization to the Registrar. In that letter the Director-General informed the Court of resolution WHA33.16 adopted by the World Health Assembly on 20 May 1980, in accordance with Article 96, paragraph 2, of the Charter of the United Nations, Article 76 of the Constitution of the World Health Organization, and Article X, paragraph 2, of the Agreement between the United Nations and the World Health Organization, by which the Organization had decided to submit two questions to the Court for advisory opinion. The text of that resolution is as follows :

“The Thirty-third World Health Assembly,

Having regard to proposals which have been made to remove from Alexandria the Regional Office for the Eastern Mediterranean Region of the World Health Organization,

Taking note of the differing views which have been expressed in the World Health Assembly on the question of whether the World Health Organization may transfer the Regional Office without regard to the provisions of Section 37 of the Agreement between the World Health Organization and Egypt of 25 March 1951,

Noting further that the Working Group of the Executive Board has been unable to make a judgment or a recommendation on the applicability of Section 37 of this Agreement,

*Decides*, prior to taking any decision on removal of the Regional Office, and pursuant to Article 76 of the Constitution of the World Health Organization and Article X of the Agreement between the United Nations and the World Health Organization approved by the General Assembly of the United Nations on 15 November 1947, to submit to the International Court of Justice for its Advisory Opinion the following questions :

‘1. Are the negotiation and notice provisions of Section 37 of the Agreement of 25 March 1951 between the World Health Organization and Egypt applicable in the event that either party to the Agreement wishes to have the Regional Office transferred from the territory of Egypt?’

2. If so, what would be the legal responsibilities of both the World Health Organization and Egypt, with regard to the Regional Office in Alexandria, during the two-year period between notice and termination of the Agreement?’”

2. By letters dated 6 June 1980, the Registrar, pursuant to Article 66, paragraph 1, of the Statute of the Court, gave notice of the request for advisory opinion to all States entitled to appear before the Court.

3. The President of the Court, having decided pursuant to Article 66, paragraph 2, of the Statute, that those States Members of the World Health Organization who were also States entitled to appear before the Court, and the Organization itself, were likely to be able to furnish information on the question submitted to the Court, made an Order on 6 June 1980 fixing 1 September 1980 as the time-limit within which written statements might be submitted by those States. Accordingly, the special and direct communication provided for in

28 mai 1980. Dans cette lettre le Directeur général porte à la connaissance de la Cour la résolution WHA33.16 adoptée par l'Assemblée mondiale de la Santé le 20 mai 1980, par laquelle, conformément à l'article 96, paragraphe 2, de la Charte des Nations Unies, à l'article 76 de la Constitution de l'Organisation mondiale de la Santé et à l'article X, paragraphe 2, de l'accord entre l'Organisation des Nations Unies et l'Organisation mondiale de la Santé, cette dernière Organisation a décidé de soumettre deux questions à la Cour pour avis consultatif. La résolution est ainsi conçue :

« La trente-troisième Assemblée mondiale de la Santé,

Tenant compte des propositions visant à transférer en un autre lieu le Bureau régional de la Méditerranée orientale qui se trouve actuellement à Alexandrie ;

Prenant note des divergences de vues qui se sont fait jour à l'Assemblée mondiale de la Santé sur le point de savoir si l'Organisation mondiale de la Santé est en droit de transférer le Bureau régional sans tenir compte des dispositions de la section 37 de l'accord entre l'Organisation mondiale de la Santé et l'Égypte en date du 25 mars 1951 ;

Notant en outre que le groupe de travail du Conseil exécutif n'a pas été en mesure de décider si la section 37 dudit accord devait ou non être appliquée ni de formuler une recommandation à ce sujet,

*Décide*, avant de prendre une décision au sujet du déplacement du Bureau régional, et conformément à l'article 76 de la Constitution de l'Organisation mondiale de la Santé ainsi qu'à l'article X de l'accord entre l'Organisation des Nations Unies et l'Organisation mondiale de la Santé approuvé par l'Assemblée générale des Nations Unies le 15 novembre 1947, de demander à la Cour internationale de Justice de rendre un avis consultatif sur les questions suivantes :

« 1. Les clauses de négociation et de préavis énoncées dans la section 37 de l'accord du 25 mars 1951 entre l'Organisation mondiale de la Santé et l'Égypte sont-elles applicables au cas où l'une ou l'autre partie à l'accord souhaite que le Bureau régional soit transféré hors du territoire égyptien ?

2. Dans l'affirmative, quelles seraient les responsabilités juridiques tant de l'Organisation mondiale de la Santé que de l'Égypte en ce qui concerne le Bureau régional à Alexandrie, au cours des deux ans séparant la date de dénonciation de l'accord et la date où celui-ci deviendrait caduc ? »

2. Par lettre du 6 juin 1980, le Greffier a notifié la requête pour avis consultatif à tous les Etats admis à ester devant la Cour, conformément à l'article 66, paragraphe 1, du Statut.

3. Le Président de la Cour ayant décidé, conformément à l'article 66, paragraphe 2, du Statut, que les Etats membres de l'Organisation mondiale de la Santé admis à ester devant la Cour ainsi que l'Organisation elle-même étaient susceptibles de fournir des renseignements sur les questions soumises à la Cour, il a, par ordonnance du 6 juin 1980, fixé au 1<sup>er</sup> septembre 1980 la date d'expiration du délai dans lequel ces Etats pourraient présenter des exposés écrits. La communication spéciale et directe prévue à l'article 66, paragraphe 2, du Statut a été

Article 66, paragraph 2, of the Statute was included in the above-mentioned letters of 6 June 1980 addressed to those States, and a similar communication was addressed to the WHO.

4. The following States submitted written statements to the Court within the time-limit fixed by the Order of 6 June 1980 ; Bolivia, Egypt, Iraq, Jordan, Kuwait, Syrian Arab Republic, United Arab Emirates, United States of America. The texts of these statements were transmitted to the States to which the special and direct communication had been sent, and to the WHO.

5. Pursuant to Article 65, paragraph 2, of the Statute and Article 104 of the Rules of Court, the Director-General of the WHO transmitted to the Court a dossier of documents likely to throw light upon the questions. This dossier was received in the Registry on 11 June 1980 ; it was not accompanied by a written statement, a synopsis of the case or an index of the documents. In response to requests by the President of the Court, the WHO supplied the Court, for its information, with a number of additional documents, and the International Labour Organisation supplied the Court with documents of that Organisation regarded as likely to throw light on the questions before the Court.

6. By a letter of 15 September 1980, the Registrar requested the States Members of the WHO entitled to appear before the Court to inform him whether they intended to submit an oral statement at the public sittings to be held for that purpose, the date fixed for which was notified to them at the same time.

7. Pursuant to Article 106 of the Rules of Court, the Court decided to make the written statements submitted to the Court accessible to the public, with effect from the opening of the oral proceedings.

8. In the course of three public sittings held on 21, 22 and 23 October 1980, oral statements were addressed to the Court by the following representatives :

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| For the <i>United Arab Emirates</i> :     | Mr. Mustafa Kamil Yasseen, Special Counsellor of the Mission of the United Arab Emirates at Geneva. |
| For the <i>Republic of Tunisia</i> :      | Mr. Abdelhawab Chérif, Counsellor, Embassy of Tunisia at The Hague.                                 |
| For the <i>United States of America</i> : | Mr. Stephen M. Schwebel, Deputy Legal Adviser, Department of State.                                 |
| For the <i>Syrian Arab Republic</i> :     | Mr. Adnan Nachabé, Legal Adviser to the Ministry of Foreign Affairs.                                |
| For the <i>Arab Republic of Egypt</i> :   | H.E. Mr. Ahmed Osman, Ambassador of Egypt to Austria.   |

In reply to a question by the President, Mr. Claude-Henri Vignes, Director of the Legal Division of the WHO, stated at the public sitting that the WHO did not intend to submit argument to the Court on the questions put in the request for Opinion, but that he would be prepared, on behalf of the Director-General, to answer any question that the Court might put to him. Questions were put by Members of the Court to the Government of Egypt and to the WHO ; replies were given by the representative of Egypt and by the Director of the Legal Division of the WHO, and additional observations were made by the representatives of the United States of America and the United Arab Emirates.

incorporée en conséquence à la lettre qui a été adressée à ces Etats le 6 juin 1980. Une communication analogue a été faite à l'OMS.

4. Les Etats énumérés ci-après ont soumis à la Cour des exposés écrits dans le délai fixé par l'ordonnance du 6 juin 1980 : Bolivie, Egypte, Emirats arabes unis, Etats-Unis d'Amérique, Irak, Jordanie, Koweït, République arabe syrienne. Le texte de ces exposés a été transmis aux Etats à qui la communication spéciale et directe avait été envoyée ainsi qu'à l'OMS.

5. Conformément à l'article 65, paragraphe 2, du Statut et à l'article 104 du Règlement, le Directeur général de l'OMS a transmis à la Cour un dossier de documents pouvant servir à élucider les questions. Ce dossier, qui est parvenu au Greffe le 11 juin 1980, n'était pas accompagné d'un exposé écrit, d'un sommaire de l'affaire ou d'un index des documents. A la demande du Président de la Cour, l'OMS a fourni à la Cour, pour information, divers documents supplémentaires et l'Organisation internationale du Travail lui a fait tenir certains de ses propres documents, considérés comme pouvant servir à élucider les questions dont la Cour est saisie.

6. Par lettre du 15 septembre 1980 le Greffier a prié les Etats membres de l'OMS admis à ester devant la Cour de lui faire savoir s'ils avaient l'intention de présenter un exposé oral pendant les audiences qui se tiendraient à cette fin, dont la date leur était simultanément notifiée.

7. Conformément à l'article 106 du Règlement, la Cour a décidé de rendre accessible au public le texte des exposés écrits à la date d'ouverture de la procédure orale.

8. Au cours de trois audiences publiques tenues les 21, 22 et 23 octobre 1980, la Cour a entendu, en leurs exposés oraux, les représentants ci-après :

pour les <i>Emirats arabes unis</i> :	M. Mustafa Kamil Yasseen, conseiller spécial de la mission des Emirats arabes unis à Genève ;
pour la <i>République de Tunisie</i> :	M. Abdelhawab Chérif, conseiller, ambassade de Tunisie à La Haye ;
pour les <i>Etats-Unis d'Amérique</i> :	M. Stephen M. Schwebel, conseiller juridique adjoint du département d'Etat ;
pour la <i>République arabe syrienne</i> :	M. Adnan Nachabé, conseiller juridique au ministère des affaires étrangères ;
pour la <i>République arabe d'Egypte</i> :	S. Exc. M. Ahmed Osman, ambassadeur d'Egypte en Autriche.

Sur interrogation du Président, M. Claude-Henri Vignes, directeur de la division juridique de l'Organisation mondiale de la Santé, a déclaré à l'audience que l'OMS n'avait pas l'intention d'exposer des arguments à la Cour sur les questions énoncées dans la demande d'avis mais qu'il serait prêt à répondre, au nom du Directeur général, à celles que lui poserait éventuellement la Cour. Des membres de la Cour ont posé des questions au Gouvernement de l'Egypte et à l'Organisation mondiale de la Santé ; le représentant de l'Egypte et le directeur de la division juridique de l'OMS y ont respectivement répondu, et les représentants des Etats-Unis d'Amérique et des Emirats arabes unis ont présenté des observations complémentaires.



9. At the close of the public sitting held on 23 October 1980, the President of the Court indicated that the Court remained ready to receive any further observations which the Director of the Legal Division of the WHO or the representatives of the States concerned might wish to submit in writing within a stated time-limit. In pursuance of this invitation, the Governments of the United States of America and Egypt transmitted certain written observations to the Court on 24 October and 29 October 1980 respectively ; copies of these were supplied to the representatives of the other States which had taken part in the oral proceedings, as well as to the WHO. Certain further documents were also supplied to the Court by the WHO after the close of the oral proceedings, in response to a request made by a Member of the Court.

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10. The first, and principal, question submitted to the Court in the request is formulated in hypothetical terms :

“1. Are the negotiation and notice provisions of Section 37 of the Agreement of 25 March 1951 between the World Health Organization and Egypt applicable in the event that either party to the Agreement wishes to have the Regional Office transferred from the territory of Egypt ?”

But a rule of international law, whether customary or conventional, does not operate in a vacuum ; it operates in relation to facts and in the context of a wider framework of legal rules of which it forms only a part. Accordingly, if a question put in the hypothetical way in which it is posed in the request is to receive a pertinent and effectual reply, the Court must first ascertain the meaning and full implications of the question in the light of the actual framework of fact and law in which it falls for consideration. Otherwise its reply to the question may be incomplete and, in consequence, ineffectual and even misleading as to the pertinent legal rules actually governing the matter under consideration by the requesting Organization. The Court will therefore begin by setting out the pertinent elements of fact and of law which, in its view, constitute the context in which the meaning and implications of the first question posed in the request have to be ascertained.

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11. The existence at the present day of a Regional Office of the World Health Organization located at Alexandria has its origin in two main circumstances. One is the policy adopted by the WHO in 1946, which is expressed in Chapter XI of the text of its Constitution, of establishing regional health organizations designed to be an *integral part of the Organization*. The other is the fact that at the end of the Second World War there existed at Alexandria a health Bureau which, pursuant to that policy

9. A la clôture de l'audience du 23 octobre 1980, le Président a indiqué que la Cour demeurerait disposée à recevoir toutes nouvelles observations que le directeur de la division juridique de l'OMS ou les représentants des Etats intéressés pourraient vouloir soumettre par écrit dans un délai qui était spécifié. Répondant à cette invitation, les Gouvernements des Etats-Unis d'Amérique et de l'Egypte ont respectivement adressé à la Cour, les 24 et 29 octobre 1980, certaines observations écrites dont le texte a été communiqué aux représentants des autres Etats qui avaient pris part à la procédure orale ainsi qu'à l'OMS. A la demande d'un membre de la Cour l'OMS a en outre fourni divers autres documents à la Cour après la clôture de la procédure orale.

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10. La première et principale question posée à la Cour dans la requête est formulée en termes hypothétiques :

« 1. Les clauses de négociation et de préavis énoncées dans la section 37 de l'accord du 25 mars 1951 entre l'Organisation mondiale de la Santé et l'Egypte sont-elles applicables au cas où l'une ou l'autre partie à l'accord souhaite que le Bureau régional soit transféré hors du territoire égyptien ? »

Or une règle du droit international, coutumier ou conventionnel, ne s'applique pas dans le vide ; elle s'applique par rapport à des faits et dans le cadre d'un ensemble plus large de règles juridiques dont elle n'est qu'une partie. Par conséquent, pour qu'une question présentée dans les termes hypothétiques de la requête puisse recevoir une réponse pertinente et utile, la Cour doit d'abord s'assurer de sa signification et en mesurer toute la portée dans la situation de fait et de droit où il convient de l'examiner. S'il en allait autrement, la réponse de la Cour à la question posée risquerait d'être incomplète et, partant, d'être inefficace, voire d'induire en erreur sur les règles juridiques pertinentes régissant en fait le sujet examiné par l'Organisation requérante. La Cour commencera donc par énoncer les éléments de fait et de droit pertinents qui, selon elle, forment le contexte dans lequel le sens et la portée de la première question posée dans la requête doivent être recherchés.

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11. Le Bureau régional de l'Organisation mondiale de la Santé, actuellement situé à Alexandrie, doit son origine à deux faits principaux. Le premier est la politique adoptée en 1946 par l'OMS et exprimée au chapitre XI de sa Constitution, qui consiste à établir des organisations régionales de santé devant faire partie intégrante de l'Organisation. L'autre est la présence à Alexandrie, à la fin de la seconde guerre mondiale, d'un bureau sanitaire qui, en exécution de la politique susmentionnée et

and by agreement between Egypt and the WHO, was subsequently incorporated in the Organization in the manner hereafter described.

12. Article 44 of the WHO Constitution empowers the World Health Assembly to define geographical areas in which it is desirable to establish a regional organization and, with the consent of a majority of the members of the Organization situated within the area, to establish the regional organization. It also provides that there is not to be more than one regional organization in each area. Articles 45 and 46 proceed to lay down that each such regional organization is to be an integral part of the Organization and to consist of a regional committee and a regional office. Articles 47-53 then set out rules to regulate the composition, functions, procedure and staff of regional committees. Finally, Article 54, which contains special provisions regarding the "integration" of pre-existing inter-governmental regional health organizations, reads as follows :

"The Pan American Sanitary Organization represented by the Pan American Sanitary Bureau and the Pan American Sanitary Conferences, and all other inter-governmental regional health organizations in existence prior to the date of signature of this Constitution, shall in due course be integrated with the Organization. This integration shall be effected as soon as practicable through common action based on mutual consent of the competent authorities expressed through the organizations concerned."

The above-mentioned provisions of Chapter XI are thus the constitutional framework within which the WHO came to establish its regional office in Egypt.

13. The existence of a health bureau in Alexandria dates back to the creation of a general Board of Health in Egypt in 1831 for the purpose of preventing the spread of cholera and other diseases by and among pilgrims on the way to and from Mecca. This Board subsequently acquired a certain international character as a result of the association with its quarantine work of seven representatives of States having rights in Egypt under the capitulations régime ; and in 1892 its character as an international health agency became more pronounced as a result of changes in the structure of its council effected by the International Sanitary Convention of Venice of that year. In this form the *Conseil sanitaire maritime et quarantenaire d'Egypte* operated successfully for over forty years, during which, by arrangement with the *Office international d'hygiène publique* and pursuant to the International Sanitary Convention of 1926, it also functioned as the Regional Bureau of Epidemiological Intelligence for the Near East. In 1938, at the request of the Egyptian Government, it was decided, at the International Sanitary Conference of that year that the *Conseil sanitaire* should be abolished and its functions assumed by the governments of Egypt and the other countries concerned, but this did not involve the suppression of the Regional Bureau of Epidemiological Intelligence. The new Bureau, although placed under the authority of the Egyptian Gov-

par accord entre l'Égypte et l'OMS, a été ultérieurement intégré dans l'Organisation suivant le processus exposé ci-après.

12. L'article 44 de la Constitution de l'OMS habilite l'Assemblée mondiale de la Santé à déterminer les régions géographiques où il est désirable d'établir une organisation régionale et, avec le consentement de la majorité des Etats membres situés dans chaque région ainsi déterminée, à y établir une organisation régionale. Le même article dispose qu'il ne pourra y avoir plus d'une organisation de ce genre dans chaque région. Les articles 45 et 46 prévoient ensuite que chacune des organisations régionales fait partie intégrante de l'Organisation et comporte un comité régional et un bureau régional. Puis les articles 47 à 53 régissent la composition, les fonctions, le règlement et le personnel des comités régionaux. Enfin l'article 54 contient des dispositions particulières relatives à l'« intégration » d'organisations régionales intergouvernementales de santé préexistantes ; cet article est ainsi rédigé :

« L'Organisation sanitaire panaméricaine, représentée par le bureau sanitaire panaméricain et les conférences sanitaires panaméricaines, et toutes autres organisations régionales intergouvernementales de santé existant avant la date de la signature de cette Constitution, seront intégrées en temps voulu dans l'Organisation. Cette intégration s'effectuera dès que possible par une action commune, basée sur le consentement mutuel des autorités compétentes exprimé par les organisations intéressées. »

Les dispositions susmentionnées du chapitre XI constituent donc le cadre constitutionnel dans lequel l'OMS a établi son Bureau régional en Égypte.

13. L'existence d'un bureau sanitaire à Alexandrie remonte à la création en Égypte, en 1831, d'une commission générale de la santé destinée à enrayer la propagation du choléra et autres maladies dont les pèlerins allant à La Mecque ou en revenant étaient porteurs. Cette commission a acquis par la suite un certain caractère international quand sept représentants d'Etats bénéficiaires du régime des capitulations en Égypte ont été associés à ses travaux en matière de quarantaine ; son caractère d'organisme sanitaire international s'est affirmé quand la convention sanitaire internationale de Venise de 1892 a modifié la structure de son conseil. Le Conseil sanitaire maritime et quarantenaire d'Égypte a fonctionné avec succès sous cette forme pendant plus de quarante ans, au cours desquels, à la suite d'un arrangement conclu avec l'Office international d'hygiène publique et conformément à la convention sanitaire internationale de 1926, il a aussi assumé les fonctions de Bureau régional de renseignements épidémiologiques pour le Proche-Orient. La conférence sanitaire internationale tenue en 1938 a décidé, à la demande du Gouvernement de l'Égypte, que le Conseil sanitaire serait aboli et que ses fonctions seraient prises en charge par les Gouvernements de l'Égypte et des autres Etats concernés, mais cela n'entraînait pas la disparition du Bureau régional de renseignements épidémiologiques. Le nouveau Bureau, quoique placé sous

ernment, was to have the same international character as the former Bureau ; the Egyptian Government was to set up a commission including technical representatives of the affiliated countries. From 1938 onwards the expenses of the Bureau were wholly borne by the Egyptian Government. The Second World War broke out before the projected commission had been constituted, and from December 1940 until the end of hostilities the work of the Alexandria Bureau was taken over by a special wartime service under the Quarantine Department of the Egyptian Ministry of Public Health. After the hostilities had ended, the Bureau resumed its operations.

14. It has not been made entirely clear to the Court what was the exact situation in regard to the Alexandria Sanitary Bureau as a result of the events just described. But it was operating under Egypt's Ministry of Public Health when in 1946, and before the WHO Constitution had been adopted, Egypt raised the question of the relation of the Bureau to the Organization. Even before that, the members of the newly created League of Arab States had taken a decision in favour of using the Alexandria Bureau as their regional sanitary bureau. Meanwhile, however, the Alexandria Bureau was continuing to operate under the Egyptian sanitary authorities rather than as an inter-governmental institution. On the other hand, the projected association of the Bureau with the League of Arab States, the international character of its functions and its previous status may have led to the Bureau being regarded as an inter-governmental institution. This no doubt explains why, as will now be seen, the Alexandria Sanitary Bureau, despite any question there may have been as to its inter-governmental character, was in fact dealt with by the Organization as a case of integration under Article 54 of the WHO Constitution.

15. On 6 March 1947, at the direction of the WHO Interim Commission, the Executive Secretary of the Commission sent a circular letter to member governments enquiring as to whether they might wish to have either the headquarters of the organization or the seat of a regional office located on their territory and as to the facilities they could offer. Soon afterwards he was also directed to get in touch with the authorities "of the Pan Arab Sanitary Organization", and wrote on 2 May 1947 for information to the Egyptian Minister of Public Health. Replying on 26 July 1947, the Egyptian Minister supplied him with a memorandum giving an account of the history and activities of the "Pan Arab Regional Health Bureau" from 1926 onwards. When, on the basis of the memorandum, a recommendation was made by the Committee on Relations to the Interim Commission in September 1947 that negotiations should be started with the "Pan Arab Sanitary Organization", objection was taken that the Pan Arab Sanitary Bureau did not really exist. Some delegates observed that the negotiations should rather be with the Egyptian Government and, ultimately, it was with the Egyptian Government that the negotiations concerning the Bureau took place. In fact, the next development was a reply from the Egyptian Government to the Executive Secretary's circular

l'autorité du Gouvernement de l'Égypte, devait avoir le même caractère international que l'ancien Bureau. Le Gouvernement de l'Égypte devait créer une commission comprenant des représentants techniques des pays affiliés de la région. A partir de 1938 il a assumé en totalité les dépenses du Bureau. La seconde guerre mondiale a éclaté avant la constitution de la commission projetée et, de décembre 1940 à la fin des hostilités, les tâches du Bureau d'Alexandrie ont été confiées à un service spécial de guerre relevant du département de la quarantaine du ministère de l'hygiène publique d'Égypte. A la fin des hostilités, le Bureau a repris ses activités.

14. La situation exacte du Bureau sanitaire d'Alexandrie à la suite des événements qui viennent d'être évoqués n'a pas été présentée à la Cour avec une clarté totale. Cependant le Bureau fonctionnait sous l'autorité du ministère de l'hygiène publique d'Égypte quand, en 1946, avant que la Constitution de l'OMS eût été adoptée, l'Égypte a soulevé la question des relations du Bureau avec l'Organisation. Auparavant les membres de la Ligue des Etats arabes qui venait d'être créée avaient pris une décision favorable à l'utilisation du Bureau d'Alexandrie à titre de bureau sanitaire régional. Entre-temps le Bureau d'Alexandrie continuait à fonctionner sous la direction des autorités sanitaires égyptiennes et non comme une institution intergouvernementale. En revanche le projet d'association du Bureau avec la Ligue des Etats arabes, le caractère international de ses fonctions et son ancien statut ont pu amener à voir en lui une institution intergouvernementale. Cela explique sans doute pourquoi le Bureau sanitaire d'Alexandrie, malgré les questions qui auraient pu se poser au sujet de son caractère intergouvernemental, a été en fait traité par l'Organisation comme un cas d'intégration au sens de l'article 54 de la Constitution de l'OMS, ainsi qu'on le verra ci-après.

15. Le 6 mars 1947, sur l'instruction de la Commission intérimaire de l'OMS, le secrétaire exécutif de cette Commission a adressé une circulaire aux gouvernements des Etats membres, leur demandant s'ils souhaiteraient que le siège de l'Organisation ou celui d'un bureau régional fût établi sur leur territoire et quelles facilités ils pourraient offrir. Peu après, ayant été chargé en outre de se mettre en rapport avec les autorités de l'« Organisation sanitaire panarabe », il a demandé des renseignements au ministre de l'hygiène publique d'Égypte par lettre du 2 mai 1947. Répondant le 26 juillet 1947, le ministre lui a fourni une note sur l'origine et les activités du « Bureau sanitaire régional panarabe » depuis 1926. Quand, sur la base de la note, le comité des relations a recommandé en septembre 1947 à la Commission intérimaire que des négociations soient entamées avec l'« Organisation sanitaire panarabe », il a été objecté que le Bureau sanitaire panarabe n'existait pas en réalité. Certains délégués ont fait observer que les négociations devraient plutôt être menées avec le Gouvernement de l'Égypte, et c'est avec celui-ci qu'elles se sont en effet déroulées. Le Gouvernement de l'Égypte a d'ailleurs répondu peu après à la circulaire du secrétaire exécutif en faisant savoir que les autorités compétentes avaient montré le vif intérêt qu'elles portaient à voir s'établir un

letter in which the Government stated that the competent authorities had declared that they were most anxious to see a regional bureau established at Alexandria, which could deal with all questions coming within the scope of the WHO for the entire Middle East.

16. Matters then began to move more quickly. It appears from a report submitted to the Interim Commission in May 1948, mentioned below, that early in January 1948 quarantine experts of the Arab countries met in Alexandria and passed a number of resolutions in favour of establishing a regional organization. This was to be composed of the member States of the League of Arab States and, it was contemplated, certain other States in the region ; it was to have a regional committee similarly composed ; and it was to use the Alexandria Bureau as its regional office. These resolutions were adopted in the light of the fact that the WHO was to take over the functions of pre-existing regional health organizations. The next step was an invitation from the Egyptian Ministry of Public Health to Dr. Stampar, Chairman of the Interim Commission, to visit Egypt and study on the spot the conditions for setting up the proposed regional organization. In May 1948 a substantial report, referred to above, was duly submitted by the Chairman of the Interim Commission in which he gave a detailed account of the past history and current activities of the Alexandria Bureau and set out the arguments in favour of it as the regional health centre for the Near and Middle East. He ended the report with the conclusion :

“we are bound to admit that the conditions which predestinate Alexandria to be the centre of the future regional health organization for the Near and the Middle East are literally unique”.

The Constitution of the WHO had now come into force and the question of the Alexandria Bureau was discussed in the Committee on Headquarters and Regional Organization at the first session of the new World Health Assembly. Mention was made of the facts that most of the member States of the Eastern Mediterranean area had agreed to the proposal for the establishment of a regional organization in that area, that the Alexandria Bureau was a pre-existing sanitary bureau, and that preliminary steps had already been taken for the final integration of this bureau with the WHO. Taking those facts into account the Committee recommended that the Executive Board should be instructed to integrate the Bureau with the WHO as soon as practicable, through common action, “in accordance with Article 54 of the WHO Constitution”, and this recommendation was approved by the World Health Assembly on 10 July 1948 (resolution WHA1.72).

17. The Director-General of the WHO then proceeded to organize the setting up of a Regional Committee for the Eastern Mediterranean and an agenda was drawn up for its inaugural meeting due to take place on 7 February 1949. Earlier, the Executive Secretary of the Interim Commission had negotiated successfully with the Swiss Government the text of an

bureau régional à Alexandrie, qui pourrait traiter toutes les questions relevant de l'OMS pour tout le Moyen-Orient.

16. Les choses ont alors commencé à évoluer plus rapidement. Il ressort d'un rapport soumis à la Commission intérimaire en mai 1948 dont il est fait mention ci-après qu'au début du mois de janvier 1948 des experts des pays arabes en matière de quarantaine se sont réunis à Alexandrie et ont adopté des résolutions prévoyant la constitution d'une organisation régionale. Celle-ci devait se composer des Etats membres de la Ligue des Etats arabes ainsi, prévoyait-on, que de certains autres Etats de la région, avoir un comité régional de composition analogue et utiliser le Bureau d'Alexandrie comme bureau régional. Ces résolutions ont été adoptées en prévision de la reprise par l'OMS des fonctions des organisations régionales de santé préexistantes. Ensuite le ministère de l'hygiène publique d'Egypte a invité le docteur A. Stampar, président de la Commission intérimaire, à se rendre en Egypte pour étudier sur place les conditions de l'établissement de l'organisation régionale projetée. En mai 1948 le président a présenté l'important rapport de la Commission intérimaire qui vient d'être mentionné, dans lequel il rendait compte en détail des antécédents et de l'activité du Bureau d'Alexandrie et exposait les arguments militant en faveur du choix de ce Bureau comme centre sanitaire régional pour le Proche et le Moyen-Orient. Il terminait en ces termes :

« On arrive nécessairement à la conclusion que les conditions qui militent en faveur du choix d'Alexandrie comme centre de la future organisation sanitaire régionale pour le Proche et le Moyen-Orient sont absolument exceptionnelles. »

La Constitution de l'OMS étant entrée en vigueur, la question du Bureau d'Alexandrie a été examinée par la commission du siège et de l'organisation régionale à la première session de la nouvelle Assemblée mondiale de la Santé. Il a été rappelé que la majorité des Etats membres de la région de la Méditerranée orientale avait accepté la proposition d'y établir une organisation régionale, que le Bureau d'Alexandrie était un bureau sanitaire préexistant et que des démarches préliminaires avaient déjà été faites en vue de l'intégration définitive de ce Bureau dans l'OMS. Cela étant, la commission a recommandé de charger le Conseil exécutif d'intégrer le Bureau régional d'Alexandrie dans l'OMS dès que possible, par une action commune, « conformément à l'article 54 de la Constitution » et cette recommandation a été approuvée par l'Assemblée mondiale de la Santé le 10 juillet 1948 (résolution WHA1.72).

17. Le Directeur général de l'OMS a donc entrepris de constituer un Comité régional de la Méditerranée orientale et un ordre du jour a été rédigé pour sa réunion inaugurale devant s'ouvrir le 7 février 1949. Auparavant le secrétaire exécutif de la Commission intérimaire avait abouti dans ses négociations avec le Gouvernement suisse au sujet du texte d'un



agreement for the WHO's headquarters in Geneva which had been approved by the First World Health Assembly on 17 July 1948 and by Switzerland on 21 August 1948 ; and a model host agreement had been prepared in the WHO for use in negotiations concerning the seats of regional or local WHO offices. Accordingly, when the agenda was drawn up for the Regional Committee's inaugural meeting on 7 February 1949, included in it was the question of a "Draft Agreement with the Host Government of the Regional Office".

18. At the Regional Committee's meeting the Egyptian Delegation informed the Committee on 7 February 1949 that the Egyptian Council of Ministers had just

"agreed, subject to approval of the Parliament, to lease to the World Health Organization, for the use of the Regional Office for the Eastern Mediterranean area, the site of land and the building thereon which are at present occupied by the Quarantine Administration and the Alexandria Health Bureau, for a period of nine years at a nominal annual rent of P.T.10".

The Committee next took up the question of the location of the Regional Office for the Eastern Mediterranean area. A motion was introduced, which the Committee at once approved, "to recommend to the Director-General and the Executive Board, subject to consultation with the United Nations, the selection of Alexandria as the site of the Regional Office". The recitals in the formal resolution to that effect, adopted the following day referred, *inter alia*, to "the desirability of the excellent site and buildings under favourable conditions generously offered by the Government of Egypt".

19. The Regional Committee also addressed itself to the question of the integration of the Alexandria Sanitary Bureau with the WHO. After recalling that a Committee of the Arab States had previously voted in favour of the integration, the Egyptian delegate observed that, should this happen, "the WHO would have to take over expenses from the date of opening of the Regional Office". A few brief explanations having been given, the Committee adopted a resolution recommending the integration of the Bureau in the following terms :

"Resolves to recommend to the Executive Board that in establishing the Regional Organization and the Regional Office for the Eastern Mediterranean the functions of the Alexandria Sanitary Bureau be integrated within those of the Regional Organization of the World Health Organization."

The Egyptian delegate responded by presenting a written statement to the Committee to the effect that, taking into account the resolution just adopted, his Government was pleased to transfer to the World Health Organization the functions and all related files and records of the Alexandria Sanitary Bureau. The statement went on to say that this transfer

accord concernant le siège de l'OMS à Genève, lequel accord avait été approuvé par la première Assemblée mondiale de la Santé le 17 juillet 1948 et par la Suisse le 21 août 1948 ; et l'on avait mis au point à l'OMS le texte d'un modèle d'accord avec les Etats hôtes, destiné à être utilisé lors des négociations relatives aux sièges de bureaux régionaux ou locaux de l'OMS. En conséquence l'ordre du jour de la réunion inaugurale du Comité régional du 7 février 1949 comportait une question intitulée « Projet d'accord avec l'Etat hôte du Bureau régional ».

18. Le 7 février 1949, la délégation égyptienne a fait savoir au Comité régional qu'un conseil des ministres tenu tout récemment avait

« accepté, sous réserve de la ratification du Parlement, de louer à l'Organisation mondiale de la Santé, à l'usage du Bureau régional pour la Méditerranée orientale, la parcelle de terrain et le bâtiment y élevé, lesquels sont actuellement occupés par l'Administration quarantenaire et le Bureau sanitaire d'Alexandrie, et ce, pour une durée de 9 ans, à un loyer nominal annuel de P.T. 10 ».

Le Comité a ensuite examiné la question de l'emplacement du Bureau régional de la Méditerranée orientale. Une motion a été présentée, que le Comité a approuvée immédiatement, « recommandant au Directeur général et au Conseil exécutif, sous réserve d'en référer aux Nations Unies, le choix d'Alexandrie comme siège du Bureau régional ». Les considérants de la résolution formelle adoptée à cet effet le lendemain faisaient notamment état de « la facilité de pouvoir disposer d'un excellent emplacement et de bâtiments, à des conditions favorables, gracieusement offerts par le Gouvernement égyptien ».

19. Le Comité régional s'est aussi penché sur la question de l'intégration du Bureau sanitaire d'Alexandrie dans l'OMS. Après avoir rappelé qu'un comité des Etats arabes s'était prononcé auparavant en faveur de l'intégration, le délégué de l'Egypte a fait observer que, quand celle-ci serait réalisée, « l'OMS aura[it] à prendre à sa charge les dépenses à partir de la date de l'ouverture du Bureau régional ». Quelques brefs éclaircissements ayant été donnés, le Comité a adopté une résolution recommandant l'intégration du Bureau dans les termes suivants :

« Décide de recommander au Conseil exécutif que, lors de l'établissement de l'organisation régionale et du Bureau régional pour la Méditerranée orientale, les fonctions du Bureau sanitaire d'Alexandrie soient intégrées dans celles de l'organisation régionale de l'Organisation mondiale de la Santé. »

Le délégué de l'Egypte a alors présenté une déclaration écrite au Comité indiquant que, en raison de la résolution qui venait d'être adoptée, son Gouvernement était heureux de transférer les fonctions du Bureau sanitaire d'Alexandrie et tous ses dossiers et archives à l'OMS. Il était précisé dans ce texte que le transfert aurait lieu à la date à laquelle l'Organisation

would be made on the date on which the Organization notified the Government of Egypt of the commencement of operations in the Regional Office for the Eastern Mediterranean Region. That statement having met with warm thanks from the Committee, the Egyptian delegate proposed that the work of the Regional Office should begin in July 1949 and this proposal was adopted.

20. The Director-General now raised the question of the "Draft Agreement with the Host Government" which he had included in the Agenda. He said he wished to inform the Committee that "such a draft agreement had been produced and handed to the Egyptian Government where it was under study in the legal department". He also stated that the WHO, "though always considering necessary formalities, never allowed them to interfere with Health Work", and the Egyptian delegate then added the comment that, should there be any difference of opinion between the WHO and the legal expert, this could be settled by negotiation.

21. The question passed to the Executive Board of the WHO which, in March 1949, adopted resolution EB3.R30 "conditionally" approving selection of Alexandria as the site of the Regional Office, "subject to consultation with the United Nations". That resolution went on to request the Director-General to thank Egypt for "its generous action" in placing the site and buildings at Alexandria at the disposal of the Organization for nine years at a nominal rent. Next, it formally approved the establishment of the Regional Office for the Eastern Mediterranean and the commencement of its operations on or about 1 July 1949. The resolution then endorsed the Regional Committee's recommendation that the "functions" of the Alexandria Sanitary Bureau be "integrated" within those of the Regional Organization. It further authorized the Director-General to express appreciation to the Egyptian Government for the transfer of the "functions, files and records of the Alexandria Sanitary Bureau to the Organization upon commencement of operations in the Regional Office". The resolution did not deal with the projected host agreement still under negotiation with the Egyptian Government. Pursuant to the Agreement between the WHO and the United Nations which came into force on 10 July 1948 (Article XI), the consultation with the United Nations referred to in the resolution was effected in May 1949. This confirmed the selection of Alexandria as the site of the Regional Office.

22. However the draft host agreement, which necessarily had implications not only for the Ministry of Public Health but for other departments of the Egyptian administration, it would seem, had been undergoing close examination. As appears from a letter of 4 May 1949 from the Ministry of Foreign Affairs to Sir Ali Tewfik Shousha Pasha, then Under-Secretary of State for Public Health but already designated as the first WHO Regional Director for the Eastern Mediterranean, he had been discussing the draft agreement with the Foreign Ministry during April. In that letter the Foreign Ministry referred to the draft agreement as one

notifierait au Gouvernement de l'Égypte le début du fonctionnement du Bureau régional de la Méditerranée orientale. La déclaration ayant été accueillie avec gratitude par le Comité, le délégué de l'Égypte a proposé que le Bureau régional commence ses travaux en juillet 1949 ; cette proposition a été adoptée.

20. Le Directeur général a alors soulevé la question du « projet d'accord avec l'Etat hôte » qu'il avait fait inscrire à l'ordre du jour. Il a indiqué qu'il désirait informer le Comité que ce « projet d'accord a été présenté au Gouvernement égyptien, qui l'a mis à l'étude au Contentieux ». Il a également signalé que l'OMS, « tout en admettant certaines formalités nécessaires, n'acceptait jamais qu'elles puissent mettre obstacle à l'œuvre sanitaire ». Le délégué de l'Égypte a ajouté qu'en cas de divergences d'opinion entre l'OMS et le conseiller juridique la difficulté pourrait être réglée par voie de négociation.

21. La question a été déférée au Conseil exécutif de l'OMS qui, en mars 1949, a adopté la résolution EB3.R30 approuvant « sous condition » le choix d'Alexandrie comme siège du Bureau régional, « cette décision devant être soumise aux Nations Unies ». Dans la même résolution, le Conseil priait le Directeur général de remercier l'Égypte d'avoir « généreusement » mis l'emplacement et les locaux d'Alexandrie à la disposition de l'Organisation pour une période de neuf ans moyennant un loyer nominal. Il approuvait ensuite formellement la création d'un Bureau régional de la Méditerranée orientale qui commencerait à fonctionner le 1<sup>er</sup> juillet 1949 ou vers cette date. Puis il faisait sienne la résolution du Comité régional demandant que les « fonctions » du Bureau sanitaire d'Alexandrie soient « intégrées » dans celles de l'organisation régionale. Le Directeur général était en outre autorisé à exprimer sa satisfaction au Gouvernement de l'Égypte pour le transfert à l'Organisation des « fonctions, dossiers et archives du Bureau sanitaire d'Alexandrie, transfert qui aura[it] lieu au moment où le Bureau régional commencera[it] à fonctionner ». La résolution ne traitait pas de l'accord de siège envisagé, qui était encore en cours de négociation avec le Gouvernement de l'Égypte. Conformément à l'accord entre l'OMS et l'ONU entré en vigueur le 10 juillet 1948 (art. XI), la consultation des Nations Unies mentionnée dans la résolution a eu lieu en mai 1949. Cela a confirmé le choix d'Alexandrie comme siège du Bureau régional.

22. Il apparaît cependant que le projet d'accord, qui avait nécessairement des incidences non seulement pour le ministère de l'hygiène publique mais pour plusieurs autres départements de l'administration égyptienne, faisait alors l'objet d'un examen approfondi. Il ressort d'une lettre adressée le 4 mai 1949 par le ministère des affaires étrangères à sir Ali Tewfik Choucha Pacha, alors sous-secrétaire d'Etat à l'hygiène publique et déjà désigné pour être le premier directeur régional de l'OMS pour la Méditerranée orientale, que celui-ci avait discuté le projet d'accord avec le ministère durant le mois d'avril. Dans sa lettre, le ministère se référait expressément au projet comme étant celui d'un accord

“which the World Health Organization intends to conclude with the Egyptian Government on the privileges and immunities to be enjoyed by its regional office which will be established in Alexandria as well as the staff of that office”.

It explained that it was enclosing a copy of the memorandum prepared by the Contentieux (legal department) of the Ministries of Foreign Affairs and Justice, setting out their comments on the draft agreement, together with a revised draft. The memorandum stated that, in studying the provisions of the draft, the Contentieux had also had regard to various other agreements concluded, or in course of conclusion, between individual States and specialized agencies on the occasion of the latter establishing headquarters or regional offices in their territories. In this connection, it made mention of the headquarters agreements already concluded by France with the United Nations Educational, Scientific and Cultural Organization, and by Switzerland with WHO itself, as well as draft agreements still under negotiation by France and Peru with the International Civil Aviation Organization regarding the seats of regional offices to be established in their territories. The memorandum went on to suggest numerous changes in the provisions of the agreement and gave detailed explanations of the amendments which the Contentieux wished to see in the draft. The memorandum and revised draft, it appears from a later note of Sir Ali Tewfik Shousha Pasha, were then transmitted to the Director-General of the WHO. It also appears from letters of 29 May and 4 June 1949 supplied to the Court by the WHO that some further exchanges took place between him and the Contentieux concerning the draft agreement at this time.

23. Meanwhile, however, the whole question of privileges and immunities for regional offices of international organizations had become at once more complicated and more pressing for the Egyptian administration. This was because by now Regional Bureaux for the Middle East had already been established in Cairo by the Food and Agriculture Organization of the United Nations, by ICAO and by Unesco, and because in any event it was becoming necessary to consider the question of Egypt's adherence to the Convention on the Privileges and Immunities of the Specialized Agencies. The general situation was laid before Egypt's Council of Ministers by the Foreign Minister in a Note of 25 May 1949. His Note ended with a proposal that, as a provisional measure the Council should grant to the staff of FAO, Unesco and WHO in their Regional Offices the same temporary exemption from customs dues on any articles and equipment imported from abroad and relating to their official work as was already enjoyed by ICAO. This proposal was endorsed by the Council of Ministers at a meeting four days later, and the Regional Director was so informed on 23 June. The operations of the Regional Office being due to commence on 1 July, the need to complete the negotiations for the host agreement had been under consideration by the World Health Assembly itself which passed a resolution on the subject on 25 June at its Second

« que l'Organisation mondiale de la Santé a l'intention de conclure avec le Gouvernement égyptien sur les privilèges et immunités dont bénéficier[ont] son Bureau régional qui va être établi à Alexandrie ainsi que les agents de ce Bureau ».

Le ministère ajoutait qu'il joignait une copie du mémorandum rédigé par le Contentieux des ministères des affaires étrangères et de la justice où figuraient des observations sur le projet d'accord, ainsi qu'un projet révisé. Le mémorandum précisait que, en étudiant les dispositions du projet, le Contentieux avait aussi pris en considération divers autres accords qui avaient été conclus, ou étaient sur le point de l'être, entre des Etats et des institutions spécialisées, à l'occasion de l'établissement de sièges ou bureaux régionaux de ces institutions sur leur territoire. A cet égard il était fait mention des accords de siège déjà conclus par la France avec l'Organisation des Nations Unies pour l'éducation, la science et la culture et par la Suisse avec l'OMS, ainsi que des projets d'accords que la France et le Pérou négociaient respectivement avec l'Organisation de l'aviation civile internationale au sujet des bureaux régionaux à établir sur leur territoire. Le mémorandum suggérait ensuite d'apporter de nombreux changements aux dispositions de l'accord et expliquait en détail ceux que le Contentieux jugeait souhaitables. Le mémorandum et le projet révisé ont été transmis au Directeur général de l'OMS, comme paraît l'indiquer une note postérieure de sir Ali Tewfik Choucha Pacha. Il ressort aussi de lettres du 29 mai et du 4 juin 1949 communiquées par l'OMS à la Cour que d'autres échanges ont eu lieu à l'époque entre sir Ali Tewfik Choucha Pacha et le Contentieux au sujet du projet d'accord.

23. Entre-temps toute la question des privilèges et immunités des bureaux régionaux des organisations internationales était devenue à la fois plus complexe et plus pressante pour l'administration égyptienne. En effet l'Organisation des Nations Unies pour l'alimentation et l'agriculture, l'OACI et l'Unesco avaient déjà établi leurs bureaux régionaux pour le Moyen-Orient au Caire et, de toute façon, il devenait nécessaire d'examiner la question de l'adhésion de l'Egypte à la convention sur les privilèges et immunités des institutions spécialisées. La situation générale a été portée par le ministre des affaires étrangères à l'attention du conseil des ministres d'Egypte par note du 25 mai 1949. Cette note proposait en conclusion qu'à titre provisoire le conseil accorde au personnel de la FAO, de l'Unesco et de l'OMS affecté aux bureaux régionaux de ces organisations en Egypte l'exemption temporaire des droits de douane sur tout article ou matériel importé pour les besoins de son activité officielle dont bénéficiait déjà l'OACI. La proposition a été approuvée par le conseil des ministres quatre jours plus tard et le directeur régional en a été avisé le 23 juin 1949. Le Bureau régional devant entrer en service le 1<sup>er</sup> juillet, la nécessité de mener à leur terme les négociations sur l'accord de siège avait été examinée par l'Assemblée mondiale de la Santé elle-même, qui a adopté une résolution à ce sujet le 25 juin pendant sa deuxième session. Par cette

Session. The Director-General was requested to continue the negotiations with the Government of Egypt in order to obtain an agreement extending privileges and immunities to the Regional Organization and to report to the next session. Pending the coming into force of that agreement, the Assembly invited the Government of Egypt to extend to the Organization the privileges and immunities set out in the Convention on the Privileges and Immunities of the Specialized Agencies. Egypt, however, had not yet adhered to that Convention, and it was only the Council of Ministers' decision authorizing, temporarily, exemption from customs dues that applied when the Regional Office commenced operations, as it did on the agreed date, 1 July 1949.

24. The Director-General continued the negotiations and on 26 July 1949 the WHO's comments on the Contentieux' memorandum were transmitted to the Egyptian Government, together with a revised draft of the host agreement and a draft lease of the site and buildings. On 9 November 1949, a host agreement on the same lines as the draft transmitted to Egypt was signed with the Government of India. In February 1950 the Executive Board noted the state of the negotiations ; a letter of 23 March 1950 to the WHO Regional Director from the Contentieux of the Egyptian Government Ministries gave the impression that, subject to minor modifications, WHO's draft was acceptable to Egypt. In that belief the Third World Health Assembly passed a resolution in the following May affirming the Agreement in the form of the WHO's revised draft. Subsequently, however, the Regional Office reported that the Egyptian authorities were, in fact, asking for a number of fairly substantial alterations. As the Director-General considered the amendments requested to touch fundamental points of principle and therefore to be unacceptable, he went himself to Egypt and, in negotiations with the Egyptian authorities on 19 and 20 December 1950, persuaded them to drop the amendments which were the cause of the disagreement. The Egyptian authorities then expressed themselves as ready to accept the host agreement, subject to the approval of the Egyptian Parliament and to certain points being set out in an accompanying Exchange of Notes. Eventually, the Agreement was signed in Cairo on 25 March 1951 and was approved by the Fourth World Health Assembly in May, although one of the points in the Exchange of Notes had given rise to some discussion in the Legal Sub-Committee. The Egyptian Parliament gave its approval towards the end of June and the long-negotiated host agreement finally entered into force on 8 August 1951. As to the lease of the site and buildings of the former Sanitary Bureau to the WHO, which under an Egyptian law also required Parliamentary approval, its execution was not completed until 1955, the operation of the lease then being expressed to have begun several years earlier on 1 July 1949.

25. Mention has finally to be made of an Agreement for the provision of services by the WHO in Egypt, signed on 25 August 1950. At the same time the Court notes that, according to the Director of the Legal Division of the

résolution, le Directeur général était prié de poursuivre les négociations avec le Gouvernement de l'Égypte pour aboutir à un accord en vue de l'octroi de privilèges et d'immunités à l'organisation régionale et de faire rapport à la session suivante. En attendant l'entrée en vigueur de l'accord, l'Assemblée invitait le Gouvernement de l'Égypte à accorder à l'Organisation les privilèges et immunités énoncés dans la convention sur les privilèges et immunités des institutions spécialisées. L'Égypte cependant n'avait pas encore adhéré à cette convention, et ce n'est que la décision du conseil des ministres autorisant temporairement l'exemption des droits de douane qui s'est appliquée à la date convenue pour l'entrée en service du Bureau régional, le 1<sup>er</sup> juillet 1949.

24. Le Directeur général a poursuivi les négociations, et les observations de l'OMS sur le mémorandum du Contentieux ont été transmises au Gouvernement de l'Égypte le 26 juillet 1949, en même temps qu'un projet révisé d'accord de siège et un projet de bail pour le terrain et les bâtiments. Le 9 novembre 1949 un accord de siège analogue au projet transmis à l'Égypte a été signé avec le Gouvernement de l'Inde. En février 1950 le Conseil exécutif a noté l'état d'avancement des négociations ; le 23 mars 1950 une lettre du Contentieux des ministères égyptiens au directeur régional de l'OMS donnait l'impression que, sous réserve de légères modifications, le projet de l'OMS serait acceptable pour l'Égypte. C'est dans cette conviction que la troisième Assemblée mondiale de la Santé a adopté en mai suivant une résolution entérinant l'accord sous la forme du projet révisé de l'OMS. Par la suite cependant le Bureau régional a fait savoir que les autorités égyptiennes demandaient en réalité plusieurs modifications assez importantes. Estimant que ces amendements touchaient des points de principe fondamentaux et étaient donc inacceptables, le Directeur général s'est rendu lui-même en Égypte et, au cours des pourparlers avec les autorités égyptiennes qui ont eu lieu les 19 et 20 décembre 1950, les a persuadées d'abandonner les amendements source du désaccord. Les autorités égyptiennes se sont alors déclarées prêtes à accepter l'accord de siège, sous réserve de l'approbation du Parlement égyptien et étant entendu que certaines questions devaient être précisées dans un échange de notes qui accompagnerait l'accord. Pour finir, l'accord a été signé au Caire le 25 mars 1951, puis approuvé par la quatrième Assemblée mondiale de la Santé en mai, bien que l'un des points de l'échange de notes eût prêté à discussion à la sous-commission juridique. Le Parlement égyptien a donné son approbation vers la fin du mois de juin et l'accord, qui avait fait l'objet de si longues négociations, est finalement entré en vigueur le 8 août 1951. Quant au contrat de bail pour la location à l'OMS du terrain et des bâtiments de l'ancien Bureau sanitaire qui, en vertu de la législation égyptienne, devait aussi être approuvé par le Parlement, ce contrat n'a été définitivement entériné qu'en 1955 ; il y était spécifié que la location avait commencé à courir plusieurs années plus tôt, le 1<sup>er</sup> juillet 1949.

25. Il convient enfin de faire mention d'un accord de fourniture de services conclu le 25 août 1950 entre l'OMS et l'Égypte. La Cour note cependant que, d'après le directeur de la division juridique de l'Organi-



Organization, this Agreement does not have any particular connection with the setting up of the Regional Office in Egypt. The 1950 Agreement, he explained, is simply a standard form of agreement for the execution of technical co-operation projects, similar to Agreements concluded with other member States which have no WHO office situated on their territories.

26. The position appearing from the events which the Court has so far set out may be summarized as follows. During the early years of the WHO, Egypt raised the question of the relation to the new Organization of the existing long-established Alexandria Sanitary Bureau, and the Interim Commission of the WHO in turn approached Egypt regarding the integration of the existing Bureau with the Organization and the location of the WHO's Regional Office for the Eastern Mediterranean in Alexandria. Agreement was then reached between the WHO and Egypt early in 1949 that the operation of the Alexandria Bureau should be taken over by the WHO in July of that year. That agreement was arrived at on the basis of offers by the Egyptian Government to lease to the Organization for the use of the Regional Office for the Eastern Mediterranean the site and buildings of the existing Alexandria Bureau, and to transfer to the Organization the functions and all related files and records of the Bureau. Egypt's offers were accepted by the Organization which, on its part, undertook to assume financial responsibility for the Bureau on the date of the opening of the Regional Office ; and it was then decided that the date should be 1 July 1949. These arrangements were approved by the Egyptian Government and were endorsed by the Organization specifically as an integration of a pre-existing institution under Article 54 of its Constitution. Temporary exemption from customs dues having been provided by Egypt's Council of Ministers, the WHO's Regional Office commenced operating at the seat of the former Sanitary Bureau on 1 July 1949.

27. Meanwhile, negotiations for the conclusion of a host agreement for the Regional Office, begun at least five months earlier, had been making slow progress and were not completed until nearly two years later. On 25 March 1951, however, the Agreement, Section 37 of which is the subject of the present request, was signed and ultimately entered into force on 8 August of that year. That agreement, in the words of its preamble, was concluded :

“for the purpose of determining the privileges, immunities and facilities to be granted by the Government of Egypt to the World Health Organization, to the representatives of its Members and to its experts and officials in particular with regard to its arrangements in the Eastern Mediterranean Region, and of regulating other related matters”.

Its provisions followed closely those of the model host agreement prepared in the WHO, and are for the most part typical of those found in host agreements of headquarters or regional or local offices of international

sation, cet accord est sans rapport particulier avec la création du Bureau régional en Egypte. L'accord de 1950, a-t-il expliqué, ne représente qu'un type d'accord courant portant sur l'exécution de projets de coopération technique, analogue aux accords conclus avec d'autres Etats membres qui n'ont pas de bureau de l'OMS sur leur territoire.

26. La situation, telle qu'elle se dégage des événements que la Cour a évoqués jusqu'ici, peut être résumée comme suit. Dans les premières années d'existence de l'OMS, l'Egypte a soulevé la question des liens entre le Bureau sanitaire d'Alexandrie, établi depuis fort longtemps, et la nouvelle Organisation, puis la Commission intérimaire de l'OMS a approché à son tour l'Egypte au sujet de l'intégration du Bureau dans l'Organisation et de l'installation à Alexandrie du Bureau régional de l'OMS pour la Méditerranée orientale. L'OMS et l'Egypte sont alors convenues, au début de 1949, que les fonctions du Bureau d'Alexandrie seraient reprises par l'OMS en juillet de la même année. L'entente a été conclue sur la base d'offres faites par le Gouvernement de l'Egypte en vue de louer à l'Organisation, à l'usage du Bureau régional de la Méditerranée orientale, le terrain et les bâtiments du Bureau d'Alexandrie et de transférer à l'Organisation les fonctions du Bureau ainsi que tous les dossiers et archives s'y rapportant. Les offres de l'Egypte ont été acceptées par l'Organisation, qui s'est engagée pour sa part à assumer la responsabilité financière du Bureau à dater de l'ouverture du Bureau régional ; il a été ensuite décidé de fixer celle-ci au 1<sup>er</sup> juillet 1949. Ces arrangements ont été approuvés par le Gouvernement de l'Egypte et ils ont été expressément entérinés par l'Organisation comme représentant l'intégration d'une institution préexistante au sens de l'article 54 de la Constitution de l'OMS. Le conseil des ministres égyptien ayant accordé l'exemption temporaire des droits de douane, le Bureau régional de l'OMS est entré en service au siège de l'ancien Bureau sanitaire le 1<sup>er</sup> juillet 1949.

27. Entre-temps les négociations en vue de la conclusion d'un accord de siège pour le Bureau régional, commencées il y avait au moins cinq mois, progressaient avec lenteur ; elles n'ont abouti que près de deux ans plus tard. Le 25 mars 1951 cependant l'accord dont la section 37 fait l'objet de la présente requête a été signé et est entré finalement en vigueur le 8 août de la même année. Aux termes de son préambule, cet accord avait pour objet :

« de déterminer les privilèges, immunités et facilités qui devront être accordés par le Gouvernement de l'Egypte à l'Organisation mondiale de la Santé, aux représentants de ses Membres, à ses experts et à ses fonctionnaires, notamment en ce qui concerne les arrangements pour la région de la Méditerranée orientale, ainsi que de régler diverses autres questions connexes ».

Ses dispositions s'inspirent de très près de celles du modèle d'accord avec les Etats hôtes établi à l'OMS et sont pour l'essentiel caractéristiques des accords de siège concernant les organisations internationales elles-mêmes

organizations. These provisions are on the lines of the Convention of 21 November 1947 on the Privileges and Immunities of the Specialized Agencies, to which Egypt became a party on 28 September 1954. Under Section 39 of that Convention, however, the Agreement of 25 March 1951 continued to be the instrument defining the legal status of the Regional Office in Alexandria as between the WHO and Egypt.

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28. The Court must now turn to the circumstances which have led to the submission of the present request to the Court. Ever since beginning its activities in Egypt on 1 July 1949, the WHO's Regional Office has operated continuously at the site of the former Sanitary Bureau in Alexandria. In doing so, however, it has encountered certain difficulties stemming from the tense political situation in the Middle East. Those difficulties are reflected in the fact that in 1954 the World Health Assembly found it necessary to divide the Committee into two sub-committees : Sub-Committee A in which Israel was not, and Sub-Committee B in which it was, represented.

29. On 7 May 1979 the Regional Director received a letter from the governments of five member States of the Region requesting the convening of an extraordinary meeting of the Regional Committee to discuss transferring the Regional Office from Alexandria to one of the other Arab member States. A special session of Sub-Committee A was held on 12 May 1979, attended by representatives of 20 States, but not by Egypt which had asked for the session to be postponed. Sub-Committee A adopted a resolution reciting the wish of the majority of its members that the Regional Office should be transferred to another State in the Region and recommending its transfer. Meanwhile, the question had also been placed on the agenda for the thirty-second Session of the World Health Assembly ; and on 16 May 1979 the Egyptian delegation submitted a Memorandum alleging certain procedural irregularities and objecting that the request for transfer was "politically motivated". The question was referred to a Committee which expressed the view that the effects of the implementation of such a decision by the Assembly needed study and recommended that the study be undertaken by the Executive Board.

30. The World Health Assembly adopted the recommendation of the Committee and, on 28 May 1979, the Executive Board set up a Working Group to study all aspects of the matter and report back in January 1980. The Working Group's report, dated 16 January 1980 (which is in the dossier of documents supplied to the Court), included a section entitled "Question of denunciation of the existing Host Agreement", as to which it said :

"The Group considered that it was not in a position to decide whether or not Section 37 of the Agreement with Egypt is applicable. The final position of the Organization on the possible discrepancies of

ou leurs bureaux régionaux ou locaux. Elles suivent étroitement celles de la convention du 21 novembre 1947 sur les privilèges et immunités des institutions spécialisées, à laquelle l'Égypte est devenue partie le 28 septembre 1954. En application de la section 39 de cette convention, toutefois, l'accord du 25 mars 1951 reste l'instrument définissant le régime du Bureau régional d'Alexandrie entre l'OMS et l'Égypte.

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28. La Cour doit maintenant en venir aux événements qui ont abouti à la soumission de la présente requête. Depuis le début de son activité en Égypte, le 1<sup>er</sup> juillet 1949, le Bureau régional de l'OMS a fonctionné sans interruption sur les lieux mêmes de l'ancien Bureau sanitaire d'Alexandrie. Il devait toutefois se heurter à certaines difficultés, tenant à la tension politique qui règne au Moyen-Orient, et dont témoigne le fait que l'Assemblée mondiale de la Santé a jugé nécessaire en 1954 de subdiviser le Comité en deux sous-comités : le sous-comité A dont Israël ne faisait pas partie et le sous-comité B où Israël était représenté.

29. Le 7 mai 1979 le Directeur général a reçu une lettre par laquelle les gouvernements de cinq des Etats membres de la région demandaient la convocation d'une session extraordinaire du Comité régional afin de discuter du transfert du Bureau régional d'Alexandrie dans un des autres Etats membres arabes de la région. Le sous-comité A s'est réuni en session extraordinaire le 12 mai 1979 avec la participation des représentants de vingt Etats mais non de l'Égypte, qui avait demandé le report de la session. Il a adopté une résolution par laquelle, considérant que la majorité de ses membres souhaitait que le Bureau régional soit transféré dans un autre Etat de la région, il recommandait le transfert dudit Bureau. Entre-temps la question avait aussi été inscrite à l'ordre du jour de la trente-deuxième session de l'Assemblée mondiale de la Santé. Le 16 mai 1979 la délégation égyptienne a présenté un mémorandum dans lequel l'Égypte alléguait certaines irrégularités de procédure et objectait que la demande de transfert obéissait à des « motifs politiques ». La question a été renvoyée à une commission, qui a estimé qu'il était nécessaire d'étudier les effets qu'aurait la mise en œuvre d'une telle décision de l'Assemblée et a recommandé que le Conseil exécutif entreprenne cette étude.

30. L'Assemblée mondiale de la Santé a adopté la recommandation de la commission et le Conseil exécutif a constitué le 28 mai 1979 un groupe de travail chargé d'étudier tous les aspects de la question et de lui faire rapport en janvier 1980. Le rapport du groupe de travail daté du 16 janvier 1980 (qui fait partie du dossier des documents soumis à la Cour) comporte une section intitulée « Question de la dénonciation de l'accord de siège actuel », où figure le passage suivant :

« Le groupe a estimé qu'il n'était pas en mesure de décider si la section 37 de l'accord conclu avec l'Égypte devait ou non être appliquée. La position finale de l'Organisation à l'égard des divergences de

views will have to be decided upon by the Health Assembly . . . the International Court of Justice could also possibly be requested to provide an advisory opinion under Article 76 of the WHO Constitution.”

The Executive Board accordingly transmitted the Working Group’s report to the World Health Assembly for consideration and decision.

31. A further special session of Sub-Committee A of the Regional Committee for the Eastern Mediterranean was held in Geneva on 9 May 1980, attended by representatives of 20 States, including Egypt. A resolution was adopted, by 19 votes to 1 (that of Egypt) whereby the Sub-Committee decided to recommend the transfer of the Regional Office for the Eastern Mediterranean to Amman, Jordan, as soon as possible. The representative of Egypt objected that the recommendation was, in his view, based on purely political considerations. The question was again referred to the World Health Assembly at its thirty-third session, and at Egypt’s request the text of the 1951 Host Agreement was distributed to member States. At its meeting on 16 May 1980, the Committee concerned had before it a draft resolution submitted by 20 Arab States under which the Health Assembly would decide to transfer the Regional Office to Amman, Jordan, as soon as possible. Before it also was a draft resolution submitted by the United States under which the Assembly would decide, “prior to taking any decision on removal of the Regional Office” to request an advisory opinion of the Court in the terms in which the request has been submitted to the Court. In the course of the debate the Arab States stressed the wish of the great majority of the member States of the Region to transfer the office from Egypt and the harm which they considered its retention in Alexandria would do to the work of the Organization. A number of other States, on the other hand, questioned the desirability of transferring a regional health office for political reasons and expressed doubts regarding the practical aspects of the transfer. The Egyptian delegate, *inter alia*, invoked Section 37, pointing out problems involved in its interpretation. The United States resolution was endorsed by the Committee which recommended its adoption to the World Health Assembly. Three days later, on 19 May, the representatives of 17 Arab States addressed a letter to the Director-General of the Organization informing him of their decision completely to “boycott” the Regional Office in its present location, not to have any dealings with it as from that date, and to deal directly with Headquarters in Geneva.

32. When the Committee’s recommendation was considered by the World Health Assembly at a Plenary Meeting on 20 May, the delegate of Jordan disputed the relevance of Section 37 to the question of the transfer of the Regional Office from Egypt, and called for an opinion to be given by the Director of the Legal Division of the Organization. The latter then gave certain explanations as to the problems which he considered to be involved in the interpretation of Section 37 and added that he was not for the moment able to enlighten it further. The Assembly thereupon adopted the

vues possibles devra être décidée par l'Assemblée mondiale de la Santé... La Cour internationale de Justice pourrait, en application de l'article 76 de la Constitution de l'OMS, également être priée de donner un avis consultatif. »

Le Conseil exécutif a donc transmis ce rapport à l'Assemblée mondiale de la Santé pour examen et décision.

31. Une nouvelle session extraordinaire du sous-comité A du Comité régional de la Méditerranée orientale s'est tenue à Genève le 9 mai 1980 ; vingt Etats y étaient représentés, dont l'Égypte. Par une résolution adoptée par dix-neuf voix contre une (celle de l'Égypte), le sous-comité a décidé de recommander que le Bureau régional de la Méditerranée orientale soit transféré le plus tôt possible à Amman, en Jordanie. Le représentant de l'Égypte s'est élevé contre cette recommandation, qui obéissait, à son avis, à des motifs purement politiques. La question a été une fois encore renvoyée à l'Assemblée mondiale de la Santé à sa trente-troisième session et, à la demande de l'Égypte, le texte de l'accord de siège de 1951 a été distribué aux Etats membres. A sa séance du 16 mai 1980, la commission compétente a été saisie d'un projet de résolution présenté par vingt Etats arabes, par lequel l'Assemblée aurait décidé de transférer le plus tôt possible le Bureau régional à Amman. Elle était en outre saisie d'un projet de résolution des Etats-Unis prévoyant que l'Assemblée déciderait, « avant de prendre une décision au sujet du déplacement du Bureau régional », de demander à la Cour un avis consultatif dans les termes mêmes de la requête soumise depuis lors à la Cour. Pendant le débat, les Etats arabes ont souligné que la grande majorité des Etats membres de la région souhaitait le transfert du Bureau hors d'Égypte et que son maintien à Alexandrie nuirait aux travaux de l'Organisation. Divers autres Etats se sont demandé en revanche s'il était souhaitable de transférer un bureau sanitaire régional pour des motifs politiques et ont exprimé des doutes sur les aspects pratiques du transfert. Le délégué de l'Égypte a notamment invoqué la section 37, soulignant les problèmes que pose son interprétation. La résolution des Etats-Unis a été approuvée par la commission, qui a recommandé à l'Assemblée mondiale de la Santé de l'adopter. Trois jours plus tard, le 19 mai 1980, les représentants de dix-sept Etats arabes ont adressé une lettre au Directeur général de l'Organisation pour l'informer de leur décision de « boycotter » complètement le Bureau régional en son siège actuel, de n'avoir aucune relation avec lui à compter de cette date et de traiter directement avec le siège de l'Organisation à Genève.

32. Lorsque l'Assemblée mondiale de la Santé a examiné la recommandation de la commission à sa séance plénière du 20 mai, le délégué de la Jordanie a contesté la pertinence de la section 37 en ce qui concerne le transfert du Bureau régional hors d'Égypte et il a demandé un avis du directeur de la division juridique de l'Organisation. Celui-ci a alors donné certaines explications sur les problèmes que posait, selon lui, l'interprétation de la section 37 et il a ajouté qu'il n'était pas pour le moment en mesure de fournir plus d'éclaircissements. Sur ce, l'Assemblée a adopté le projet de

draft resolution recommended by the Committee, the full text of which has been given in the opening paragraph of this Opinion. The resolution, the Court observes, in setting out the Assembly's decision to submit the present request to the Court, explained in recitals the reasons why the Assembly found it necessary to do so. In those recitals the Assembly took note of "the differing views" which had been expressed on the question of whether the Organization "may transfer the Regional Office without regard to the provisions of Section 37 of the Agreement between the World Health Organization and Egypt of 25 March 1951" ; and it further noted that the Working Group of the Executive Board had been "unable to make a judgment or a recommendation on the applicability of Section 37 of this Agreement".

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33. In the debates in the World Health Assembly just referred to, on the proposal to request the present opinion from the Court, opponents of the proposal insisted that it was nothing but a political manoeuvre designed to postpone any decision concerning removal of the Regional Office from Egypt, and the question therefore arises whether the Court ought to decline to reply to the present request by reason of its allegedly political character. In none of the written and oral statements submitted to the Court, on the other hand, has this contention been advanced and such a contention would in any case, have run counter to the settled jurisprudence of the Court. That jurisprudence establishes that if, as in the present case, a question submitted in a request is one that otherwise falls within the normal exercise of its judicial process, the Court has not to deal with the motives which may have inspired the request (*Conditions of Admission of a State to Membership in the United Nations (Article 4 of Charter)*, Advisory Opinion, 1948, I.C.J. Reports 1947-1948, pp. 61-62 ; *Competence of the General Assembly for the Admission of a State to the United Nations*, Advisory Opinion, I.C.J. Reports 1950, pp. 6-7 ; *Certain Expenses of the United Nations (Article 17, paragraph 2, of the Charter)*, Advisory Opinion, I.C.J. Reports 1962, p. 155). Indeed, in situations in which political considerations are prominent it may be particularly necessary for an international organization to obtain an advisory opinion from the Court as to the legal principles applicable with respect to the matter under debate, especially when these may include the interpretation of its constitution.

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34. Having thus examined the factual and legal context in which the present request for an advisory opinion comes before it, the Court will now consider the full meaning and implications of the hypothetical questions on which it is asked to advise. Since those are formulated in the request by reference to the applicability of Section 37 of the Agreement of 25 March 1951 to a transfer of the Regional Office from Egypt, it is necessary at once

résolution recommandé par la commission, dont le texte intégral est cité au début du présent avis consultatif. La Cour note que la résolution, qui concrétise la décision de l'Assemblée de soumettre la présente requête à la Cour, expose en son préambule les raisons pour lesquelles l'Assemblée a jugé bon d'agir ainsi. L'Assemblée y prend note des « divergences de vues » qui se sont fait jour sur le point de savoir si l'Organisation « est en droit de transférer le Bureau régional sans tenir compte des dispositions de la section 37 de l'accord entre l'Organisation mondiale de la Santé et l'Égypte en date du 25 mars 1951 » ; elle relève en outre que le groupe de travail du Conseil exécutif n'avait pas été « en mesure de décider si la section 37 dudit accord devait ou non être appliquée ni de formuler une recommandation à ce sujet ».

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33. Au cours des débats mentionnés au paragraphe précédent, auxquels la proposition de soumettre la présente requête pour avis consultatif a donné lieu à l'Assemblée mondiale de la Santé, les adversaires de cette proposition ont insisté sur le fait qu'il ne s'agissait là que d'une manœuvre politique visant à retarder toute décision sur le retrait d'Égypte du Bureau régional ; la question se pose donc de savoir si la Cour devrait refuser de répondre à la requête en raison du caractère politique qu'elle présenterait. Cependant cette thèse n'est développée dans aucun des exposés écrits et oraux soumis à la Cour et elle irait de toute façon à l'encontre de sa jurisprudence constante. Selon cette jurisprudence, s'il advient que, comme c'est le cas dans la présente espèce, une question formulée dans une requête relève de d'autres égards de l'exercice normal de sa juridiction, la Cour n'a pas à traiter des mobiles qui ont pu inspirer la requête (*Conditions de l'admission d'un Etat comme Membre des Nations Unies (article 4 de la Charte), avis consultatif, 1948, C.I.J. Recueil 1947-1948, p. 61 et 62 ; Compétence de l'Assemblée générale pour l'admission d'un Etat aux Nations Unies, avis consultatif, C.I.J. Recueil 1950, p. 6 et 7 ; Certaines dépenses des Nations Unies (article 17, paragraphe 2, de la Charte), avis consultatif, C.I.J. Recueil 1962, p. 155*). En fait, lorsque des considérations politiques jouent un rôle marquant il peut être particulièrement nécessaire à une organisation internationale d'obtenir un avis consultatif de la Cour sur les principes juridiques applicables à la matière en discussion, surtout quand ces principes peuvent mettre en jeu l'interprétation de sa constitution.

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34. Après avoir ainsi examiné le contexte de fait et de droit dans lequel la présente requête pour avis consultatif lui est soumise, la Cour va maintenant considérer toute la signification et la portée des questions hypothétiques auxquelles il lui est demandé de répondre. Ces questions étant formulées dans la requête en fonction de l'applicabilité de la section 37 de l'accord du 25 mars 1951 à un transfert du Bureau régional hors d'Égypte,



to turn to the provisions of that Section. Included in the 1951 Agreement as one of its "Final Provisions", Section 37 reads :

"Section 37. The present Agreement may be revised at the request of either party. In this event the two parties shall consult each other concerning the modifications to be made in its provisions. If the negotiations do not result in an understanding within one year, the present Agreement may be denounced by either party giving two years' notice."

The "differing views" in the World Health Assembly as to the applicability of these provisions to a transfer of the Regional Office from Egypt, which are mentioned in the recitals to the resolution, concerned various points. One of these was whether a transfer of the seat of the Regional Office from Egypt is or is not covered by the provisions of the 1951 Agreement which to a large extent deal with privileges, immunities and facilities. Another was whether the provisions of Section 37 relate only to the case of a request by one or other party for revision of provisions of the Agreement relating to the question of privileges, immunities and facilities or are also apt to cover its total revision or outright denunciation. But the differences of view also involved further points, as appears from the debates and from the explanations given by the Director of the Legal Division of the WHO at the World Health Assembly's meeting of 20 May. Dealing with a question from the delegate of Jordan about the two years' notice provided for in Section 37, the Director of the Legal Division referred to the enlightenment to be obtained on the point by comparing the provisions in other host agreements. He also drew attention to the possibility of referring to the applicable general principles of international law, emphasizing the relevance in this connection of Article 56 of the International Law Commission's draft articles on treaties concluded between States and international organizations or between international organizations.

35. Accordingly, it is apparent that, although the questions in the request are formulated in terms only of Section 37, the true legal question under consideration in the World Health Assembly is : What are the legal principles and rules applicable to the question under what conditions and in accordance with what modalities a transfer of the Regional Office from Egypt may be effected ? This, in the Court's opinion, must also be considered to be the legal question submitted to it by the request. The Court points out that, if it is to remain faithful to the requirements of its judicial character in the exercise of its advisory jurisdiction, it must ascertain what are the legal questions really in issue in questions formulated in a request (cf. *Admissibility of Hearings of Petitioners by the Committee on South West Africa, Advisory Opinion, I.C.J. Reports 1956*, p. 26, and see also p. 37 ; *Certain Expenses of the United Nations (Article 17, paragraph 2, of the*

il est nécessaire de commencer par examiner les dispositions de cette section. La section 37, qui fait partie des « Dispositions finales » de l'accord de 1951, est libellée comme suit :

« *Section 37.* Le présent accord peut être révisé à la demande de l'une ou l'autre partie. Dans cette éventualité, les deux parties se consultent sur les modifications qu'il pourrait y avoir lieu d'apporter aux dispositions du présent accord. Au cas où, dans le délai d'un an, les négociations n'aboutiraient pas à une entente, le présent accord peut être dénoncé par l'une ou l'autre partie moyennant un préavis de deux ans. »

Les « divergences de vues » qui se sont fait jour à l'Assemblée mondiale de la Santé au sujet de l'applicabilité de ces dispositions à un transfert du Bureau régional hors d'Égypte, divergences mentionnées dans le préambule de la résolution, portaient sur divers points. Il s'agissait d'abord de savoir si un transfert du siège du Bureau régional hors d'Égypte est régi ou non par les dispositions de l'accord de 1951, qui portent en grande partie sur les privilèges, immunités et facilités. Il s'agissait aussi de déterminer si les dispositions de la section 37 visent uniquement le cas où l'une ou l'autre partie demande la révision de clauses de l'accord relatives à la question des privilèges, immunités et facilités ou si elles peuvent également s'appliquer à sa révision totale ou à sa dénonciation pure et simple. Mais les divergences de vues portaient encore sur d'autres points, comme il ressort des débats et des explications données par le directeur de la division juridique de l'OMS à la séance tenue par l'Assemblée mondiale de la Santé le 20 mai. En réponse à une question posée par le délégué de la Jordanie au sujet du préavis de deux ans prévu par la section 37, le directeur de la division juridique a indiqué que l'on pourrait obtenir des éclaircissements à ce sujet en procédant à une comparaison avec les dispositions d'autres accords de siège. Il a signalé aussi la possibilité de se reporter aux principes généraux applicables du droit international, soulignant la pertinence à cet égard de l'article 56 du projet de la Commission du droit international sur les traités conclus entre États et organisations internationales ou entre organisations internationales.

35. Il appert donc que, bien que les questions de la requête soient formulées uniquement en fonction de la section 37, la véritable question juridique qui se pose à l'Assemblée mondiale de la Santé est celle-ci : Quels sont les principes et les règles juridiques applicables à la question de savoir selon quelles conditions et selon quelles modalités peut être effectué un transfert du Bureau régional hors d'Égypte ? De l'avis de la Cour, c'est aussi cet énoncé qui doit être considéré comme la question juridique à elle soumise par la requête. La Cour souligne que, pour rester fidèle aux exigences de son caractère judiciaire dans l'exercice de sa compétence consultative, elle doit rechercher quelles sont véritablement les questions juridiques que soulèvent les demandes formulées dans une requête (voir par exemple *Admissibilité de l'audition de pétitionnaires par le Comité du Sud-Ouest africain, avis consultatif, C.I.J. Recueil 1956*, p. 26 et aussi p. 37 ;

*Charter*), *Advisory Opinion, I.C.J. Reports 1962*, pp. 156-158). It also points out in this connection that the Permanent Court of International Justice, in replying to requests for an advisory opinion, likewise found it necessary in some cases first to ascertain what were the legal questions really in issue in the questions posed in the request (cf. *Jaworzina, Advisory Opinion, 1923, P.C.I.J., Series B, No. 8*, p. 282 ; *Interpretation of the Greco-Turkish Agreement of 1 December 1926, Advisory Opinion, 1928, P.C.I.J., Series B, No. 16*, pp. 5-16). Furthermore, as the Court has stressed earlier in this Opinion, a reply to questions of the kind posed in the present request may, if incomplete, be not only ineffectual but actually misleading as to the legal rules applicable to the matter under consideration by the requesting Organization. For this reason, the Court could not adequately discharge the obligation incumbent upon it in the present case if, in replying to the request, it did not take into consideration all the pertinent legal issues involved in the matter to which the questions are addressed.

36. The Court will therefore now proceed to consider its replies to the questions formulated in the request on the basis that the true legal question submitted to the Court is : What are the legal principles and rules applicable to the question under what conditions and in accordance with what modalities a transfer of the Regional Office from Egypt may be effected ?

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37. The Court thinks it necessary to underline at the outset that the question before it is not whether, in general, an organization has the right to select the location of the seat of its headquarters or of a regional office. On that question there has been no difference of view in the present case, and there can be no doubt that an international organization does have such a right. The question before the Court is the different one of whether, in the present case, the Organization's power to exercise that right is or is not regulated by reason of the existence of obligations vis-à-vis Egypt. The Court notes that in the World Health Assembly and in some of the written and oral statements before the Court there seems to have been a disposition to regard international organizations as possessing some form of absolute power to determine and, if need be, change the location of the sites of their headquarters and regional offices. But States for their part possess a sovereign power of decision with respect to their acceptance of the headquarters or a regional office of an organization within their territories ; and an organization's power of decision is no more absolute in this respect than is that of a State. As was pointed out by the Court in one of its early Advisory Opinions, there is nothing in the character of international organizations to justify their being considered as some form of "super-State" (*Reparations for Injuries Suffered in the Service of the United Nations, Advisory Opinion, I.C.J. Reports 1949*, p. 179). International organizations are subjects of international law and, as such, are bound by

*Certaines dépenses des Nations Unies (article 17, paragraphe 2, de la Charte), avis consultatif, C.I.J. Recueil 1962, p. 156 à 158).* Elle souligne également à ce propos qu'en réponse à des requêtes pour avis consultatif la Cour permanente de Justice internationale a elle aussi jugé parfois nécessaire de déterminer quels points de droit étaient véritablement mis en jeu par les questions posées dans la requête (voir *Jaworzina, avis consultatif, 1923, C.P.J.I. série B n° 8, p. 282 ; Interprétation de l'accord gréco-turc du 1<sup>er</sup> décembre 1926, avis consultatif, 1928, C.P.J.I. série B n° 16, p. 5 à 16*). En outre, comme la Cour l'a relevé plus haut dans le présent avis consultatif, une réponse incomplète à des questions comme celles de la requête peut non seulement être inefficace mais induire réellement en erreur sur les règles juridiques qui régissent le sujet examiné par l'Organisation requérante. Aussi la Cour ne pourrait-elle s'acquitter convenablement de l'obligation qui lui incombe en l'espèce si, dans sa réponse à la requête, elle ne prenait pas en considération tous les aspects juridiques pertinents du sujet sur lequel portent les questions.

36. La Cour se propose donc maintenant d'étudier les réponses aux demandes formulées dans la requête en partant de l'idée que la véritable question juridique qui lui est soumise est celle-ci : Quels sont les principes et les règles juridiques applicables à la question de savoir selon quelles conditions et selon quelles modalités peut être effectué un transfert du Bureau régional hors d'Égypte ?

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37. La Cour estime nécessaire de souligner dès le départ que la question dont elle est saisie n'est pas de savoir si en général une organisation a le droit de choisir l'emplacement de son siège ou d'un bureau régional. Il n'y a pas eu de divergences de vues à cet égard en la présente espèce et il n'est pas douteux qu'une organisation internationale jouit de ce droit. La question posée à la Cour est différente ; elle est de savoir si, en l'occurrence, le pouvoir que possède l'Organisation d'exercer ce droit est ou non soumis à des règles, du fait de l'existence d'obligations dont l'Organisation serait tenue envers l'Égypte. La Cour constate que, au sein de l'Assemblée mondiale de la Santé comme dans certains des exposés écrits ou oraux qui lui ont été présentés, on paraît avoir eu tendance à considérer que les organisations internationales jouissent d'une sorte de pouvoir absolu de déterminer ou éventuellement de changer l'emplacement de leur siège ou de leurs bureaux régionaux. Mais les États aussi possèdent un pouvoir souverain de décision pour ce qui est d'accueillir le siège ou un bureau régional d'une organisation sur leur territoire ; et le pouvoir de décision d'une organisation à cet égard n'est pas plus absolu que celui d'un État. Ainsi que la Cour l'a souligné dans l'un de ses premiers avis consultatifs, rien dans le caractère d'une organisation internationale ne justifie qu'on la considère comme une sorte de « super-État » (*Réparation des dommages subis au service des Nations Unies, avis consultatif, C.I.J. Recueil 1949, p. 179*). L'organisation internationale est un sujet de droit international lié en tant

any obligations incumbent upon them under general rules of international law, under their constitutions or under international agreements to which they are parties. Accordingly, it provides no answer to the questions submitted to the Court simply to refer to the right of an international organization to determine the location of the seat of its regional offices.

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38. The “differing views” expressed in the World Health Assembly regarding the relevance of the Agreement of 25 March 1951, and regarding the question whether the terms of Section 37 of the Agreement are applicable in the event of any transfer of the Regional Office from Egypt, were repeated and further developed in the written and oral statements submitted to the Court. As to the relevance of the 1951 Agreement in the present connection, the view advanced on one side has been that the establishment of the Regional Office in Alexandria took place on 1 July 1949, pursuant to an agreement resulting either from Egypt’s offer to transfer the operation of the Alexandria Bureau to the WHO and the latter’s acceptance of that offer, or from Egypt’s acceptance of a unilateral act of the competent organs of the WHO determining the site of the Regional Office. Proponents of this view maintain that the 1951 Agreement was a separate transaction concluded after the establishment of the Regional Office in Egypt had been completed and the terms of which only provide for the immunities, privileges and facilities of the Regional Office. They point to the fact that some other host agreements of a similar kind contain provisions expressly for the establishment of the seat of the Regional Office and stress the absence of such a provision in the 1951 Agreement. This Agreement, they argue, although it may contain references to the seat of the Regional Office in Alexandria, does not provide for its location there. On this basis, and on the basis of their understanding of the object of the 1951 Agreement deduced from its title, preamble, and text, they maintain that the Agreement has no bearing on the Organization’s right to remove the Regional Office from Egypt. They also contend that the 1951 Agreement was not limited to the privileges, immunities and facilities granted only to the Regional Office, but had a more general purpose, namely, to regulate the above-mentioned questions between Egypt and the WHO in general.

39. Proponents of the opposing view say that the establishment of the Regional Office and the integration of the Alexandria Bureau with the WHO were not completed in 1949 ; they were accomplished by a series of acts in a composite process, the final and definitive step in which was the conclusion of the 1951 host agreement. To holders of this view, the act of transferring the operation of the Alexandria Bureau to the WHO in 1949 and the host agreement of 1951 are closely related parts of a single transaction whereby it was agreed to establish the Regional Office at Alexandria. Stressing the several references in the 1951 Agreement to the location of the Office in Alexandria, they argue that the absence of a specific provision regarding its establishment there is due to the fact that this

que tel par toutes les obligations que lui imposent les règles générales du droit international, son acte constitutif ou les accords internationaux auxquels il est partie. Dès lors, se contenter d'invoquer le droit que possède une organisation internationale de déterminer le siège de ses bureaux régionaux ne fournit aucune réponse aux questions posées à la Cour.

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38. Les « divergences de vues » qui se sont fait jour à l'Assemblée mondiale de la Santé au sujet de la pertinence de l'accord du 25 mars 1951 et de l'applicabilité des termes de sa section 37 dans l'éventualité d'un transfert du Bureau régional hors d'Égypte se retrouvent et s'accusent dans les exposés écrits et oraux présentés à la Cour. A propos de la pertinence de l'accord de 1951 en l'espèce, l'une des thèses soutenues est que le Bureau régional a été établi à Alexandrie le 1<sup>er</sup> juillet 1949 en vertu d'un accord consistant, ou bien dans l'offre faite par l'Égypte de transférer les fonctions du Bureau d'Alexandrie à l'OMS suivie de l'acceptation de cette offre par l'OMS, ou bien dans l'acceptation par l'Égypte d'un acte unilatéral des organes compétents de l'OMS déterminant le siège du Bureau régional. Les tenants de cette thèse maintiennent que l'accord de 1951 représente une transaction distincte, consécutive à l'établissement du Bureau régional en Égypte et qui concerne uniquement les immunités, les privilèges et les facilités accordés à ce Bureau. Ils font observer que certains autres accords comparables contiennent des dispositions fixant expressément le siège du Bureau régional et ils soulignent l'absence d'une disposition à cet effet dans l'accord de 1951. Ils font valoir que, si celui-ci mentionne le siège du Bureau régional à Alexandrie, aucune de ses dispositions ne spécifie que ce siège y est situé. Ils se fondent sur cette constatation et sur la manière dont ils comprennent l'objet de l'accord de 1951 d'après son titre, son préambule et son texte pour soutenir que cet accord ne touche en rien le droit que possède l'Organisation de transférer le Bureau régional hors d'Égypte. Ils soutiennent aussi que l'accord de 1951 ne se limitait pas aux privilèges, immunités et facilités accordés au seul Bureau régional, mais qu'il avait un objet plus large, à savoir qu'il réglait d'une façon générale les questions susmentionnées entre l'Égypte et l'OMS.

39. D'après les partisans de la thèse contraire, l'établissement du Bureau régional et l'intégration du Bureau d'Alexandrie dans l'OMS n'ont pas été achevés en 1949 ; ils sont le résultat d'un processus complexe, comportant une série d'actes, dont l'étape définitive a été la conclusion de l'accord de siège de 1951. Pour ceux qui défendent cette thèse, le transfert effectif des fonctions du Bureau d'Alexandrie à l'OMS en 1949 et l'accord de 1951 sont des éléments intimement liés d'une transaction unique par laquelle il a été convenu d'établir le Bureau régional à Alexandrie. Rappelant que l'accord de 1951 fait à plusieurs reprises mention d'Alexandrie comme siège du Bureau, ils soutiennent que l'absence d'une disposition prévoyant expressément son établissement dans cette ville tient à ce que

Agreement was dealing with a pre-existing Sanitary Bureau already established in Alexandria. In general, they emphasize the significance of the character of the 1951 Agreement as a headquarters agreement, and of the constant references to it as such in the records of the WHO and in official acts of the Egyptian State.

40. The differences regarding the application of Section 37 of the Agreement to a transfer of the Regional Office from Egypt have turned on the meaning of the word "revise" in the first sentence and on the interpretation then to be given to the two following sentences of the Section. According to one view the word "revise" can cover only modifications of particular provisions of the Agreement and cannot cover a termination or denunciation of the Agreement, such as would be involved in the removal of the seat of the Office from Egypt ; and this is the meaning given to the word "revise" in law dictionaries. On that assumption, and on the basis of what they consider to be the general character of the 1951 Agreement, they consider all the provisions of the Section, including the right of denunciation in the third sentence, to apply only in cases where a request has been made by one or other party for a partial modification of the terms of the Agreement. They conclude that, in consequence, the 1951 Agreement contains no general right of denunciation and invoke the general rules expressed in the first paragraph of Article 56 of the Vienna Convention on the Law of Treaties and the corresponding provision of the International Law Commission's draft articles on treaties concluded between States and international organizations or between international organizations. Under those articles a treaty, "which contains no provision regarding its termination and which does not provide for denunciation or withdrawal" is not subject to denunciation or withdrawal unless, *inter alia*, such a right may be implied by the nature of the treaty. Referring to opinions expressed in the International Law Commission that headquarters agreements of international organizations are by their nature agreements in which a right of denunciation may be implied under the articles in question, they then maintain that such a general right of denunciation is to be implied in the 1951 Agreement. The proponents of this view go on to argue that in any case the transfer of the Regional Office from Egypt is not a matter which can be said to fall within the provisions of Section 37, and that the removal of the seat of the Office from Egypt would not necessarily mean the denunciation of the 1951 Agreement.

41. Opponents of the view just described insist, however, that the word "revise" may also have the wider meaning of "review" and cover a general or total revision of an agreement, including its termination. According to them, the word has not infrequently been used with that meaning in treaties and was so used in the 1951 Agreement. They maintain that this is confirmed by the *travaux préparatoires* of Section 37, which are to be found in negotiations between representatives of the Swiss Government and the ILO concerning the latter's headquarters agreement with Switzerland. These negotiations, they consider, concern the specific question of the

l'accord concernait un bureau sanitaire préexistant et qui s'y trouvait déjà installé. D'une façon générale ils soulignent l'importance du caractère d'accord de siège de l'accord de 1951 et du fait qu'il est constamment désigné par cette expression dans les documents de l'OMS et dans les actes officiels de l'Etat égyptien.

40. Les divergences sur l'applicabilité de la section 37 de l'accord à un transfert du Bureau régional hors d'Egypte portent essentiellement sur la signification du verbe *reviser* employé dans la première phrase et par conséquent sur l'interprétation à donner aux deux phrases suivantes de ladite section. Une thèse voudrait que le mot *reviser* puisse seulement s'appliquer à des modifications de dispositions particulières de l'accord et non à l'extinction ou à la dénonciation de celui-ci qu'entraînerait le transfert du Bureau hors d'Egypte ; c'est d'ailleurs le sens que les dictionnaires de droit donnent au mot *reviser*. Partant de là et de ce qu'ils estiment être le caractère général de l'accord de 1951, les tenants de cette thèse considèrent que toutes les dispositions de la section, y compris le droit de dénonciation prévu à la troisième phrase, ne s'appliquent que si l'une des parties demande une modification partielle des termes de l'accord. Ils en concluent que l'accord de 1951 ne prévoit donc aucun droit général de dénonciation et ils invoquent les règles générales énoncées dans le paragraphe 1 de l'article 56 de la convention de Vienne sur le droit des traités et dans la disposition correspondante du projet d'articles de la Commission du droit international sur les traités conclus entre Etats et organisations internationales ou entre organisations internationales. En vertu de ces textes, un traité « qui ne contient pas de dispositions relatives à son extinction et ne prévoit pas qu'on puisse le dénoncer ou s'en retirer » ne peut faire l'objet d'une dénonciation ou d'un retrait à moins notamment que ce droit ne puisse être déduit de la nature du traité. S'appuyant sur certaines opinions exprimées à la Commission du droit international, suivant lesquelles les accords de siège des organisations internationales sont par nature des accords comportant implicitement un droit de dénonciation en vertu des textes susvisés, les partisans de cette thèse affirment qu'un tel droit général de dénonciation doit être déduit dans le cas de l'accord de 1951. Ils poursuivent en faisant valoir qu'en tout état de cause le transfert du Bureau régional hors d'Egypte ne saurait être considéré comme entrant dans le cadre de la section 37 et que le retrait d'Egypte du siège du Bureau régional n'emporterait pas nécessairement dénonciation de l'accord de 1951.

41. Les adversaires de la thèse qui vient d'être exposée insistent en revanche sur le fait que le verbe *reviser* peut aussi avoir le sens plus large de *revoir* et désigner une révision totale ou générale de l'accord, y compris son extinction. D'après eux, ce terme a assez souvent été utilisé en ce sens dans des traités et il possède cette acception dans l'accord de 1951. Ils en voient la confirmation dans les travaux préparatoires de la section 37, qui sont consignés dans le compte rendu des négociations entre les représentants du Gouvernement suisse et de l'OIT au sujet de l'accord de siège déjà mentionné de l'OIT avec la Suisse. Ils considèrent que ces négociations ont



establishment of the ILO's seat in Geneva and, while Switzerland wished in this connection to include a provision for denunciation in the agreement, the ILO did not. The result, they say, was the compromise formula, subsequently introduced into WHO host agreements, which provides for the possibility of denunciation, but only after consultation and negotiation regarding the revision of the instrument. In their view, therefore, the *travaux préparatoires* confirm that the formula in Section 37 was designed to cover revision of the location of the Regional Office's seat at Alexandria, including the possibility of its transfer outside Egypt. They further argue that this interpretation is one required by the object and purpose of Section 37 which, they say, was clearly meant to preclude either of the parties to the Agreement from suddenly and precipitately terminating the legal régime it created. The proponents of this view of Section 37 also take the position that, even if it were to be rejected and the Agreement interpreted as also including a general right of denunciation, Egypt would still be entitled to notice under the general rules of international law. In this connection, they point to Article 56 of the Vienna Convention on the Law of Treaties and the corresponding article in the International Law Commission's draft articles on treaties concluded between States and international organizations or between international organizations. In both articles paragraph 2 specifically provides that in any case where a right of denunciation or withdrawal is implied in a treaty a party shall give not less than twelve months' notice of its intention to exercise the right.

42. The Court has described the differences of view regarding the application of Section 37 to a transfer of the Regional Office from Egypt only in a broad outline which does not reproduce all the refinements with which they have been expressed nor all the considerations by which they have been supported. If it has done this, it is because it considers that the emphasis placed on Section 37 in the questions posed in the request distorts in some measure the general legal framework in which the true legal issues before the Court have to be resolved. Whatever view may be held on the question whether the establishment and location of the Regional Office in Alexandria are embraced within the provisions of the 1951 Agreement, and whatever view may be held on the question whether the provisions of Section 37 are applicable to the case of a transfer of the Office from Egypt, the fact remains that certain legal principles and rules are applicable in the case of such a transfer. These legal principles and rules the Court must, therefore, now examine.

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43. By the mutual understandings reached between Egypt and the Organization from 1949 to 1951 with respect to the Regional Office of the Organization in Egypt, whether they are regarded as distinct agreements or as separate parts of one transaction, a contractual legal régime was created

précisément porté sur la question de l'établissement du siège de l'OIT à Genève ; la Suisse souhaitait à ce propos insérer dans l'accord une clause de dénonciation, l'OIT ne le souhaitait pas. Il en est résulté, disent-ils, la formule de compromis ultérieurement introduite dans les accords de siège de l'OMS, formule qui prévoit la possibilité de dénoncer mais uniquement après consultations et négociations portant sur la revision de l'instrument. A leur avis, les travaux préparatoires confirment donc que les termes de la section 37 étaient conçus comme s'appliquant à une revision concernant la localisation du Bureau régional d'Alexandrie, y compris l'éventualité de son transfert hors d'Égypte. Ils font valoir en outre que cette interprétation est imposée par l'objet et le but de la section 37 qui, selon eux, visait clairement à éviter que l'une des parties à l'accord puisse mettre fin d'une manière soudaine et précipitée au régime juridique créé par celui-ci. Les partisans de cette façon d'envisager la section 37 sont d'autre part d'avis que, même si elle devait être rejetée et si l'accord devait être interprété comme comportant aussi un droit général de dénonciation, l'Égypte n'en aurait pas moins droit à un préavis en application des règles générales du droit international. A cet égard ils invoquent l'article 56 de la convention de Vienne sur le droit des traités et la disposition correspondante du projet d'articles de la Commission du droit international sur les traités conclus entre Etats et organisations internationales ou entre organisations internationales. Dans ces deux textes, le paragraphe 2 prévoit expressément que, lorsque, dans un traité, le droit de dénonciation ou de retrait peut être déduit, une partie doit notifier au moins douze mois à l'avance son intention d'exercer ce droit.

42. La Cour a exposé les divergences de vues sur l'applicabilité de la section 37 à un transfert du Bureau régional hors d'Égypte dans des termes très généraux qui ne rendent pas toutes les nuances des thèses en présence ni toutes les considérations sur lesquelles elles s'appuient. Si elle a procédé ainsi, c'est parce qu'elle considère que l'accent placé sur la section 37 dans les questions énoncées dans la requête fausse dans une certaine mesure le contexte juridique général dans lequel doivent être résolus les véritables problèmes de droit qui lui sont soumis. Quoi que l'on puisse penser de la question de savoir si les dispositions de l'accord de 1951 régissent l'établissement et le siège du Bureau régional à Alexandrie, ou de l'applicabilité de la section 37 dans l'hypothèse d'un transfert du Bureau hors d'Égypte, il reste que certains principes et règles juridiques s'appliquent dans cette hypothèse. La Cour doit donc maintenant en venir à l'examen de ces principes et règles juridiques.

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43. En vertu des ententes auxquelles l'Égypte et l'Organisation sont parvenues de 1949 à 1951 au sujet du Bureau régional de l'Organisation, qu'on les considère comme des accords distincts ou comme des éléments d'une seule et même transaction, un régime juridique contractuel a été créé

between Egypt and the Organization which remains the basis of their legal relations today. Moreover, Egypt was a member – a founder member – of the newly created World Health Organization when, in 1949, it transferred the operation of the Alexandria Sanitary Bureau to the Organization ; and it has continued to be a member of the Organization ever since. The very fact of Egypt's membership of the Organization entails certain mutual obligations of co-operation and good faith incumbent upon Egypt and upon the Organization. Egypt offered to become host to the Regional Office in Alexandria and the Organization accepted that offer ; Egypt agreed to provide the privileges, immunities and facilities necessary for the independence and effectiveness of the Office. As a result the legal relationship between Egypt and the Organization became, and now is, that of a host State and an international organization, the very essence of which is a body of mutual obligations of co-operation and good faith. In the present instance Egypt became host to the Organization's Regional Office, with its attendant advantages, and the Organization acquired a valuable seat for its office by the handing over to the Organization of an existing Egyptian Sanitary Bureau established in Alexandria, and the element of mutuality in the legal régime thus created between Egypt and the WHO is underlined by the fact that this was effected through common action based on mutual consent. This special legal régime of mutual rights and obligations has been in force between Egypt and WHO for over thirty years. The result is that there now exists in Alexandria a substantial WHO institution employing a large staff and discharging health functions important both to the Organization and to Egypt itself. In consequence, any transfer of the WHO Regional Office from the territory of Egypt necessarily raises practical problems of some importance. These problems are, of course, the concern of the Organization and of Egypt rather than of the Court. But they also concern the Court to the extent that they may have a bearing on the legal conditions under which a transfer of the Regional Office from Egypt may be effected.

44. The problems were studied by the Working Group set up by the Executive Board of WHO in 1979, and it is evident from the report of that Working Group that much care and co-operation between the Organization and Egypt is needed if the risk of serious disruption to the health work of the Regional Office is to be avoided. It is also apparent that a reasonable period of time would be required to effect an orderly transfer of the operation of the Office from Alexandria to the new site without disruption to the work. Precisely what period of time would be required is a matter which can only be finally determined by consultation and negotiation between WHO and Egypt. It is, moreover, evident that during this period the Organization itself would need to make full use of the privileges, immunities and facilities provided in the Agreement of 25 March 1951 in order to ensure a smooth and orderly transfer of the Office from Egypt to its new site. In short, the situation arising in the event of a transfer of the

entre l'Égypte et l'Organisation, qui constitue aujourd'hui encore le fondement de leurs relations juridiques. Au surplus, au moment où en 1949 elle a transféré à l'Organisation les fonctions du Bureau sanitaire d'Alexandrie, l'Égypte était membre – membre fondateur – de l'Organisation mondiale de la Santé qui venait d'être créée et elle n'a pas cessé depuis lors d'en être membre. Le simple fait d'être membre de l'Organisation entraîne certaines obligations réciproques de coopération et de bonne foi qui incombent à l'Égypte et à l'Organisation. L'Égypte a offert d'accueillir le Bureau régional à Alexandrie et l'Organisation a accepté cette offre ; l'Égypte a accepté d'accorder les privilèges, immunités et facilités nécessaires à l'indépendance et à l'efficacité du Bureau. En conséquence les relations juridiques entre l'Égypte et l'Organisation sont devenues et demeurent celles d'un Etat hôte et d'une organisation internationale, c'est-à-dire des relations dont l'essence même consiste en un ensemble d'obligations réciproques de coopération et de bonne foi. En l'espèce l'Égypte est devenue l'Etat hôte du Bureau régional de l'Organisation, avec les avantages qui en découlent, et l'Organisation a ainsi bénéficié d'excellentes installations grâce au transfert à l'Organisation du Bureau sanitaire égyptien existant à Alexandrie ; le caractère de réciprocité du régime juridique ainsi créé entre l'Égypte et l'OMS est souligné par le fait que cette opération a été effectuée par une action commune, basée sur le consentement mutuel. Ce régime juridique spécial, comportant des droits et obligations réciproques, est en vigueur entre l'Égypte et l'OMS depuis plus de trente ans. Il en résulte qu'il existe aujourd'hui à Alexandrie une institution de l'OMS qui emploie un personnel nombreux et s'acquitte de fonctions sanitaires importantes pour l'Organisation comme pour l'Égypte. Dans ces conditions tout transfert du Bureau régional de l'OMS hors du territoire égyptien pose nécessairement des problèmes pratiques d'une certaine ampleur. Certes ces problèmes sont du ressort de l'Organisation et de l'Égypte plutôt que de la Cour. Mais ils concernent également la Cour dans la mesure où ils sont susceptibles d'influer sur les conditions juridiques selon lesquelles un transfert du Bureau régional hors d'Égypte pourrait se réaliser.

44. Ces problèmes ont été étudiés par le groupe de travail constitué en 1979 par le Conseil exécutif de l'OMS, et il ressort comme une donnée d'évidence du rapport de ce groupe que l'Organisation et l'Égypte doivent agir avec beaucoup de précaution et coopérer étroitement si l'on veut éviter tout risque de perturbation grave des travaux sanitaires du Bureau régional. Il est non moins évident qu'il faudrait prévoir un laps de temps raisonnable pour que les fonctions du Bureau d'Alexandrie soient transférées de façon ordonnée au nouveau siège sans que les travaux en souffrent. Quant à la détermination du délai précis à observer, c'est là une question qui ne peut être finalement résolue que par des consultations et des négociations entre l'OMS et l'Égypte. Il est par ailleurs évident que pendant ce délai l'Organisation elle-même aurait besoin de tous les privilèges, immunités et facilités prévus dans l'accord du 25 mars 1951 pour que le déménagement du Bureau hors d'Égypte puisse s'opérer en bon ordre.

Regional Office from Egypt is one which, by its very nature, demands consultation, negotiation and co-operation between the Organization and Egypt.

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45. The Court's attention has been drawn to a considerable number of host agreements of different kinds, concluded by States with various international organizations and containing varying provisions regarding the revision, termination or denunciation of the agreements. These agreements fall into two main groups : (1) those providing the necessary régime for the seat of a headquarters or regional office of a more or less permanent character, and (2) those providing a régime for other offices set up *ad hoc* and not envisaged as of a permanent character. As to the first group, which includes agreements concluded by the ILO and the WHO, their provisions take different forms. The headquarters agreement of the United Nations itself, with the United States, which leaves to the former, the right to decide on its removal, provides for its termination if the seat is removed from the United States "except for such provisions as may be applicable in connection with the orderly termination of the operations of the United Nations at its seat in the United States and the disposition of its property therein". Other agreements similarly provide for cessation of the host agreement upon the removal of the seat, subject to arrangements for the orderly termination of the operations, while others, for example, provide for one year's or six months' notice of termination or denunciation, and there are other variants. The *ad hoc* type of agreement, on the other hand, commonly provides for termination on short periods of notice or by agreement or simply on cessation of the operations subject to orderly arrangements for bringing them to an end.

46. In considering these provisions, the Court feels bound to observe that in future closer attention might with advantage be given to their drafting. Nevertheless, despite their variety and imperfections, the provisions of host agreements regarding their revision, termination or denunciation are not without significance in the present connection. In the first place, they confirm the recognition by international organizations and host States of the existence of mutual obligations incumbent upon them to resolve the problems attendant upon a revision, termination or denunciation of a host agreement. But they do more, since they must be presumed to reflect the views of organizations and host States as to the implications of those obligations in the contexts in which the provisions are intended to apply. In the view of the Court, therefore, they provide certain general indications of what the mutual obligations of organizations and host States to co-operate in good faith may involve in situations such as the one with which the Court is here concerned.

47. A further general indication as to what those obligations may entail is to be found in the second paragraph of Article 56 of the Vienna Con-

Bref, en cas de transfert du Bureau régional hors d'Égypte, la situation, par sa nature même, nécessiterait des consultations, des négociations et une coopération entre l'Organisation et l'Égypte.

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45. L'attention de la Cour a été attirée sur un nombre considérable d'accords de siège de types différents, conclus par des Etats avec diverses organisations internationales et contenant des dispositions variées relatives à leur revision, à leur extinction ou à leur dénonciation. Ces accords relèvent de deux catégories principales : 1) ceux qui prévoient le régime nécessaire pour le siège d'une organisation ou celui d'un bureau régional de caractère plus ou moins permanent ; 2) ceux qui définissent le régime applicable à d'autres bureaux établis sur une base *ad hoc* et qui ne sont pas conçus comme étant de caractère permanent. Pour ce qui est de la première catégorie, qui comprend les accords conclus par l'OIT et par l'OMS, les dispositions revêtent diverses formes. L'accord de siège de l'Organisation des Nations Unies elle-même avec les Etats-Unis, qui laisse à la première le droit de décider du transfert, dispose qu'il peut prendre fin si le siège est transféré hors des Etats-Unis « exception faite toutefois de celles de ses dispositions qui seraient nécessaires pour la terminaison régulière des activités de l'Organisation des Nations Unies dans son siège des Etats-Unis et pour la disposition de celles de ses propriétés qui s'y trouvent ». D'autres accords prévoient de même leur extinction en cas de retrait du siège, sous réserve des arrangements prévus pour la liquidation ordonnée des opérations ; d'autres envisagent par exemple un préavis de dénonciation ou de résiliation d'un an ou de six mois ; il existe encore d'autres variantes. En revanche il est couramment prévu dans les accords *ad hoc* que ces accords peuvent prendre fin moyennant un court préavis, par consentement mutuel ou par la simple cessation des opérations sous réserve des arrangements destinés à en assurer l'achèvement dans l'ordre.

46. S'agissant de ces dispositions, la Cour se voit obligée de relever qu'à l'avenir il pourrait y avoir avantage à prêter plus d'attention à leur rédaction. Néanmoins, malgré leur diversité et leurs imperfections, les dispositions des accords de siège concernant leur revision, leur extinction ou leur dénonciation ne sont pas en l'occurrence sans intérêt. Elles confirment tout d'abord que les organisations internationales et les Etats hôtes reconnaissent être tenus de l'obligation réciproque de résoudre les problèmes que peuvent soulever la revision, l'extinction ou la dénonciation d'un accord de siège. Elles font même plus que cela, puisqu'il faut présumer qu'elles traduisent les vues des organisations et des Etats hôtes sur ce que cette obligation implique dans les circonstances où les dispositions sont destinées à jouer. La Cour est donc d'avis qu'il s'en dégage certaines indications générales quant à ce que peut impliquer l'obligation réciproque des organisations et des Etats hôtes de coopérer de bonne foi dans des situations comme celle dont la Cour connaît en l'espèce.

47. Une autre indication générale de ce que peut impliquer cette obligation est fournie par le paragraphe 2 de l'article 56 de la convention de

vention on the Law of Treaties and the corresponding provision in the International Law Commission's draft articles on treaties between States and international organizations or between international organizations. Those provisions, as has been mentioned earlier, specifically provide that, when a right of denunciation is implied in a treaty by reason of its nature, the exercise of that right is conditional upon notice, and that of not less than twelve months. Clearly, these provisions also are based on an obligation to act in good faith and have reasonable regard to the interests of the other party to the treaty.

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48. In the present case, as the Court has pointed out, the true legal question submitted to it in the request is : What are the legal principles and rules applicable to the question under what conditions and in accordance with what modalities a transfer of the Regional Office from Egypt may be effected ? Moreover, as it has also pointed out, differing views have been expressed concerning both the relevance in this connection of the 1951 Agreement and the interpretation of Section 37 of that Agreement. Accordingly, in formulating its reply to the request, the Court takes as its starting point the mutual obligations incumbent upon Egypt and the Organization to co-operate in good faith with respect to the implications and effects of the transfer of the Regional Office from Egypt. The Court does so the more readily as it considers those obligations to be the very basis of the legal relations between the Organization and Egypt under general international law, under the Constitution of the Organization and under the agreements in force between Egypt and the Organization. The essential task of the Court in replying to the request is, therefore, to determine the specific legal implications of the mutual obligations incumbent upon Egypt and the Organization in the event of either of them wishing to have the Regional Office transferred from Egypt.

49. The Court considers that in the context of the present case the mutual obligations of the Organization and the host State to co-operate under the applicable legal principles and rules are as follows :

- In the first place, those obligations place a duty both upon the Organization and upon Egypt to consult together in good faith as to the question under what conditions and in accordance with what modalities a transfer of the Regional Office from Egypt may be effected.
- Secondly, in the event of its being finally decided that the Regional Office shall be transferred from Egypt, their mutual obligations of co-operation place a duty upon the Organization and Egypt to consult together and to negotiate regarding the various arrangements needed to effect the transfer from the existing to the new site in an orderly manner and with a minimum of prejudice to the work of the Organization and the interests of Egypt.
- Thirdly, those mutual obligations place a duty upon the party which

Vienne sur le droit des traités et par la disposition correspondante du projet d'articles de la Commission du droit international sur les traités entre Etats et organisations internationales ou entre organisations internationales. Ces dispositions, comme la Cour l'a déjà mentionné, prévoient expressément que, quand un droit de dénonciation peut être déduit de la nature d'un traité, ce droit ne peut être exercé que moyennant un préavis, lequel doit être de douze mois au moins. Il est clair que ces dispositions supposent elles aussi une obligation d'agir de bonne foi et de tenir raisonnablement compte des intérêts de l'autre partie au traité.

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48. En la présente espèce, ainsi que la Cour l'a souligné, la véritable question juridique qui lui est soumise dans la requête est celle-ci : Quels sont les principes et les règles juridiques applicables à la question de savoir selon quelles conditions et selon quelles modalités peut être effectué un transfert du Bureau régional hors d'Egypte ? De plus, comme la Cour l'a également rappelé, des vues divergentes ont été exprimées au sujet tant de la pertinence à cet égard de l'accord de 1951 que de l'interprétation de sa section 37. En conséquence, pour formuler sa réponse à la requête, la Cour prend comme point de départ les obligations réciproques de l'Egypte et de l'Organisation, qui sont tenues de coopérer de bonne foi relativement aux implications et aux effets d'un transfert du Bureau régional hors d'Egypte. Cette méthode lui paraît d'autant plus opportune qu'elle considère ces obligations comme le fondement même des relations juridiques entre l'Organisation et l'Egypte en vertu du droit international général, de la Constitution de l'Organisation et des accords en vigueur entre elle et l'Egypte. Pour répondre à la requête, la tâche essentielle de la Cour est donc de déterminer quelles sont les implications juridiques précises des obligations réciproques incombant à l'Egypte et à l'Organisation au cas où l'une ou l'autre souhaite que le Bureau régional soit transféré hors d'Egypte.

49. La Cour considère que, dans le contexte de la présente espèce, les obligations réciproques de coopérer dont l'Organisation et l'Etat hôte sont tenus en vertu des principes et règles juridiques applicables sont les suivantes :

- En premier lieu, l'Organisation et l'Egypte doivent se consulter de bonne foi au sujet de la question de savoir selon quelles conditions et selon quelles modalités peut être effectué un transfert du Bureau régional hors d'Egypte.
- En deuxième lieu, s'il était finalement décidé de transférer le Bureau régional hors d'Egypte, leurs obligations réciproques de coopération leur imposeraient de se consulter et de négocier au sujet des diverses dispositions à prendre pour que le transfert de l'ancien au nouvel emplacement s'effectue en bon ordre et nuise le moins possible aux travaux de l'Organisation et aux intérêts de l'Egypte.
- En troisième lieu, ces obligations réciproques imposent à la partie qui



wishes to effect the transfer to give a reasonable period of notice to the other party for the termination of the existing situation regarding the Regional Office at Alexandria, taking due account of all the practical arrangements needed to effect an orderly and equitable transfer of the Office to its new site.

Those, in the view of the Court, are the implications of the general legal principles and rules applicable in the event of the transfer of the seat of a Regional Office from the territory of a host State. Precisely what periods of time may be involved in the observance of the duties to consult and negotiate, and what period of notice of termination should be given, are matters which necessarily vary according to the requirements of the particular case. In principle, therefore, it is for the parties in each case to determine the length of those periods by consultation and negotiation in good faith. Some indications as to the possible periods involved, as the Court has said, can be seen in provisions of host agreements, including Section 37 of the Agreement of 25 March 1951, as well as in Article 56 of the Vienna Convention on the Law of Treaties and in the corresponding article of the International Law Commission's draft articles on treaties between States and international organizations or between international organizations. But what is reasonable and equitable in any given case must depend on its particular circumstances. Moreover, the paramount consideration both for the Organization and the host State in every case must be their clear obligation to co-operate in good faith to promote the objectives and purposes of the Organization as expressed in its Constitution ; and this too means that they must in consultation determine a reasonable period of time to enable them to achieve an orderly transfer of the Office from the territory of the host State.

50. It follows that the Court's reply to the second question is that the legal responsibilities of the Organization and Egypt during the transitional period between the notification of the proposed transfer of the Office and the accomplishment thereof would be to fulfil in good faith the mutual obligations which the Court has set out in answering the first question.

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51. For these reasons,

THE COURT,

1. By twelve votes to one,

*Decides* to comply with the request for an advisory opinion ;

IN FAVOUR : *President* Sir Humphrey Waldock ; *Vice-President* Elias ; *Judges* Forster, Gros, Lachs, Nagendra Singh, Ruda, Mosler, Oda, Ago, El-Erian and Sette-Camara ;

AGAINST : *Judge* Morozov ;

souhaite le transfert de donner à l'autre un préavis raisonnable pour mettre fin à la situation actuelle du Bureau régional à Alexandrie, compte étant dûment tenu de toutes les dispositions pratiques à prendre pour que le transfert au nouvel emplacement s'effectue dans l'ordre et dans des conditions équitables.

Telles sont, selon la Cour, les implications des principes et règles juridiques généraux applicables en cas de transfert du siège d'un bureau régional hors du territoire d'un Etat hôte. Les délais précis qui peuvent être nécessaires pour s'acquitter des obligations de consultation et de négociation et le préavis de dénonciation exact qui doit être donné varient forcément en fonction des nécessités de l'espèce. En principe, c'est donc aux parties qu'il appartient de déterminer dans chaque cas la durée de ces délais en procédant de bonne foi à des consultations et à des négociations. Ainsi que la Cour l'a noté, on peut trouver certaines indications à ce sujet dans les dispositions des accords de siège, y compris la section 37 de l'accord du 25 mars 1951, dans l'article 56 de la convention de Vienne sur le droit des traités et dans l'article correspondant du projet de la Commission du droit international sur les traités entre Etats et organisations internationales ou entre organisations internationales. Mais ce qui est raisonnable et équitable dans un cas donné dépend nécessairement des circonstances. De plus, la considération primordiale aussi bien pour l'Organisation que pour l'Etat hôte doit être dans tous les cas leur évidente obligation de coopérer de bonne foi pour servir les buts et objectifs de l'Organisation tels qu'ils s'expriment dans son acte constitutif ; ce qui signifie qu'ils doivent se consulter pour déterminer un délai raisonnable devant leur permettre de réaliser le transfert en bon ordre du Bureau hors du territoire de l'Etat hôte.

50. Il en découle que la réponse de la Cour à la seconde question est que, au cours de la période transitoire séparant la notification du préavis pour le transfert projeté du Bureau et l'accomplissement de ce transfert, l'Organisation et l'Egypte auraient la responsabilité juridique de s'acquitter de bonne foi des obligations réciproques que la Cour a énoncées dans sa réponse à la première question.

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51. Par ces motifs,

LA COUR,

1. Par douze voix contre une,

*Décide* de donner suite à la requête pour avis consultatif ;

POUR : Sir Humphrey Waldock, *Président* ; M. Elias, *Vice-Président* ;

MM. Forster, Gros, Lachs, Nagendra Singh, Ruda, Mosler, Oda, Ago, El-Erian, Sette-Camara, *juges* ;

CONTRE : M. Morozov, *juge* ;

## 2. With regard to Question 1,

By twelve votes to one,

*Is of the opinion* that in the event specified in the request, the legal principles and rules, and the mutual obligations which they imply, regarding consultation, negotiation and notice, applicable as between the World Health Organization and Egypt are those which have been set out in paragraph 49 of this Advisory Opinion and in particular that :

- (a) their mutual obligations under those legal principles and rules place a duty both upon the Organization and upon Egypt to consult together in good faith as to the question under what conditions and in accordance with what modalities a transfer of the Regional Office from Egypt may be effected ;
- (b) in the event of its being finally decided that the Regional Office shall be transferred from Egypt, their mutual obligations of co-operation place a duty upon the Organization and Egypt to consult together and to negotiate regarding the various arrangements needed to effect the transfer from the existing to the new site in an orderly manner and with a minimum of prejudice to the work of the Organization and the interests of Egypt ;
- (c) their mutual obligations under those legal principles and rules place a duty upon the party which wishes to effect the transfer to give a reasonable period of notice to the other party for the termination of the existing situation regarding the Regional Office at Alexandria, taking due account of all the practical arrangements needed to effect an orderly and equitable transfer of the Office to its new site ;

IN FAVOUR : *President* Sir Humphrey Waldock ; *Vice-President* Elias ; *Judges* Forster, Gros, Lachs, Nagendra Singh, Ruda, Mosler, Oda, Ago, El-Erian and Sette-Camara ;

AGAINST : *Judge* Morozov ;

## 3. With regard to Question 2.

By eleven votes to two,

*Is of the opinion* that, in the event of a decision that the Regional Office shall be transferred from Egypt, the legal responsibilities of the World Health Organization and Egypt during the transitional period between the notification of the proposed transfer of the Office and the accomplishment thereof are to fulfil in good faith the mutual obligations which the Court has set out in answering Question 1 ;

IN FAVOUR : *President* Sir Humphrey Waldock ; *Vice-President* Elias ; *Judges* Forster, Gros, Nagendra Singh, Ruda, Mosler, Oda, Ago, El-Erian and Sette-Camara ;

AGAINST : *Judges* Lachs and Morozov.

## 2. En ce qui concerne la question 1,

Par douze voix contre une,

*Est d'avis* que, dans l'éventualité spécifiée dans la requête, les principes et règles juridiques et les obligations réciproques qui en découlent, applicables en matière de consultation, de négociation et de préavis entre l'Organisation mondiale de la Santé et l'Égypte, sont ceux qui ont été énoncés au paragraphe 49 du présent avis consultatif, et en particulier que :

- a) leurs obligations réciproques en vertu de ces principes et règles juridiques imposent à l'Organisation et à l'Égypte de se consulter de bonne foi au sujet de la question de savoir selon quelles conditions et selon quelles modalités peut être effectué un transfert du Bureau régional hors du territoire égyptien ;
- b) au cas où il serait finalement décidé de transférer le Bureau régional hors d'Égypte, leurs obligations réciproques de coopération leur imposeraient de se consulter et de négocier au sujet des diverses dispositions à prendre pour que le transfert de l'ancien au nouvel emplacement s'effectue en bon ordre et nuise le moins possible aux travaux de l'Organisation et aux intérêts de l'Égypte ;
- c) leurs obligations réciproques en vertu de ces principes et règles juridiques imposent à la partie qui souhaite le transfert de donner à l'autre un préavis raisonnable pour mettre fin à la situation actuelle du Bureau régional à Alexandrie, compte étant dûment tenu de toutes les dispositions pratiques à prendre pour que le transfert du Bureau en son nouvel emplacement s'effectue dans l'ordre et dans des conditions équitables ;

POUR : Sir Humphrey Waldock, *Président* ; M. Elias, *Vice-Président* ;  
MM. Forster, Gros, Lachs, Nagendra Singh, Ruda, Mosler, Oda, Ago,  
El-Erian, Sette-Camara, *juges* ;

CONTRE : M. Morozov, *juge* ;

## 3. En ce qui concerne la question 2,

Par onze voix contre deux,

*Est d'avis* que, dans l'éventualité d'une décision tendant à transférer le Bureau régional hors d'Égypte, les responsabilités juridiques de l'Organisation mondiale de la Santé et de l'Égypte, au cours de la période transitoire séparant la notification du préavis pour le transfert projeté du Bureau et l'accomplissement de ce transfert, consisteraient à s'acquitter de bonne foi des obligations réciproques que la Cour a énoncées dans sa réponse à la question 1 ;

POUR : Sir Humphrey Waldock, *Président* ; M. Elias, *Vice-Président* ;  
MM. Forster, Gros, Nagendra Singh, Ruda, Mosler, Oda, Ago, El-Erian,  
Sette-Camara, *juges* ;

CONTRE : MM. Lachs et Morozov, *juges*.

Done in English and in French, the English text being authoritative, at the Peace Palace, The Hague, this twentieth day of December, one thousand nine hundred and eighty, in three copies, of which one will be placed in the archives of the Court, and the others transmitted to the Secretary-General of the United Nations and to the Director-General of the World Health Organization, respectively.

*(Signed)* Humphrey WALDOCK,  
President.

*(Signed)* Santiago TORRES BERNÁRDEZ,  
Registrar.

Judges GROS, LACHS, RUDA, MOSLER, ODA, AGO, EL-ERIAN, and SETTE-CAMARA append separate opinions to the Opinion of the Court.

Judge MOROZOV appends a dissenting opinion to the Opinion of the Court.

*(Initialed)* H.W.

*(Initialed)* S.T.B.

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Fait en anglais et en français, le texte anglais faisant foi, au palais de la Paix, à La Haye, le vingt décembre mil neuf cent quatre-vingt, en trois exemplaires, dont l'un restera déposé aux archives de la Cour et dont les autres seront transmis au Secrétaire général de l'Organisation des Nations Unies et au Directeur général de l'Organisation mondiale de la Santé.

Le Président,

*(Signé)* Humphrey WALDOCK,

Le Greffier,

*(Signé)* Santiago TORRES BERNÁRDEZ.

MM. GROS, LACHS, RUDA, MOSLER, ODA, AGO, EL-ERIAN et SETTE-CAMARA, juges, joignent à l'avis consultatif les exposés de leur opinion individuelle.

M. MOROZOV, juge, joint à l'avis consultatif l'exposé de son opinion dissidente.

*(Paraphé)* H.W.

*(Paraphé)* S.T.B.

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**International Arbitration Institute  
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# **Towards a Uniform International Arbitration Law?**

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faith is expressed in particular by the necessity of cooperating and of behaving fairly, which exists even before a contract is entered into.<sup>23</sup>

The question that arises is whether the duty to perform agreements in good faith includes a duty to renegotiate these agreements when specific circumstances arising after the signature of the contract threaten the original balance. In other words, would the saying "*rebus sic stantibus*" (it is also common to evoke concepts of *imprévision* (failure to foresee or hardship) be liable to call into question the principle of the binding nature of contracts. The majority opinion tends towards the negative,<sup>24</sup> and we agree with it. It is worth quoting an award rendered in 1997:

If one can admit the existence of a tendency, in certain branches, to stipulate hardship clauses with some certainty, it is certain that in the practice of business the obligation to rebalance the contract (by negotiation and, failing which, by the intervention of a third party, as provided for in Article 6.2.3, paragraph 4 of UNIDROIT Principles), which characterizes hardship, constitutes an absolutely exceptional principle, which is only accepted in the context of contractual clauses, which should determine in detail the situations justifying hardship as well as its consequences. It

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<sup>23</sup> See 1993 Award in ICC Case No. 7105, 127 J.D.I. 1062 (2000); see also 1991 Award in ICC Case No. 6519, 118 J.D.I. 1065 (1991).

<sup>24</sup> See the case law cited in Yves Derains's observations under the 1996 Award in ICC Case No. 8486, *supra* note 21; at 1050, see also RACINE, *supra* note 7, ¶ 698, at 386; Gaillard, *supra* note 5, ¶ 11, at 12; Jan Paulsson, *La Lex Mercatoria dans l'arbitrage CCI*, 1990 REV. ARB. 55, 95; Piero Bernardini, *Is the Duty to Cooperate in Long-Term Contracts a Substantive Transnational Rule in International Commercial Arbitration?*, in TRANSNATIONAL RULES IN INTERNATIONAL COMMERCIAL ARBITRATION 137, 140 (E. Gaillard ed., ICC Pub. No. 480/4, 1993); Hans Van Houtte, *Changed Circumstances and Pacta Sunt Servanda*, in TRANSNATIONAL RULES IN INTERNATIONAL COMMERCIAL ARBITRATION 105 (E. Gaillard ed., ICC Pub. No. 480/4, 1993).



is therefore not possible to consider the provisions in matters of hardship contained in 'Unidroit Principles' as trade practices. On the contrary, it is a question of rules, which do not correspond, at least in their current state, to the usual practice of business in international trade and which will consequently only be applicable when the parties make an express reference to them, which is not the case here.<sup>25</sup>

Despite the exclusion of the principle of *imprévision*, it is true that the good faith obligation resulted in a certain number of transnational rules of primary importance. This is true concerning the principle according to which no party can contradict itself to the detriment of another, also known under its original name "principle of estoppel by representation." In an ICC award rendered in 1995, arbitrators had occasion to apply this principle. A defendant in the arbitration proceedings had raised, in previous court proceedings, the lack of jurisdiction of the judge on the grounds that the disputes related to arbitration. The arbitrators considered that the defendants could not then, at the risk of contradicting themselves to the detriment of another, claim in the arbitration proceedings that the arbitration clause was not applicable.<sup>26</sup>

It is by referring to the same good faith obligation that arbitration tribunals lift "the corporate veil" and apply the arbitration clause to non-signatory companies. In an ICC Award rendered in 1995, the arbitration tribunal noted that: "There is no doubt that the international community developed a right to settle this question. In numerous international disputes, arbitration

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<sup>25</sup> 1997 Award in ICC Case No. 8873, 125 J.D.I. 1017, 1019 (1998); see also Paulsson, *supra* note 24, at 95-96.

<sup>26</sup> See 1995 Award in ICC Cases No. 7604 and 7610, 125 J.D.I. 1027 (1998).

## ARTICLES

Protecting Investors' Legitimate Expectations:  
Recognizing and Delimiting a General Principle*Elizabeth Snodgrass\**

## INTRODUCTION

RECENT AWARDS IN INVESTMENT TREATY arbitrations between foreign investors and the States in which they invest are notable for their repeated references to the “legitimate expectations” of the foreign investor. The award in *Técnicas Medioambientos Tecmed, SA v. United Mexican States*<sup>1</sup> well illustrates the trend. In this case, the Tribunal interpreted the obligation of “fair and equitable treatment” in the bilateral investment treaty at issue to require “treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment.”<sup>2</sup> The Tribunal articulated a broad statement of the expectations the investor would be deemed to have:

The foreign investor expects the host State to act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor, so that it may know beforehand any and all rules and

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\* Senior Associate, International Arbitration Group, Freshfields Bruckhaus Deringer. This article develops a thesis submitted for the degree of Master of Philosophy (Law) at the University of Oxford. The views expressed here are personal and do not necessarily reflect those of Freshfields Bruckhaus Deringer or its clients.

<sup>1</sup> ICSID Case No. ARB(AF)/00/2, Award of the Tribunal, May 29, 2003 (hereinafter *Tecmed*), 19 ICSID Rev.—FILJ 158 (2004); 43 I.L.M. 133 (2004) (Spanish original); *available at* <http://www.worldbank.org/icsid/cases/laudo-051903%20-English.pdf> (unofficial English translation).

<sup>2</sup> *Tecmed*, *supra* note 1, para. 154.

regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investments and comply with such regulations.... The foreign investor also expects the host State to act consistently, i.e. without arbitrarily revoking any preexisting decisions or permits issued by the state that were relied upon by the investor to assume its commitments as well as to plan and launch its commercial and business activities.<sup>3</sup>

And then, finding the investor's expectations to have been frustrated by a regulatory measure (in that case the denial of an extension of a permit to operate a landfill in circumstances in which the investor could have expected the permit to be extended), the *Tecmed* Tribunal ruled that this amounted to unfair and inequitable treatment that entitled the investor to compensation under the bilateral investment treaty at issue in the case.<sup>4</sup> Other cases, discussed in more detail in Part I of this article, refer to protection for legitimate expectations as aspects of other investment treaty protections. And taken together this body of authority now provides ample support for the conclusion reached in *International Thunderbird Gaming Corporation v. United Mexican States*<sup>5</sup> that the principle of protection for investors' legitimate expectations has developed into "a self-standing subcategory and independent basis for a claim" under bilateral and multilateral investment treaties.<sup>6</sup>

Although the emergence of the legitimate expectations principle cannot now be doubted, to date there has been little systematic consideration of the scope or limits of the protection being recognized.<sup>7</sup> This article aims to contribute to that analysis, arguing in particular that protection for investors' legitimate expectations can be justified as reflecting a "general principle of law recognized by civilized nations" as that phrase is used to describe a source of international law,<sup>8</sup> and that the methodology for recognizing a general principle

<sup>3</sup> *Id.* para. 98.

<sup>4</sup> *Id.* paras. 173–74.

<sup>5</sup> Arbitral Award, Jan. 26, 2006 (hereinafter *Thunderbird*), available at <http://ita.law.uvic.ca/documents/ThunderbirdAward.pdf>; Separate Opinion of Professor Thomas W. Wälde, Jan. 26, 2006 (hereinafter *Thunderbird* Separate Opinion), available at <http://ita.law.uvic.ca/documents/ThunderbirdSeparateOpinion.pdf>.

<sup>6</sup> *Id.* para. 37.

<sup>7</sup> The *Thunderbird* Separate Opinion, *supra* note 5, is an important exception.

<sup>8</sup> See Statute of the International Court of Justice, June 26, 1945, art. 38(1)(c), 33 U.N.T.S. 993. The Statute codifies international law on this point. Bin Cheng, *General Principles of Law as Applied by International Courts and Tribunals* 21 *et seq.* (1987).

can be applied to develop a more highly articulated expression of that principle to guide the protection given investors' legitimate expectations in future cases.

Following a brief summary in Part I of several of the recent investment awards in which the investors' legitimate expectations feature, Part II explains the relevance of the concept of a "general principle of law" to the analysis. The role general principles play in the international legal system is precisely to facilitate the application of primary norms such as those embodied in investment treaties. General principles do this both by filling gaps between other applicable norms and by resolving conflicts or "overlaps" between them. Moreover, the methodology for identifying a general principle filters jurisprudential "hunches" or notions of fundamental fairness through a comparative analysis of the positive enactments of municipal law in order to identify common legal principles for application as rules of international law. Drawing as it does on this more or less empirical foundation, the general principles framework validates the concern expressed in recent awards to protect investors' legitimate expectations at the same time that it disciplines the development of the concept as a legal norm. Accordingly, general principles is an appropriate and attractive intellectual framework for analyzing the concept of protection for investors' legitimate expectations emerging in recent investment treaty arbitrations.

Parts III and IV apply the general principles methodology at two levels of abstraction. Part III proceeds at a general level, looking at a selection of national legal systems to see whether, and if so how, in those systems individual's legitimate expectations are protected against inconsistent government action. This analysis validates the assertion in the recent investment awards that individual's legitimate expectations warrant protection: the references to legitimate expectations in recent investment cases echo explicit protections for legitimate expectations found in the municipal public law of a number of States and the administrative law of the European Union. The survey in Part III reflects not only consensus around the broad statement of principle—legitimate expectations should be protected—but also a notable degree of consensus on more detailed questions such as: What governmental conduct can give rise to expectations that are protected? What makes certain expectations legitimate and others illegitimate? What would constitute compelling reasons for not providing protection? And what does it mean for expectations to be fulfilled? Extending the general principles methodology, and with reference to recent investment arbitration awards, Part IV proposes consensus-based answers to these key questions.

The final step in analyzing whether a principle widely reflected in municipal law should be recognized as a general principle for international law purposes is a somewhat amorphous enquiry into the "appropriateness"

of the proposed principle for extrapolation to the international legal plane. Part V argues that, as arbitral tribunals have already instinctively grasped, the principle of protection for legitimate expectations can work justice in disputes between investors and host States and can usefully play a role in resolving such disputes. The emergence and further development of the principle should therefore be welcomed. There remain interesting and important open questions about how the principle should be applied and refined that will determine the breadth of protection that is afforded to investors by virtue of this principle. These include such questions as how stringently to assess the reasonableness of investors' expectations or of the host State's conduct and, perhaps most interestingly a range of questions surrounding how the balance between individual expectations and the public purposes for which States purport to act will be struck. This article must leave to others further consideration of these questions and in particular the provocative recent suggestion that the balance should be tilted to favor investors.<sup>9</sup>

## I. PROTECTION FOR LEGITIMATE EXPECTATIONS IN RECENT INVESTMENT AWARDS

In the recent cases, investors' legitimate expectations have been discussed most frequently in connection with claims arising under investment treaty guarantees of "fair and equitable treatment." The discussion of this standard in *Tecmed* and the protection for legitimate expectations that resulted was summarized above.

The recent case which most explicitly addresses the principle of legitimate expectations is *Thunderbird*. In this case, all members of the Tribunal accepted "that the principle of legitimate expectations forms part, *i.e.* a subcategory, of the duty to afford fair and equitable treatment" to investors.<sup>10</sup> And they

concur[red] on the general conditions for this claim—an expectation of the investor to be caused by and attributed to the government, backed-up by investment relying on such expectation, requiring the legitimacy of the expectation in terms of the competency of the officials responsible for it and the procedure for issuing it and the reasonableness of the investor in relying on the expectation.<sup>11</sup>

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<sup>9</sup> See *Thunderbird* Separate Opinion, *supra* note 5, paras. 33–36, 47, 50.

<sup>10</sup> *Id.* para. 1.

<sup>11</sup> *Id.*

The author of the separate opinion differed from his colleagues on the question of whether, as a matter of fact, the claimant investor's expectations were legitimate.<sup>12</sup>

In addition to *Thunderbird* and *Tecmed*, the claim that actions attributable to the respondent State "arbitrarily dissolve[d] the 'legitimate expectations' created by previous decisions of U.S. courts and administrative agencies" was one aspect of the claim under the fair and equitable treatment provision of the investment chapter of the North American Free Trade Agreement (NAFTA) in *ADF Group Inc. v. United States of America*.<sup>13</sup> Although the *ADF* Tribunal rejected this argument (without much discussion), like the *Thunderbird* majority it did so on the facts, in essence finding no such legitimate expectation, rather than because of any fundamental disagreement with the notion that interference with legitimate expectations could constitute a denial of fair and equitable treatment.<sup>14</sup> Similarly, although the claim of unfair and inequitable treatment failed in *Waste Management Inc. v. United Mexican States*,<sup>15</sup> the Tribunal in that case identified "complete lack of transparency and candour in an administrative process" and the fact "that the treatment is in breach of representations made by the host State which were reasonably relied on by the claimant" as factors that would weigh in its necessarily fact-specific evaluation of whether there had been a denial of fair and equitable treatment in that case.<sup>16</sup>

In *GAMI Investments, Inc v. The Government of the United Mexican States*,<sup>17</sup> the Tribunal dismissed a claim of unfair and inequitable treatment in circumstances where the investor could not point to "an unambiguous affirmation" that the Government would act in a certain manner, in part because no "certain expectation" had been created.<sup>18</sup> This was the conclusion even when it was shown that the Government had failed to apply its regulations according to their terms, the Tribunal explaining:

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<sup>12</sup> An important basis for the conclusion by Professor Wälde that the investor's expectations were legitimate also appeared to be his appreciation of the imbalance of power as between investors and host States and the fact that the purpose of investment treaties is to protect and encourage investment by favoring investors with heightened protection. *See id.* paras. 33–36.

<sup>13</sup> ICSID Case No. ARB(AF)/00/1, Award, Jan. 9, 2003 (hereinafter *ADF*), para.72, 18 ICSID Rev.-FILJ 195 (2003), 6 ICSID Rep. 470 (2004), available at <http://www.worldbank.org/icsid/cases/ADF-award.pdf>.

<sup>14</sup> *Id.* para. 189.

<sup>15</sup> ICSID Case No. ARB(AF)/00/3, Award, Apr. 30, 2004 (hereinafter *Waste Management II*), 43 I.L.M. 967 (2004), available at <http://www.economia-snci.gov.mx/ls23al.php?s=18&p=1&l=2>.

<sup>16</sup> *Id.* para. 98.

<sup>17</sup> Final Award, Nov. 15, 2004 (hereinafter *GAMI*), available at <http://www.state.gov/documents/organization/38789.pdf>.

<sup>18</sup> *Id.* para. 76.

International law does not appraise the content of a regulatory programme extant before an investor decides to commit. The inquiry is whether the state abided by or implemented that programme. It is in this sense that a government's failure to implement or abide by its own law in a manner adversely affecting a foreign investor may but will not necessarily lead to a violation of Article 1105 [of NAFTA, the "fair and equitable treatment" provision]. Much depends on context. The imposition of a new licence requirement may for example be viewed quite differently if it appears on a blank slate or if it is an arbitrary repudiation of a preexisting licensing regime upon which a foreign investor has demonstrably relied.<sup>19</sup>

In addition to *Tecmed*, quoted above, fair and equitable treatment claims framed in terms of the investors' legitimate expectations succeeded in *MTD Equity Sdn Bhd and MTD Chile S.A. v. Republic of Chile*,<sup>20</sup> *Occidental Exploration and Production Company v. The Republic of Ecuador*,<sup>21</sup> and *Eureko B.V. v. Republic of Poland*.<sup>22</sup> The Tribunals in *MTD* and *Eureko* explicitly drew upon *Tecmed's* formulation: that the obligation of fair and equitable treatment required host States to "provide to international investments treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment."<sup>23</sup> *MTD* claimed that the Republic of Chile

breached the fair and equitable treatment provisions of the BIT... when it "created and encouraged strong expectations that the Project, which was the object of the investment, could be built in the specific proposed location and entered into a contract confirming that location, but then disapproved that location as a matter of policy after *MTD* irrevocably committed its investment to build the Project in that location."<sup>24</sup>

<sup>19</sup> *Id.* para. 91.

<sup>20</sup> ICSID Case No. ARB/01/7, Award, May 25, 2004 (hereinafter *MTD*), available at <http://www.asil.org/ilib/MTDvChile.pdf>.

<sup>21</sup> Final Award, July 1, 2004 (hereinafter *OEPC*), available at <http://www.asil.org/ilib/OEPC-Ecuador.pdf>.

<sup>22</sup> Partial Award, Aug. 19, 2005 (hereinafter *Eureko*), available at <http://ita.law.uvic.ca/documents/Eureko-PartialAwardandDissentingOpinion.pdf>.

<sup>23</sup> *MTD*, *supra* note 20, para. 114; *Eureko*, *supra* note 22, para. 235 (both quoting *Tecmed*, *supra* note 1, para. 154).

<sup>24</sup> *MTD*, *supra* note 20, para. 116.

The *MTD* Tribunal described the Government's approval of the Project as "a key element in the consideration of whether the Respondent fulfilled its obligation to treat the Claimants fairly and equitably"<sup>25</sup> and found that:

Approval of a Project in a location would give *prima facie* to an investor the expectation that the project is feasible in that location from a regulatory point of view.... This is not to say that approval of a project in a particular location entitles the investor to develop that site without further governmental approval.... What the Tribunal emphasizes here is the inconsistency of action between two arms of the same Government *vis-à-vis* the same investor even when the legal framework of the country provides for a mechanism to coordinate.<sup>26</sup>

The *MTD* Tribunal accepted Chile's argument that the Claimants had a duty to inform themselves of the relevant regulations and policies, but it stressed that "Chile also has an obligation to act coherently and apply its policies consistently, independently of how diligent an investor is"<sup>27</sup> and ultimately concluded "that approval of an investment...for a project that is against the urban policy of the Government is a breach of the obligation to treat an investor fairly and equitably."<sup>28</sup>

In *OEPC*, the Tribunal drew on these precedents to hold simply that "[t]he stability of the legal and business framework is...an essential element of fair and equitable treatment,"<sup>29</sup> one "that does not depend on whether the Respondent has proceeded in good faith or not,"<sup>30</sup> suggesting that there is a violation of the treaty standard whenever the investor's expectations of stability and consistency are disappointed.

Investors' legitimate expectations have played a role in other contexts. *Tecmed* also considered the investor's legitimate expectations as part of the analysis of a regulatory expropriation claim. The investor argued that, because the landfill facility it owned was not able to operate following the Government's refusal to extend a permit, a regulatory taking of all or substantially all of the value of its investment had occurred. As is usual in regulatory expropriation cases,

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<sup>25</sup> *Id.* para. 159.

<sup>26</sup> *Id.* para. 163.

<sup>27</sup> *Id.* para. 165.

<sup>28</sup> *Id.* para. 166.

<sup>29</sup> *OEPC*, *supra* note 21, para. 183.

<sup>30</sup> *Id.* para. 184.



the Mexican Government responded that its decision not to renew the permit “was a regulatory measure issued in compliance with the State’s police power within the highly regulated and extremely sensitive framework of environmental protection and public health” and as such was “a legitimate action of the State that does not amount to an expropriation under international law.”<sup>31</sup>

The *Tecmed* Tribunal accepted both propositions—that regulatory measures that have the effect of destroying all or substantially all of the value of an investment can be expropriations that give rise to an obligation to pay compensation<sup>32</sup> and that exercises of the State’s police powers do not require compensation even if they completely destroy (the value of) an investment.<sup>33</sup> Having found that denial of the permit did cause a substantial deprivation of the value of Tecmed’s investment, the Tribunal was confronted with the issue of whether the regulatory measure in question was a privileged exercise of the State’s police power or not. The Tribunal invoked the investor’s legitimate expectations to guide that determination. The Tribunal stated that it would

determine whether such measures are reasonable with respect to their goals, the deprivation of economic rights and the legitimate expectations of [the investor] who suffered such deprivation. There must be a reasonable relationship of proportionality between the charge or weight imposed to the foreign investor and the aim sought to be realized by any expropriatory measure.<sup>34</sup>

The Tribunal assessed the stated (and other possible) justifications for denying the permit and determined that the decision was motivated not by any concern for public health or the environment but as a response to “political circumstances,” namely public opposition to the location of the landfill, that neither could be blamed on any misconduct by the investor nor rose to the level of a genuine social crisis.<sup>35</sup> Weighing against this justification, which the Tribunal clearly viewed as less than substantial, was the fact that the denial of the permit frustrated the investor’s legitimate expectations in a number of respects:

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<sup>31</sup> *Tecmed*, *supra* note 1, para. 97.

<sup>32</sup> *Id.* paras. 114–17.

<sup>33</sup> *Id.* para. 119.

<sup>34</sup> *Id.* para. 122.

<sup>35</sup> *Id.* para. 127.

- (i) “at the time the investment was made, [the investor] had no reason to doubt the lawfulness of the Landfill’s location, regardless of the social and political pressure that appeared subsequently. These companies were not negligent upon analyzing the legal issues related to the Landfill’s location”;<sup>36</sup>
- (ii) the investor “had legitimate reasons to believe that the operation of the Landfill would extend over the long term,” a legitimate expectation of which the Government “could not be unaware”;<sup>37</sup> and
- (iii) after the investor agreed to a plan to relocate the landfill to another site identified by the Mexican authorities, it legitimately expected that it would be able to operate the landfill at its present location up until the time such relocation could be effected.<sup>38</sup>

Finding that the decision not to extend the permit did not strike an appropriate balance between the investor’s expectations and the interests served by the decision, the *Tecmed* Tribunal found “that the Resolution and its effects amount to an expropriation in violation of Article 5 of the [bilateral investment treaty] and international law.”<sup>39</sup>

The Claimants in *MTD* invoked legitimate expectations to bolster their (unsuccessful) claim under the so-called “umbrella clause,” which obliged the host State to “observe any obligation it may have entered into with regard to investments of investors of the other Contracting Party.”<sup>40</sup> They argued that the Government’s refusal to effect re-zoning necessary for the Project to go forward as envisaged “frustrated the rights and legitimate expectations of MTD under the Foreign Investment Contracts and treated the entire Foreign Investment Application procedure [which authorized the investment] as an empty formality.”<sup>41</sup> Although the *MTD* Tribunal ultimately found that there had been no breach of the umbrella clause, because the Foreign Investment Contracts did not in terms obviate the need to obtain further permits and approvals,<sup>42</sup> it referred back to its finding that there had been a failure to afford fair and equitable treatment and observed that:

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<sup>36</sup> *Id.* para. 141.

<sup>37</sup> *Id.* paras. 149, 150.

<sup>38</sup> *Id.* para. 160.

<sup>39</sup> *Id.* para. 151.

<sup>40</sup> See *MTD*, *supra* note 20, para. 179 (referring to, but not quoting, this provision).

<sup>41</sup> *Id.* para. 180 (quoting Claimants’ Memorial para.110).

<sup>42</sup> *Id.* para. 188.

Even accepting the limited significance of the Foreign Investment Contracts for purposes of other permits and approvals that may be required, they should be at least in themselves an indication that, from the Government's point of view, the Project is not against Government policy.<sup>43</sup>

Further, the Tribunal in *Nagel v. Czech Republic*<sup>44</sup> even used the concept of the investor's legitimate expectations to determine whether a Cooperation Agreement made between the Claimant investor and a State enterprise of the host State gave rise to a "claim to...performance under contract having a financial value" such that it constituted a protected "investment" under the bilateral investment treaty at issue. The Cooperation Agreement envisaged that the Claimant and the State enterprise would work together to secure a telecommunications license, and it obliged the State enterprise not to support the efforts of any third party to secure such a license. A year after the Cooperation Agreement was signed the host State passed a regulation pursuant to which two licenses were to be issued, including one to the State enterprise and a joint venture partner to be identified by public tender. Ultimately, the license was issued to the State enterprise and a tenderer other than the Claimant.

The *Nagel* Tribunal found that the Cooperation Agreement did not constitute "a binding commitment" chargeable to the Government and that it "was not, and could not be a guarantee that a licence would in fact be obtained."<sup>45</sup> Accordingly, the Cooperation Agreement could not be said to have "create[d] legitimate expectation of performance in the future," which the Tribunal had determined was the touchstone for whether a claim of performance under a contract can be said to have financial value, and thus constitute an "investment."<sup>46</sup> The Tribunal acknowledged that the Claimant "may have been encouraged by various remarks from Ministers or government officials or by the general interest they demonstrated in his plans, [but] this was not sufficient... to raise his prospects based on the Cooperation Agreement to the level of a 'legitimate expectation with financial value.'"<sup>47</sup>

This brief summary of a number of recent awards illustrates that tribunals in investment disputes increasingly consider the investor's legitimate expectations,

<sup>43</sup> *Id.* para. 189.

<sup>44</sup> Final Arbitral Award Rendered in 2003 in SCC Case 49/2002, Stockholm Arb. Rep. 141 (2004) (hereinafter *Nagel*), available at [http://www.sccinstitute.com/\\_upload/shared\\_files/artikelarkiv/poncet\\_mouawad\\_2004\\_1.pdf](http://www.sccinstitute.com/_upload/shared_files/artikelarkiv/poncet_mouawad_2004_1.pdf).

<sup>45</sup> *Id.* at 163, 164.

<sup>46</sup> *Id.* at 158.

<sup>47</sup> *Id.* at 164.

and often base their decisions in a variety of contexts on such expectations. These awards generally stop short of articulating the scope or any limits to the protection that should be given to investors' legitimate expectations. And these awards are generally short on discussion of the authority for providing protection for such expectations aside from (in the later awards) references to other investment awards that also consider legitimate expectations.<sup>48</sup> This would thus seem to be a developing area of the law of investor-State relations that is ripe for more systematic analysis.

## II. GENERAL PRINCIPLES OF LAW

This article uses the concept of a "general principle of law" as the intellectual lens through which the legitimate expectations principle is studied. This part of the article aims to demonstrate that general principles provide an appropriate framework for evaluating the protection afforded investors' legitimate expectations in recent investment cases both because of the way in which general principles of law function in the international legal system (addressed in II.A.) and because the methodology for identifying a general principle (addressed in II.B.) grounds the emerging norm in the empirical foundation of positive enactments of municipal law, thus both validating its normative status and disciplining the recognition of the principle.

### *A. The Function of General Principles of Law: Gaps and Overlaps*

The primary function of general principles of law in the international legal system is to facilitate the resolution of disputes by managing the interplay of other, usually customary or conventional, norms to knit together the sometimes patchy fabric of international law into a comprehensive system capable of resolving disputes. General principles perform this function in one of two basic ways: (i) by providing "principles to fill the gaps in positive law"<sup>49</sup> and providing an answer to a question left unsettled by other norms or (ii) by resolving conflicts between norms that otherwise would overlap.

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<sup>48</sup> *Tecmed*, *supra* note 1, which does refer to the jurisprudence of the European Court of Human Rights, and the extensive discussion in the *Thunderbird* Separate Opinion, *supra* note 5, are exceptions in this respect.

<sup>49</sup> Permanent Court of International Justice, Advisory Committee of Jurists, *Procès-verbaux* of the Proceedings of the Committee June 16th-July 24th 1920 with Annexes 296 (1920) (hereafter *Procès-verbaux*) (Hagerup); *accord id.* at 323 (Baron Descamps), 312 (de Lapradelle), 316 (Hagerup), 318, 332 (Baron Descamps).

### 1. *Filling Gaps*

Gap-filling by general principles itself takes one of two forms: providing a primary rule in the absence of an applicable treaty or customary norm (“primary gap-filling”) or filling a gap in the relevant treaty or customary regime (“secondary gap-filling”).

Primary gap-filling is most likely in respect of those topics, such as judicial procedure or estoppel, where it is unlikely that treaties or norm-creating State practice will generate rules. In fact, though, it is difficult to identify a case in which no treaty or customary norm was applicable and a general principle has been applied to fill such an obvious hole in the fabric of international law.<sup>50</sup> And although the general principles of law have been referred to (albeit not necessarily in terms) in majority and separate opinions in a number of cases in the International Court of Justice (ICJ),<sup>51</sup> the ICJ has enumerated few

<sup>50</sup> This is despite the fact that concern over such obvious gaps, namely *non liquet*, was a clear motive for the recognition of general principles as a source of law in the Statute of the Permanent Court of International Justice. See *Military and Paramilitary Activities in and Against Nicaragua* (Nicar. v. U.S.), 1986 I.C.J. 14, 212 (June 27) (dissenting opinion of Judge Oda) (“In the case of international law, the Statute of the Permanent Court of International Justice introduced the clause ‘the general principles of law recognized by civilized nations’ mainly to avoid a non liquet resulting from the lack of any positive rules.”); *South West Africa (Second Phase)* (Eth. v. S. Afr.; Liber. v. S. Afr.), 1966 I.C.J. 6, 250, 299 (July 18) (dissenting opinion of Judge Tanaka) (describing “filling in gaps in the positive sources in order to avoid non liquet decisions” as “an important role which can be played by Article 38, paragraph 1(c)”).

<sup>51</sup> Opinions of the court in which general principles were referenced include *Application for Review of Judgment No. 273 of the United Nations Administrative Tribunal*, 1982 I.C.J. 325, 338–40, 345, 356 (July 20) (principles of judicial procedure); *Application for Review of Judgment No. 158 of the United Nations Administrative Tribunal*, 1973 I.C.J. 166, 177, 181, 210 (July 12) (various “principles governing the judicial process”); *Barcelona Traction, Light and Power Company, Limited (Second Phase)* (Belg. v. Spain), 1970 I.C.J. 3, 33–5 (Feb. 5) (municipal law concept of limited liability company); *Effect of Awards of Compensation Made by the UN Administrative Tribunal*, 1954 I.C.J. 53 (July 13) (*res judicata*); *International Status of South West Africa*, 1950 I.C.J. 128, 134, 142 (July 11) (estoppel); *Corfu Channel* (U.K. v. Alb.), 1949 I.C.J. 4, 18 (Dec. 15) (admitting circumstantial evidence on the basis that “this indirect evidence is admitted in all systems of law, and its use is recognized by international decisions”); *Electricity Company of Sofia and Bulgaria* (Belg. v. Bulg.), 1939 P.C.I.J. (ser. A/B) No. 79, at 199 (Dec. 5) (“the principle universally accepted by international tribunals . . . to the effect that the parties to a case must abstain from any measure capable of exercising a prejudicial effect in regard to the execution of the decision to be given”); *Legal Status of Eastern Greenland* (Den. v. Nor.), 1933 P.C.I.J. (ser. A/B) No. 53, at 68 *et seq.* (Apr. 5) (estoppel); *Mosul Boundary*, 1925 P.C.I.J. (ser. B) No. 12, at 32 (Nov. 21) (principle that no one can be a judge in his own suit); *Certain German Interests in Polish Upper Silesia (Jurisdiction)* (Ger. v. Pol.), 1925 P.C.I.J. (ser. A) No. 6, at 20 (Aug. 25) (litispence); *Factory at Chorzów (Merits)* (Ger. v. Pol.), 1927 P.C.I.J. (ser. A) No. 17, at 47 (Sept. 13) (*restitutio in integrum*).

Separate opinions referring to general principles include *South West Africa (Second Phase)* (Eth. v. S. Afr.; Liber. v. S. Afr.), 1966 I.C.J. 6, 294–99 (July 18) (dissenting opinion of Judge Tanaka) (human rights); *Temple of Preah Vihear* (Camb. v. Thai.), 1962 I.C.J. 6, 40–43 (June 15) (separate opinion of Judge Alfaro), 62–4 (separate opinion of Judge Fitzmaurice) (estoppel); *Right of Passage Over Indian Territory* (Port. v. India), 1960 I.C.J. 6, 66 (April 12) (separate opinion of Judge Koo), 136–40 (dissenting opinion of Judge Fernandes) (right of access to enclaved territory).

“general principles of law” as such. Other international tribunals, especially *ad hoc* tribunals, have been somewhat more willing to have recourse to general principles of law,<sup>52</sup> drawing on general principles for

legal rules in those areas which, while outside the normal scope of national rules of private law, do not fall within the traditional scope of international law, such as relations between international organizations and between them and, on the other hand, states or private persons (especially their employees) and certain transactions of states (particularly in their dealings with private corporations on essentially private law matters).<sup>53</sup>

Practice thus suggests that the law of investor-State relations is a context in which the recognition of general principles might be especially appropriate.

This is the case even though, by and large, investor-State relations are regulated as a matter of international law by an extensive network of bilateral investment treaties and also by customary norms. General principles commonly supplement treaty and customary norms, filling gaps interstitially and operating alongside treaty and custom.<sup>54</sup> An example of this secondary, interstitial gap-filling is “the use of general principles to establish minimum standards of procedural fairness in those cases where international treaties and agreements do not provide for them.”<sup>55</sup> In fact, this is described as “the most frequent and successful use” of general principles of law.<sup>56</sup>

General principles have also been used to fill substantive gaps. In perhaps the most famous example, the case concerning the *Factory at Chorzów*, a treaty established an obligation and a general principle established the remedy for failure to fulfill the obligation. The Court explained the interplay between treaty and general principle in the following terms:

It is a principle of international law that the breach of an engagement involves an obligation to make reparation in an adequate form.

<sup>52</sup> Pippa Tubman, National Jurisprudence in International Tribunals, 28 N.Y.U. J. Int'l L. & Pol. 115, 127 (1995–1996).

<sup>53</sup> Oppenheim's International Law 39 (Sir Hersch Lauterpacht ed., 1955).

<sup>54</sup> Tubman, *supra* note 52, at 123; F.A. Mann, Reflections on a Commercial Law of Nations, 33 Brit. Y.B. Int'l L. 20, 34 (1957).

<sup>55</sup> Tubman, *supra* note 52, at 125. See also V.S. Mani, International Adjudication: Procedural Aspects 4 (1980).

<sup>56</sup> Ian Brownlie, Principles of Public International Law 18 (5th ed. 1998) (citing numerous cases involving principles of procedure).

Reparation therefore is the indispensable complement of a failure to apply a convention and there is no necessity for this to be stated in the convention itself.<sup>57</sup>

In the *Fabiani* case, reference was made to general principles of law on State responsibility for the acts of State agents and on the assessment of damages for denial of justice in violation of both general principles of the law of nations and a convention between France and Venezuela.<sup>58</sup>

The fact that investor-State relations are governed by well-developed customary norms and an extensive network of investment treaties thus should not indicate that there is no occasion for the application of a general principle:

Even if there is a treaty, its interpretation may require the application of general principles of law recognized by civilized nations. This is particularly true of the numerous treaties [including investment treaties] which employ broad language such as “freedom of access to the courts” or “most constant protection and security for their persons and property.”<sup>59</sup>

## 2. *Resolving Overlaps*

Indeed, the existence of a network of treaty provisions and customary norms governing investor-State relations may give rise to a need for general principles to assist in resolving overlaps between these norms. In this, the second context in which general principles function, the problem is not that other norms do not provide an answer, but that contending norms provide different answers to the same question. General principles of law may resolve overlaps or conflicts between primary norms by providing rules of interpretation, limiting principles, or principles of reconciliation that allow the simultaneous application of otherwise potentially conflicting norms to a particular case.

<sup>57</sup> (Jurisdiction) (Ger. v. Pol.), 1927 P.C.I.J. (ser. A) No. 9, at 21 (July 26).

<sup>58</sup> Reported in Henri La Fontaine, *Pasicrisie internationale 1794–1900: Histoire documentaire des arbitrages internationaux* 343, 344 (1997). See also Fabiani, 10 RIAA 83 (French-Venezuelan Commission 1902).

<sup>59</sup> Rudolph B. Schlesinger, Research on the General Principles of Law Recognized by Civilized Nations, 51 Am. J. Int'l L. 734, 735 (1957). Accord F.T.F. Jalet, The Quest for the General Principles of Law Recognized by Civilized Nations—A Study, 10 UCLA L. Rev. 1041, 1063 (1963).



In this context, general principles often take the form of canons of interpretation,<sup>60</sup> which shape the application of treaty norms in such a way as to reduce friction and overlaps between them. For example, the principle *lex specialis derogat generalis* addresses the potential conflict between a general rule and a specific rule that might address the same subject matter inconsistently. Another way in which general principles address overlaps is illustrated by the principle of good faith, which can circumscribe the otherwise apparent scope of a treaty norm in order to reduce a clash with a countervailing principle.<sup>61</sup>

It is clear that the problem of overlaps is not a new one: general principles, especially principles of interpretation, have long operated in conjunction with treaty and other norms to ameliorate potential conflicts between them. Nevertheless, this tailoring and reconciling function of general principles does seem likely to be of increasing importance. As the reach of international law extends both horizontally to new subject matter (environmental law, criminal law) and vertically to new subjects (supra-national organizations, individuals), norms proliferate, and, as they do, the likelihood that they will conflict also increases. General principles can play a significant role in resolving conflicts between such contending rights.

The separate opinions of Judges Koo and Fernandes in *Right of Passage over Indian Territory* illustrate this point particularly well. That case involved Portugal's claim that it had a right to pass over Indian territory to reach an enclave of land over which Portugal was sovereign. There was no dispute about either Portugal's rights within the enclaved territory or India's sovereignty over the surrounding land, the normal implication of which would be that India did not have to allow Portugal, or anyone, passage over its land. But applying those settled norms with no limitation did not address, and indeed created, the practical difficulty that, without passage over Indian territory, Portugal could not effectively exercise its undisputed rights over the enclave. The judgment of the Court addressed this question on the basis of a customary practice between the two parties allowing the passage of certain types of traffic to and from the enclaved territory.<sup>62</sup> Judges Koo and Fernandes, however, based their separate conclusions that Portugal had a right of passage over Indian land on a general principle directed by logical and practical necessity.

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<sup>60</sup> Tubman, *supra* note 52, at 123.

<sup>61</sup> See Timor Case, 1 Hague Ct. Rep. 354, 365 (Perm. Ct. Arb. 1914).

<sup>62</sup> (Port. v. India), 1960 I.C.J. 6, 43 (April 12).



Judge Koo referred to this as “the principle of justice founded on reason,”<sup>63</sup> and would have ruled that, because the principle of access to enclaved territory was “based upon reason and the elementary principle of justice,” it represented a general principle of law.<sup>64</sup> Judge Fernandes’ opinion goes into more detail about how logical and practical necessity led to the recognition of a general principle of a right of passage to enclaved land:

What has to be determined is whether there is not a reason deeply rooted in the legal consciousness of all peoples for admitting, as a logical and practical necessity, the recognition of a right of passage to one who has a certain legal capacity to exercise in an area to which he cannot have access without using an area reserved for another. If that is not a general principle of law, valid alike in municipal and international law, within the meaning of Article 38 of the Statute of the Court, then no principles will meet the conditions of that Article.<sup>65</sup>

Although neither opinion says so explicitly, a general principle of law, *i.e.* that there is a right of passage to access enclaved lands, was used to reconcile two conflicting absolute principles—on the one hand that India’s sovereignty meant it could exclude Portugal from Indian land and on the other that Portugal had the right to exercise sovereignty over the enclave, which it could only do if it were allowed to pass over Indian land—in a way that both were as effective as possible.

The separate opinion of Vice-President Weeramantry in the case concerning the *Gabcikovo-Nagymaros Project*, which focused on “sustainable development” as a general principle of law, makes this point explicit. Vice-President Weeramantry echoed the Koo and Fernandes opinions in deriving this principle, in part, as a matter of “inescapable logical necessity.”<sup>66</sup> He explained that the rights of economic development and environmental protection having been recognized, the principle of sustainable development is necessary to resolve the tension between them:

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<sup>63</sup> *Id.* at 66 *et seq.* (separate opinion of Judge Koo).

<sup>64</sup> *Id.* at 67 (separate opinion of Judge Koo).

<sup>65</sup> *Id.* at 136 (dissenting opinion of Judge Fernandes).

<sup>66</sup> (*Hung. v. Slovak Rep.*), 1997 I.C.J. 7, 95 (Sept. 25) (separate opinion of Vice-President Weeramantry).

The problem of steering a course between the needs of development and the necessity to protect the environment is a problem alike of the law of development and of the law of the environment. Both these vital and developing areas of law require, and indeed assume, the existence of a principle which harmonizes both needs.

To hold that no such principle exists in the law is to hold that current law recognizes the juxtaposition of two principles which could operate in collision with each other, without providing the necessary basis of principle for their reconciliation. The untenability of the supposition that the law sanctions such a state of normative anarchy suffices to condemn a hypothesis that leads to so unsatisfactory a result.

Each principle cannot be given free rein, regardless of the other. The law necessarily contains within itself the principle of reconciliation. That principle is the principle of sustainable development.<sup>67</sup>

Vice-President Weeramantry thus clearly saw a critical function of the general principle of “sustainable development” as reconciling otherwise conflicting rights.

### *B. The Methodology for Recognizing a General Principle*

Given the significant, if often interstitial, role general principles play in knitting together and tailoring the fabric of international law, the methodology for identifying general principles is the subject of a surprising amount of uncertainty. The practice of international tribunals has not explicated a systematic methodology. Rather “[i]n case after case, the judge writing the opinion simply expressed a hunch probably based upon the legal systems with which he happened to be familiar.”<sup>68</sup> But though the methodology for identifying general principles is not always transparent in practice, as a matter of doctrine, a straightforward methodology can be identified which promises to discipline what might otherwise appear to be subjective (or at least unpredictable) jurisprudential “hunches” about how open-ended investment treaty standards should be applied in individual cases and thereby to validate the principles that are articulated as applications of those standards.

<sup>67</sup> *Id.* at 90 (separate opinion of Vice-President Weeramantry).

<sup>68</sup> Schlesinger, *supra* note 59, at 734; *accord* Mann, *supra* note 54, at 35.

### 1. *Rules of Municipal Public Law as a Source of General Principles*

Rules of municipal law, including public law, constitute an important empirical foundation for the identification of general principles.

#### (a) *Municipal Law*

Luis Henkin wrote that “[t]he use of analogies drawn from municipal legal systems to develop or supplement international law is as old as international law itself.”<sup>69</sup> And “the majority of jurists... take the line that general principles recognized in national law constitute a reservoir of principles which an international judge is authorized by Article 38 to apply in international disputes, if their application appears relevant and appropriate in the different context of inter-State relations.”<sup>70</sup> In fact, concerns that the content of the category of sources of international law that is now called “general principles of law recognized by civilized nations” would be unpredictable and subjective<sup>71</sup> were assuaged at the time the concept was first codified in the Statute of the Permanent Court of International Justice (PCIJ) by emphasizing that this category drew its content from municipal law. As Baron Descamps explained,

far from giving too much liberty to the judges’ decision, his proposal would limit it. As a matter of fact it would impose on the judges a duty which would prevent them from relying too much on their own subjective opinion; it would be incumbent on them to consider whether the dictates of their conscience were in agreement with the conception of justice of civilized nations.<sup>72</sup>

Rather than providing an occasion for judges to create law, the application of general principles was “merely [bringing] to light a *latent* rule,... [which] is

<sup>69</sup> Louis Henkin *et al.*, *International Law Cases and Materials* 110 (3d ed. 1993).

<sup>70</sup> Humphrey Waldock, *General Course on Public International Law*, 106 *Recueil des Cours* 5, 55 *et seq.* (1962 II). The issue of “appropriateness” is considered *infra* at parts II.3. and V.

<sup>71</sup> See *Procès-verbaux*, *supra* note 49, at 293–94, 308 (Root).

<sup>72</sup> *Id.* at 311. Cf. Michael Akehurst, *Equity and General Principles of Law*, 25 *Int’l & Comp. L.Q.* 801, 817 (1976); Wolfgang Friedmann, *The Uses of “General Principles” in the Development of International Law*, 57 *Am. J. Int’l L.* 279, 285 (1963) (quoting Harold Cooke Gutteridge, *Comparative Law* 70 *et seq.* (2d ed. 1949)).

quite legitimate because it is logically contained in a principle already recognized by the Nation concerned.”<sup>73</sup> A focus on municipal law thus imposes critical discipline on the essentially creative process of identifying a general principle of law by allowing objective “verification” of any claim about the universal validity of the principle against “a purely empirical municipal law basis.”<sup>74</sup> Thus the drafters of Article 38 emphasized general principles

as having acquired through recognition *in foro domestico* by the civilized nations that positive character which makes them rules of law and which forbids including among them what has been called the “ideal element” or mere aspiration...<sup>75</sup>

*(b) Public Law*

Having established the relevance of rules of municipal law as important raw materials for general principles of law, the next point to canvass is that public law, as well as private law, can be a source of general principles. The basic (though not uncomplicated) distinction is between private law, which governs relations among individuals, and public law, which governs relations between individuals and the State.<sup>76</sup>

This point bears emphasizing because the traditional focus of scholarship on general principles has been on analogies drawn from municipal private law.<sup>77</sup> One explanation for this might be that traditionally international law was chiefly concerned with inter-State relations, relations between sovereign equals, which are more closely analogous to individual relations in private law. Only relatively recently has international law been seen as imposing much of a meaningful constraint on State action vis-à-vis sub-State actors, a role similar to that played by public law on the municipal plane. That being said, recourse to public law principles is not unknown to international law: As long ago as the late nineteenth century, arbitrators were looking to municipal public law

<sup>73</sup> *Procès-verbaux*, *supra* note 49, at 345 *et seq.* (Fernandes).

<sup>74</sup> Oscar Schachter, *International Law in Theory and Practice* 53 *et seq.* (1991).

<sup>75</sup> Charles de Visscher, *Theory and Reality in Public International Law* 400 (rev. ed. 1957).

<sup>76</sup> For a slightly different, but consistent, formulation see Sir Harry Woolf, *Public Law-Private Law: Why the Divide? A Personal View*, *Pub. L.*, 220, 222 (1986).

<sup>77</sup> *See, e.g.*, Hersch Lauterpacht, *Private Law Sources and Analogies in International Law* (with Special Reference to International Arbitration) (1927).

on issues such as the responsibility of States for the acts of their agents.<sup>78</sup> Thus Brownlie has noted that “[a] problem worth examination is whether public law is a better source of analogies in the present state of international law and institutions.”<sup>79</sup>

International law is notoriously expanding in scope to reach beyond issues of strictly inter-State relations analogous to the individual relations governed by private law. As one commentator observes, the “proliferation of international rules and standards, whatever their precise legal status . . . extend to virtually every field of human activity that transcends national boundaries.”<sup>80</sup> The proliferation of investment treaties, giving protection—and direct access to treaty arbitration—to individual investors is but one very clear example of this phenomenon. Thus international law now governs precisely the sorts of relations between individuals and the State that public law speaks to in the municipal context. Other examples (albeit ones outside the scope of this article) are international administrative law, which is a body of law rapidly evolving to address the relationship between individuals, especially employees, and international organizations,<sup>81</sup> and of course human rights law. Against this backdrop, Friedmann’s conclusion, now almost half a century old, rings even more true today:

Because so many of the new domains of international law are no longer clearly allocable to either public or private law but constitute a blend of both, the statement made a generation ago by Lauterpacht that “these general principles of law are, in the great majority of cases, in substance co-extensive with the general principles of private law” would no longer be correct today.<sup>82</sup>

It seems that the time is ripe for international lawyers to look as much to public as to private law for general principles of law.

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<sup>78</sup> See the *Fabiani* arbitration reported in Henri La Fontaine, *Pasicrisie internationale 1794–1900: Histoire documentaire des arbitrages internationaux* 343, 355–56 (1997).

<sup>79</sup> Brownlie, *supra* note 56, at 16.

<sup>80</sup> Oscar Schachter, Recent Trends in International Law Making, 12 *Austrl. Y.B. Int’l L.* 1, 1 (1992). See also Wolfgang Friedmann, *Law in a Changing Society*, ch. 14 (2d ed. 1972).

<sup>81</sup> See generally Chittharanjan Felix Amerasinghe, *The Law of the International Civil Service* (2d ed. 1994); Michael B. Akehurst, *The Law Governing Employment in International Organisations* (1967).

<sup>82</sup> Friedmann, *supra* note 72, at 281.

## 2. *How Much Consensus is Enough?*

In extrapolating a general principle of law from rules of municipal law one need not establish actual universality of application of identical rules. One should seek to identify the principle in legal systems representative of various legal traditions in the world, and it is enough commonality if systems agree on the solution to a particular legal problem or the outcome of a particular case, even if they do so through different doctrines and procedures.

### (a) *How Many and Which Legal Systems?*

Theory supports two quite different answers to this question. On one view, the ideal of a truly “general” principle of law is universal adherence.<sup>83</sup> On the other hand, someone who was confident of her ability to appreciate what Cheng called “the general feeling of mankind for the requirements of equity” might adopt his suggestion that it would be possible to identify a general principle of law with reference to only one municipal legal system, or none. Practice picks out a middle path between these extremes. According to a survey of practice in the PCIJ, “in most cases the alleged general principle of law was claimed to exist in all countries,” and the ICJ and other international tribunals often assert that a general principle is “universal.”<sup>84</sup> But in fact “tribunals that have applied ‘general principles’ have not considered it necessary to carry out a detailed examination of the main (or ‘representative’) systems of national law to determine whether the principles pervade ‘the municipal law of nations in general.’”<sup>85</sup> Often this is a matter of assertion, and “[u]sually only the laws of a small number of countries, or of none, are cited.”<sup>86</sup>

This accommodation to reality reflects the fact that in a world of nearly two hundred independent States, such an extensive comparative exercise as would be required to establish true unanimity would be likely to sink under its own weight

<sup>83</sup> Cf. *Procès-verbaux*, *supra* note 49, at 335 (de Lapradelle) (“The only generally recognized principles which exist, however, are those which have obtained unanimous or quasi-unanimous support.”).

<sup>84</sup> Akehurst, *supra* note 72, at 820.

<sup>85</sup> Henkin *et al.*, *supra* note 69, at 112.

<sup>86</sup> Akehurst, *supra* note 72, at 819.

The notable tendency of the ICJ to identify purportedly “general” principles by perhaps a less robust comparative exercise than might be expected—or than would suffice for an academic inquiry—is somewhat ameliorated by the fact that Article 9 of the Court’s Statute aims to ensure “representation of the main forms of civilization and of the principal legal systems of the world.” The practice of *ad hoc* tribunals and other, less representative bodies is more problematic. See Waldock, *supra* note 70, at 67.

(Waldock's image of a "legal tower of Babel"<sup>87</sup> comes to mind) and may for an arbitral tribunal or academic be practically impossible—it certainly would be for this author. Thus "almost all authors" emphasize "[t]hat universality of application is not a prerequisite of a general principle of law."<sup>88</sup> Instead identification of the principle under study in representative systems of municipal law—such as common, civil, socialist, Islamic, and Japanese law—is sufficient.<sup>89</sup>

*(b) How Similar Do They Have to Be?*

Reality must also be conceded to when considering the degree of similarity one should expect or hope to find when comparing different legal systems. It is conventional wisdom among comparative lawyers that finding identical rules in the municipal law of States from different legal traditions is unlikely and that even superficially identical rules might operate quite differently in different systems. As Dr. Mann noted,

[c]omparative lawyers will regard it as almost platitudinous that complete identity, extending to all the details of a legal rule, hardly ever exists between the legal systems of two or more countries; even if the wording of a statutory provision is the same, its judicial interpretation may differ from country to country.<sup>90</sup>

This reality need not foil the attempt to identify a general principle; in contrast, the article aims at ascertaining congruence between the principles served by the rules, not between the rules themselves. Thus, a general principle may be identified when different rules in different legal systems reflect the same principle, despite differences in points of detail, as when legal systems reach similar outcomes in similar cases, even if by different routes of legal reasoning:

[C]omparative lawyers will not hesitate to testify to the existence of a surprising degree of similarity of rules or at least results, arrived at frequently by differing means, processes of reasoning or classification. It is this similarity which permits the deduction of general principles.<sup>91</sup>

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<sup>87</sup> *Id.* at 66.

<sup>88</sup> Mann, *supra* note 54, at 34–39.

<sup>89</sup> Akehurst, *supra* note 72, at 818 (recommending this approach).

<sup>90</sup> Mann, *supra* note 54, at 39.

<sup>91</sup> *Id.*

### 3. *Final Considerations—“Appropriateness”*

Even once widespread consensus on a principle has been identified, the analysis of whether that principle constitutes a general principle of law applicable as international law does not end, although the paucity of jurisprudence on Article 38(1)(c) and on general principles does make it difficult to identify a basis for distinguishing between a widely accepted principle that is a general principle of law and one that is not. Commentators suggest that such principles are part of international law “in so far as they are applicable to relations of States,”<sup>92</sup> or, slightly more helpfully, that they “are appropriate for application on the international level”<sup>93</sup> or are “suited to the international environment.”<sup>94</sup>

These question-begging formulations do appear to track the rationale the ICJ has given for analyzing the existence of a general principle. In the Advisory Opinion concerning the *International Status of South West Africa*, the Court rejected the proposed analogy between the Mandate system under the League of Nations and trusts in municipal law. The Court emphasized the “essentially international character of the functions which had been entrusted to the Union of South Africa,” stressed that “[t]he object of the Mandate regulated by international rules far exceeded that of contractual relations regulated by national law,” and distinguished the League’s supervision and control over the Mandate territory from the role of “mandator” in national law, differences between the national and international systems that made the analogy ill fitting.<sup>95</sup>

One suspects that another reason for rejecting the analogy between trust and mandate in *South West Africa* was the Court’s rejection of the implication the South African government sought to draw from it—that because the League as mandator had ceased to exist, the Mandate had lapsed, leaving South Africa in control of the territory. A different approach was taken in Lord McNair’s separate opinion. Willing to entertain the analogy between Mandate and trust even while acknowledging that the analogy was not perfect, he drew from it a number of principles that weakened South Africa’s claims.<sup>96</sup> This suggests an organizing methodological principle: The Court rejected the analogy to municipal law because it worked an injustice, while Lord McNair embraced

<sup>92</sup> Brownlie, *supra* note 56, at 16.

<sup>93</sup> Schachter, *supra* note 74, at 52.

<sup>94</sup> Akehurst, *supra* note 72, at 816.

<sup>95</sup> 1950 I.C.J. 128, 132 *et seq.* (July 11).

<sup>96</sup> *Id.* at 148 *et seq.* (separate opinion of Lord McNair).



the analogy because he saw that it could be made to serve justice. Or, as Cheng concluded,

[a]ssuming a basic analogy between individuals, international courts and tribunals apply to international relations those principles underlying municipal rules of law which have been found to work substantial justice between individuals, whenever circumstances similar to those justifying their application exist.<sup>97</sup>

The separate opinions of Judges Koo and Fernandes in *Right of Passage over Indian Territory* also suggest justice is one of the basic evaluative criteria to be used in deciding whether to extrapolate a general principle of law from municipal law.

The “practical or logical necessity” of a principle—and in particular the extent to which it performs the function of filling gaps or resolving overlaps between primary norms discussed above—is also a basis for recognizing a general principle of law. Practical necessity may have as much to do with whether an issue is likely to arise for resolution by an international tribunal as anything: Because the effective judicial resolution of international disputes is a key *raison d’être* for general principles, they are unlikely as a practical matter to develop in areas of international law that are not subject to formal dispute settlement processes. This may begin to explain why “the universally accepted common crimes—murder, theft, assault, incest—that apply to individuals are not crimes under international law [simply] by virtue of their ubiquity”<sup>98</sup>: International tribunals have, until recently, not been faced with disputes concerning crimes under international law, so analogies to domestic criminal law have not been necessary for the resolution of international disputes.

Reason and “logical necessity” were additional bases for Judges Koo and Fernandes to identify a general principle of a right of access to enclaved territory in the *Right of Passage* case. Judge Koo, while acknowledging that “there are important distinctions between a right of passage of an international enclave and that of an enclaved land owned by a private individual,” insisted that at the foundation of the law governing both situations lay “the principle of justice founded on reason.”<sup>99</sup> Accordingly, because the principle of access to enclaved

<sup>97</sup> Cheng, *supra* note 8, at 391.

<sup>98</sup> Schachter, *supra* note 74, at 52.

<sup>99</sup> (Port. v. India), 1960 I.C.J. 6, 66 *et seq.* (April 12) (separate opinion of Judge Koo).

territory was “based upon reason and the elementary principle of justice,” it represented a general principle of law.<sup>100</sup> For his part, Judge Fernandes justified international recognition of the principle in the following terms:

[I]t was shown by a study of comparative law by Professor Max Rheinstein, filed with the Court, that the laws of all civilized nations recognize the right of access to enclaved property in favour of its owner. No sort of analogy needs to be drawn between ownership and sovereignty, nor is it necessary to transfer a rule of municipal law to the field of international law. What has to be determined is whether there is not a reason deeply rooted in the legal consciousness of all peoples for admitting, as a logical and practical necessity, the recognition of a right of passage to one who has a certain legal capacity to exercise in an area to which he cannot have access without using an area reserved for another.<sup>101</sup>

Similarly, in his separate opinion in the case concerning the *Gabcikovo-Nagymaros Project* Vice-President Weeramantry derived the general principle of law of “sustainable development,” in part, as a matter of “inescapable logical necessity.”<sup>102</sup> It may go too far to argue on the basis of Vice-President Weeramantry’s opinion that legal logic would direct the recognition as a general principle of law of any principle that would reconcile otherwise conflicting absolute rights. But his approach does provide an argument in support of a principle that would have such an effect that could also be justified on the bases of widespread acceptance, “appropriateness,” and substantial justice that have been the touchstones for identifying general principles of law in international jurisprudence to date.

### III. THE PRINCIPLE OF PROTECTING LEGITIMATE EXPECTATIONS IN NATIONAL LEGAL SYSTEMS

National legal systems reflect the principle of protecting legitimate expectations in a variety of ways. Reflections of the principle are easiest to identify in those systems that explicitly recognize the principle as a doctrine of public or

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<sup>100</sup> *Id.* at 67 (separate opinion of Judge Koo).

<sup>101</sup> *Id.* at 136 (dissenting opinion of Judge Fernandes).

<sup>102</sup> (Hung. v. Slovak Rep.), 1997 I.C.J. 7, 95 (Sept. 25) (separate opinion of Vice-President Weeramantry).

administrative law. For example, German law protects legitimate expectations as a constitutional norm, reflected in the principle of *Vertrauensschutz*, literally the “protection of trust.”<sup>103</sup> This concept heavily influenced the development by the European Court of Justice (ECJ) of the European administrative law doctrine of protection for legitimate expectations. This doctrine first appeared in the *Algera* case of 1957, where the ECJ ruled that

an administrative measure conferring individual rights on the person concerned cannot in principle be withdrawn, if it is a lawful measure; in that case, since the individual right is vested, the need to safeguard confidence in the stability of the situation thus created prevails over the interests of an administration desirous of reversing its decision.<sup>104</sup>

There is debate about whether the English courts borrowed legitimate expectations from European law or the common law developed the doctrine on its own,<sup>105</sup> but there is no denying that the doctrine of protecting legitimate expectations now features importantly in English administrative law.<sup>106</sup> Other systems that explicitly recognize a doctrine of protecting legitimate expectations include the public law of the Netherlands<sup>107</sup> and legal systems that have been more or less influenced by English law, such as the

<sup>103</sup> Grundgesetz (Basic Law), arts. 20 & 28; OVG Berlin, DVBl 72 (1957), 505 *et seq.* (holding for the first time that the duty of the administration to follow the law had to be reconciled with individual’s legitimate expectations by an *ad hoc* balancing process); BverfGE 59 (1981), 128, 164–67 (confirming that balancing approach was mandated by the Basic Law). *See also* Jürgen Schwarze, *European Administrative Law* 886 (1992).

<sup>104</sup> Cases 7/56 and 3–7/57, *Algera v. Common Assembly*, 1957 E.C.R. 56 (E.C.J. 1957).

<sup>105</sup> *See* Christopher Forsyth, *The Provenance and Protection of Legitimate Expectations*, 47 *Camb. L.J.* 238, 241 (1985) (citing a letter from Lord Denning indicating that his Lordship felt “sure [the concept of legitimate expectations] came out of my own head and not from any continental or other source”).

<sup>106</sup> *E.g.*, *Schmidt v. Secretary of State for Home Affairs*, 2 Ch. 149, 171 (1969); *R. v. Ministry for Agriculture, Fisheries and Food, ex parte Hamble (Offshore) Ltd.*, 2 All E.R. 714 (Q.B. 1995); *R. v. Gaming Board of Great Britain, ex parte Kingsley*, 1996 C.P.D. 241. *See also* Paul P. Craig, *Administrative Law* 611–50 (3d ed. 1994).

<sup>107</sup> *Rapport van de Commissie inzake algemene bepalingen van administratief recht* 187 (5th ed. 1984) (noting the general principle that public authorities may not disappoint expectations created by administrative action); *see also* Schwarze, *supra* note 103, at 869 n. 8, 926.

administrative laws of Australia,<sup>108</sup> Canada,<sup>109</sup> New Zealand,<sup>110</sup> Scotland,<sup>111</sup> and South Africa.<sup>112</sup>

An explicit doctrine of protecting legitimate expectations has not gained approval by the French courts.<sup>113</sup> Although at least one lower administrative tribunal has provided protection for such expectations (*confiance légitime*),<sup>114</sup> on appeal that decision was disapproved.<sup>115</sup> And both the *Conseil d'Etat* and the *Conseil constitutionnel* have indicated that the principle is not part of French administrative law.<sup>116</sup> Nevertheless French law effectively protects legitimate expectations as “vested rights” (*droits acquis*) and imposes restrictions on the revocation of certain administrative acts (the doctrine of *intangibilité*).<sup>117</sup> Thus, with respect to protection for legitimate expectations one commentator concluded, “French law needs such a principle less than [other legal systems might].”<sup>118</sup>

<sup>108</sup> Ian Ellis-Jones, *Essential Administrative Law* 30–32 (1999).

<sup>109</sup> *Old St Boniface Residents Ass'n v. Winnipeg (City)*, 3 S.C.R. 1170 (1990); *Reference Re Canada Assistance Plan (BC)*, 2 S.C.R. 525 (1991); see David J. Mullan, *Administrative Law* 177–86 (2001); D. Wright, *Rethinking the doctrine of legitimate expectations in Canadian administrative law*, 35 *Osgoode Hall L.J.* 139 (1997).

<sup>110</sup> S. France, *Legitimate expectations in New Zealand*, 14 *New Zeal. Univ. L. Rev.* 123 (1990).

<sup>111</sup> Christina Ashton & Valerie Finch, *Administrative Law in Scotland* 337–46 (1997); Scott Blair, *Scots Administrative Law: Cases and Materials* 113–18, 428 (1999).

<sup>112</sup> *Beyond Administrator, Transvaal v. Traub: Legitimate Expectations for South African Administrative Law*, 22 *Col. Hum. Rts. L. Rev.* 149 (1990).

<sup>113</sup> The European administrative law principle of legitimate expectations been mentioned, but never applied, in cases relating to the implementation of EC legislation. *E.g.*, *Conseil d'Etat*, June 19, 1992, *FDSEA des Côtes-du-Nord*, Rec. 783; *Conseil d'Etat*, Nov. 30, 1994, *SCI Résidence Dauphine*, R.J.F. 1995, no. 132.

<sup>114</sup> *Trib. adm. Strasbourg*, Aug. 12, 1994, *Freymuth*, A.J.D.A. 1995, 555.

<sup>115</sup> *C.A.A. Nancy*, June 17, 1999, *Freymuth*, A.J.D.A. 1999, 950.

<sup>116</sup> *Conseil d'Etat*, Mar. 5, 1999, *Rouquette*, R.D.F.A. 1999, 370 (confirming that unless the decision being challenged is “implementing the provisions of European Community law, the applicant’s claim that the CE should overrule this provision [or decision] on the grounds that it is contrary to the principle of legitimate expectations has no validity”); *accord* *Cons. const.*, 30/12–96, no. 96–385, *Recueil C* 141; *Cons. const.*, July 11, 1997, no. 97–391, *J.O.*, Nov. 11, 1997, 16390 (ruling that principle of legitimate expectations is not a principle of French constitutional law).

<sup>117</sup> *Conseil d'Etat*, Mar. 11, 1922, *Cachet*, Rec. 790 (recognizing “general principle of law” that administrative acts that “create rights” cannot, in principle, be revoked); *Commissaire de Gouvernement Henry conclusions*, *Conseil d'Etat*, Apr. 1, 1960, *Quériad*, Rec. 245, 247. (“The principle consistently upheld by the courts is that of the inviolability of the legal effects of individualized administrative acts that have created rights.”).

<sup>118</sup> Søren J. Schönberg, *Legitimate Expectations in Administrative Law* 117 (2000).

Other legal systems protect legitimate expectations even more indirectly. For example, while lawyers trained in the United States might not instinctively identify a principle of protecting legitimate expectations as such in U.S. law,<sup>119</sup> upon a closer look, legitimate expectations is one of the animating themes of jurisprudence under the Takings Clause of the Fifth Amendment<sup>120</sup> and the Due Process Clauses of the Fifth and Fourteenth Amendments to the U.S. Constitution.<sup>121</sup> In particular, U.S. courts have emphasized under the Due Process Clauses that “[r]etroactive legislation presents problems of unfairness that are more serious than those posed by prospective legislation, because it can deprive citizens of legitimate expectations and upset settled transactions.”<sup>122</sup> And a central analysis in regulatory takings cases is whether the interests at stake “were sufficiently bound up with the reasonable expectations of the claimant to constitute “property” for Fifth Amendment purposes.”<sup>123</sup> Thus, though there is no explicit doctrine of protecting legitimate expectations in U.S. law, the principle is reflected in that legal system.

Rules limiting retrospective legislation, which exist in each of the systems studied here and in many others, are also animated by a concern to protect settled expectations: “The well-established presumption against retroactive legislation, which serves to protect settled expectations, is grounded in a respect for vested rights.”<sup>124</sup> This rule of construction, whereby a statute will not be interpreted to have retrospective effect unless the legislative intent that it should is clearly expressed, is recognized in the U.S., the U.K. and France.<sup>125</sup> European administrative law similarly deals with “the applicability

<sup>119</sup> *But see* L. Harold Levinson, *The Legitimate Expectation that Public Officials Will Act Consistently*, 46 *Am. J. Comp. L.* 549 (1998) (identifying “consistency principle and the related concept of legitimate expectations . . . reflected—although seldom specifically identified—in American public law” generally).

<sup>120</sup> *See Penn Central Transportation Co. v. City of New York*, 438 U.S. 104, 124 (1978) (identifying “the extent to which the regulation has interfered with distinct investment-backed expectations” as one of three factors “that have particular significance” in evaluating regulatory takings claims).

<sup>121</sup> *Compare Board of Regents v. Roth*, 408 U.S. 564 (1972) *with Perry v. Sindermann*, 408 U.S. 593 (1972) (where different outcomes can be said to turn on the presence or absence of reasonable expectations, described as “legitimate claim to entitlement” to right short of contract or other traditional manifestation of property).

<sup>122</sup> *General Motors Corp v. Romein*, 503 U.S. 181, 191 (1991).

<sup>123</sup> *Penn Central Transportation Co. v. City of New York*, 438 U.S. 104, 125 (1978).

<sup>124</sup> *Landgraf v. USI Film Products*, 511 U.S. 244, 296 (1994) (Blackmun, J. dissenting); *accord* Elmer E. Smead, *The Rule Against Retroactive Legislation: A Basic Principle of Jurisprudence*, 20 *Minn. L Rev.* 775, 784 (1936).

<sup>125</sup> *Landgraf*, 511 U.S. 244; *Phillips v. Eyre*, 6 Q.B. 1, 23 (1870); Marcel Waline, *Droit administratif* (9th ed. 1963), at no. 221.

of legislative acts to events which originated in the past but which have yet to be definitively concluded”<sup>126</sup> with an interpretive canon or clear statement rule.<sup>127</sup> Significantly, however, none of these systems imposes an absolute ban on retrospective legislation. In France, although retroactive statutes are outlawed by Article 2 of the Civil Code,<sup>128</sup> this is only a statutory principle, subject to legislative revision, and in practice it has been diluted to the rule of interpretation discussed above. German law most clearly applies the principle of protecting legitimate expectations to the question of retrospective legislation: Actual retrospective effect, which changes the legal significance of acts that were completed in the past, is only exceptionally consistent with the requirements of the legitimate expectations doctrine, while so-called “apparent” retrospectivity, which affects acts that may have begun in the past but are ongoing, is in principle consistent with the German constitution and may only exceptionally transgress the doctrine of protection for legitimate expectations.<sup>129</sup>

These rules on retrospective legislation suggest that, although there is in principle some concern about legitimate expectations of a stable legal situation, this concern will only infrequently give rise to protection for these expectations. U.S. law is particularly clear on this point:

[O]ur cases are clear that legislation readjusting rights and burdens is not unlawful solely because it upsets otherwise settled expectations. This is true even though the effect of the legislation is to impose a new duty or liability based on past acts.<sup>130</sup>

Thus such retroactive legislation is generally permissible whenever retroactivity serves some rational purpose.<sup>131</sup>

The fact that the legal systems referenced in this discussion are all identifiably “Western” should not obscure the fact that more than one of the world’s legal families is represented, and each reflects a noticeably different public law

<sup>126</sup> Schwarze, *supra* note 103, at 1121.

<sup>127</sup> See Case 1/73, Westzucker GmbH v. Einfuhr- und Vorratsstelle für Zucker, 1973 E.C.R. 723.

<sup>128</sup> “*La loi ne dispose que pour l’avenir, elle n’a point d’effet rétroactif.*”

<sup>129</sup> Schwarze, *supra* note 103, at 899 *et seq.*

<sup>130</sup> *Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1, 16 (1975).

<sup>131</sup> *E.g.*, *Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 729 (1984) (“Provided that the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means, judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches.”).

tradition: The United States and the United Kingdom are both common law systems, but the United States has both a written constitution and a statute-based system of administrative law.<sup>132</sup> The United Kingdom, by contrast, has an unwritten constitution and until fairly recently not only did not distinguish between public law and private law,<sup>133</sup> but has been described as not having “a developed system of administrative law.”<sup>134</sup> Scholars have emphasized the divergence between the essentially pragmatic (and some would say anti-rationalist) common-law, especially English, approach to issues of public law and administration and highly articulated Continental conceptions such as the French *l'état de droit* and the German *Rechtsstaat*.<sup>135</sup> But it also bears noting that, while France and Germany are both civil law systems, they come from the Romanic and Germanic branches of that legal family respectively. The key components of French administrative law were born of the Revolution of 1789 and the period of the Consulate (1798–1802),<sup>136</sup> while German administrative law is heavily influenced by developments in German constitutional law after the Second World War.<sup>137</sup> These different histories have led to significantly different structures and approaches to the problems of administration. European law, for its part, is a supra-national hybrid of the legal traditions of its members, including both common law and civilian systems. These systems thus support a more meaningful comparison than their shared “Western-ness” might suggest.

#### IV. THE CONTOURS OF A GENERAL PRINCIPLE OF PROTECTING LEGITIMATE EXPECTATIONS

As the discussion of rules on retroactive legislation made especially clear, any expression of a principle of protecting legitimate expectations based on an analogy to municipal public law would not be absolute: Consider, for example, the position in U.S. constitutional law, which provides that “legislation readjusting rights and burdens is not unlawful solely because it upsets otherwise

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<sup>132</sup> See Administrative Procedure Act, 5 USCA § 500 *et seq.*

<sup>133</sup> See *O'Reilly v. Mackman*, 1983 A.C. 237 (importing public law/private law distinction into English law).

<sup>134</sup> *Ridge v. Baldwin*, 2 All E.R. 66, 76 (H.L.) (1963).

<sup>135</sup> Robert Thomas, *Legitimate Expectations and Proportionality in Administrative Law* 4 (2000).

<sup>136</sup> L. Neville Brown and John S. Bell, *French Administrative Law* 9 *et seq.* (5th ed. 1998).

<sup>137</sup> Georg Nolte, *General Principles of German and European Administrative Law—A Comparison in Historical Perspective*, 57 *Modern L. Rev.* 191, 198 (1994).



settled expectations.”<sup>138</sup> This tracks the outcome of the recent investment cases, where although some legitimate expectations claims have been upheld, others have failed.

This part of the article extends the general principles methodology to attempt to identify factors that support the protection of legitimate expectations and those which do not. Two caveats before turning to this analysis: First, it is beyond the scope of this article to recount every manifestation of this principle in the legal systems of the world, or even just in those systems in which it features most explicitly. Second, as the methodological discussion in part II made clear, one need not prove universal adherence to a doctrine that takes the identical form in various legal systems for it to reflect a “general principle of law recognized by civilized nations.” Accordingly, the references to the doctrines protecting legitimate expectations in various systems of national law that follow will not be an attempt to identify the “least common denominator” or “greatest common factor” between legal systems, but will instead propose a hybrid principle of protection for legitimate expectations drawn from various sources.

The analysis in this part is organized around the following working statement of the principle reflected in a comparative survey: “any individual who, as a result of governmental conduct, holds certain expectations concerning future governmental activity, can require those expectations to be fulfilled unless there are compelling reasons for not doing so.”<sup>139</sup> Each of the sections that follows looks for further consensus among national legal systems on each element of that statement of principle: What is the nature of the “governmental conduct” that can give rise to expectations? Only “certain” expectations are legitimate, but which are they? What would constitute “compelling reasons” for not providing protection? And what form does this protection take—what does it mean for “expectations to be fulfilled”? The answers municipal law gives to these questions, which are considered along with recent investment awards, suggest the direction in which the principle of protection for legitimate expectations might develop as a matter of international law.

### *1. What “Governmental Conduct” Can Give Rise to Expectations?*

#### *(a) Form*

National legal systems impose few formal requirements for the type of governmental conduct that can give rise to legitimate expectations,

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<sup>138</sup> *Usery*, 428 U.S. at 16.

<sup>139</sup> Thomas, *supra* note 135, at xv.



although the person asserting expectations must be able to point to some overt government action, and the conduct in question must be precise and unambiguous.

The first point, that legitimate expectations actually have to be based on government conduct, may seem obvious, but it serves to distinguish what U.S. courts refer to as a mere “unilateral expectation” from expectations that are to be protected.<sup>140</sup> As commentators on protection for legitimate expectations in European administrative law emphasize, the ECJ normally “requires a certain degree of active participation in the raising of the expectation.”<sup>141</sup>

Otherwise the government conduct that might give rise to an expectation can take many forms. European and English courts have recognized a particularly wide range of administrative acts, in addition to formal administrative decisions, that may generate expectations. The *Châtillon* case from 1966 established in European law that legitimate expectations could be raised by an informal “statement” as well as a formal decision, although the expectations were not found deserving of protection in that case.<sup>142</sup> And though it may be more difficult to establish an expectation on the basis of an oral statement, oral statements that are sufficiently precise have been held to give rise to legitimate expectations.<sup>143</sup>

Similarly, English courts have accepted that expectations can be raised in a number of different ways, including by a government promise or undertaking, or simply by a representation or the provision of information to an individual.<sup>144</sup> Such administrative act may be express or implied<sup>145</sup> and may be identified on the basis of government conduct either alone or in addition to words.<sup>146</sup> Possible sources of a representation include a statement by an individual, a circular, report or other document, an agreement between the individual claiming the expectation and the government, and an international

<sup>140</sup> Board of Regents v. Roth, 408 U.S. 564, 577 (1972).

<sup>141</sup> Schwarze, *supra* note 103, at 952.

<sup>142</sup> Case 54/65, *Châtillon v. High Authority*, 1966 E.C.R. 185, 196.

<sup>143</sup> Cases T-66/96 and 221/97, *Mellett v. ECJ*, 1998 E.C.R.-S.C. II-1305.

<sup>144</sup> Paul P. Craig, *Substantive Legitimate Expectations in Domestic and Community Law*, Cambridge L.J. 289, 290 (1996).

<sup>145</sup> *R. v. Secretary of State for Transport, ex parte Richmond upon Thames*, 1 W.L.R. 74 (Q.B.) (1994).

<sup>146</sup> *R. v. Inland Revenue Commissioners, ex parte MFK Underwriting Agencies Ltd.*, 1 W.L.R. 1595 (Q.B.) (1990); *R. v. Gaming Board of Great Britain, ex parte Kingsley*, 1996 C.O.D. 241.

treaty.<sup>147</sup> A representation need not have been made directly to the individual claiming an expectation.<sup>148</sup> An expectation has also been found on the basis of a consistent course of conduct over an extended period of time.<sup>149</sup>

Likewise in U.S. law, expectations that were protected as property under the Due Process Clauses have been based on “a broad range of interests that are secured by ‘existing rules or understandings.’”<sup>150</sup> These include implied promises<sup>151</sup> and statements in administrative handbooks, administrative guidelines, and consistent practice in conformity with those statements.<sup>152</sup>

Because the rules that most clearly reflect the principle of protection for legitimate expectations in French and German law are, by and large, rules about the withdrawal or revocation of administrative decisions, they are necessarily directed at administrative action of a certain degree of formality. It is nevertheless clear in these systems that administrative decisions across the range of administrative competence, and taking different forms, are capable of giving rise to legitimate expectations. Those administrative acts that give rise to protected expectations include the decision to award a contract,<sup>153</sup> the grant of a permit or license,<sup>154</sup> and a promotion decision in the civil service.<sup>155</sup> And it is clear that in French law, administrative representations that do not take the form of a formal decision may give rise to expectations at least sufficient to support an award of damages when the expectations are disappointed, although

<sup>147</sup> *Hamble Fisheries*, 2 All E.R. 714 (1995) (agreement); *R. v. Secretary of State for Health, ex parte United States Tobacco International Inc.*, 1992 Q.B. 353 (agreement); *R. v. Secretary of State for the Home Department, ex parte Ahmed*, 1999 C.O.D. 69 (treaty).

<sup>148</sup> *Attorney-General of Hong Kong v. Ng Yuen Shiu*, 2 A.C. 629, 634–35 (1983) (expectation based on television reporting of oral statement of senior official in response to petition by third parties similarly situated to applicant claiming expectation).

<sup>149</sup> *See R. v. Inland Revenue Commissioners, ex parte Unilever plc*, 1996 S.T.C. 681, 1996 C.O.D. 421.

<sup>150</sup> *Perry v. Sindermann*, 408 U.S. 593, 600 (1972) (citations omitted).

<sup>151</sup> *Connell v. Higginbotham*, 403 U.S. 207, 208 (1971).

<sup>152</sup> *Perry*, 408 U.S. at 599 *et seq.*

<sup>153</sup> *E.g.*, *Conseil d'Etat*, Dec. 16, 1988, *SCI Paule*, R.D.P. 1898, 1796 (award of procurement contract).

<sup>154</sup> *Conseil d'Etat*, Jan. 20, 1960, *Zagame*, Rec. 35 (construction permit); *Conseil d'Etat*, June 1, 1973, *Roulin*, Rec. 390 (same); *Conseil d'Etat*, Oct. 10, 1982, *Crédit Lyonnais*, D.A. 1982 no. 372 (same); *Conseil d'Etat*, Oct. 26, 1988, *Jagord*, no. 79.185 (professional license); *Conseil d'Etat*, Dec. 3, 1982, *Société continentale de promotion immobilière*, Rec. 409 (commercial activity license).

<sup>155</sup> *Conseil d'Etat*, Feb. 24, 1967, *De Maistre*, Rec. 91 (promotion of civil servant); *Conseil d'Etat*, Feb. 22, 1989, *Fentenille*, Rec. 44 (same).

the administration will not be bound to comply with or otherwise satisfy the expectations generated by the representation.<sup>156</sup>

While there is widespread agreement that much government conduct can, in principle, give rise to an expectation, national courts do look for a certain degree of specificity and precision. The ECJ has held that, to give rise to expectations, the administrative conduct in question must amount to a “precise and specific assurance”<sup>157</sup>: “it is only a concrete expectation which is protected.”<sup>158</sup> The English courts also look for conduct that is “clear and unambiguous.”<sup>159</sup> And U.S. courts refer to “mutually explicit understanding[s].”<sup>160</sup>

None of the rules discussed so far concerns expectations that are effectively based on legislation itself, such as an expectation, based on nothing more than the current state of the law, that existing legislation will not be amended or repealed or reinterpreted. This is not because national law does not recognize that expectations may be implicated by legislation—rules on retroactivity do reflect this awareness—and although protection of such expectations is often very limited, that they can arise is not in doubt.

This brief survey suggests that a general principle of protecting legitimate expectations in international law might impose little in the way of formal requirements for the type of governmental conduct that could potentially give rise to expectations, although it should insist that such conduct be overt, clear, and specific. *Tecmed* reflects the view that a broad range of government conduct may generate expectations, having identified legitimate expectations based on, among other things, an unwritten agreement between the investor and the authorities.<sup>161</sup> To the extent that it would recognize that expectations may be raised by various forms of government conduct, including informal communications, such an approach may seem to be more generous than the approach outlined in *Nagel*, which emphasized not only that there had been insufficiently “concrete Government involvement” but also that the investor sought to rely on informal personal contacts with various government ministers

<sup>156</sup> *E.g.*, Conseil d’Etat, Oct. 18, 1957, Bouveret, Rec. 542.

<sup>157</sup> Case T-123/89, *Chomel v. Commission*, 1990 E.C.R. II-131, para. 26. *See also* Case T-465/93, *Murgia Messapica v. Commission*, 1994 E.C.R. II-361, para. 67; Case T-571/93, *Lefebvre v. Commission*, 1995 E.C.R. II-2379, para. 72–74; Case T-521, *Atlanta v. Council*, 1996 E.C.R. II-1707, para. 57.

<sup>158</sup> *Schwarze*, *supra* note 103, at 951.

<sup>159</sup> *Craig*, *supra* note 144, at 290.

<sup>160</sup> *Perry*, 408 U.S. at 601.

<sup>161</sup> *See Tecmed*, *supra* note 1, para.160 (noting “that the relocation agreement has not been memorialized in an instrument signed by all the parties involved”).

or officials and that formalities necessary to bind the Government had not been observed.<sup>162</sup> But the focus in that case was as much on the vagueness and generality of the expressions of interest by government officials as on the fact that no formal commitment had been made. And of course the issue of legitimate expectations arose as part of the analysis of whether a claim to performance under a contract had financial value, a context in which the scope and limits of any contractual obligation would seem to be decisive. A requirement that conduct be overt, clear, and specific tracks the result in *GAMI*, where the legitimate expectations claim failed in part because the investor could not point to “an unambiguous affirmation” by the Government.<sup>163</sup>

It is submitted that a flexible approach to the form of government actions that may give rise to expectations is a sensible starting point for an international legal principle of protecting legitimate expectations: There seems to be little basis in international or comparative law for distinguishing among the types of administrative activity that can give rise to expectations, although it is just and reasonable that expectations must be traceable to some overt and specific government conduct. Thus, without more, it would be unusual for legitimate expectations to be founded solely on the basis of the pre-existing legal regime.

### *(b) Beneficial Effect*

In order to give rise to expectations in national law, governmental conduct, whatever its form, generally has to tend to the benefit of the addressee.

The identification of administrative acts that “create rights”<sup>164</sup> and hence may be entitled to protection is an area in which French “administrative courts [have] never provided a conceptual definition.”<sup>165</sup> Generally, though, it appears that only favorable decisions will be found to create rights.<sup>166</sup> German law makes this point more explicitly, distinguishing between government acts that benefit individuals and those that impose burdens on them. Only expectations based

<sup>162</sup> *Nagel*, *supra* note 44, at 158–64.

<sup>163</sup> *GAMI*, *supra* note 17, para. 76.

<sup>164</sup> Conseil d’Etat, Nov. 3, 1922, Cachet, Rec. 790.

<sup>165</sup> Schönberg, *supra* note 118, at 71.

<sup>166</sup> *Id.* at 73 & n.70 (acknowledging that though no French case explicitly imposes this requirement, “a survey of numerous decisions suggests that this requirement is implicitly and consistently applied”; also citing French commentators who note “that favourable decisions normally create rights while unfavourable normally do not”).

on the former will be protected.<sup>167</sup> Withdrawal or revocation of administrative decisions imposing burdens is discretionary, while withdrawal of acts that confer benefits is limited by the need to protect legitimate expectations.<sup>168</sup> The ECJ has blended the German distinction between administrative acts that benefit as opposed to burden and the French focus on acts that “create rights.” In early cases, the Court limited the revocation of an act that “created a right or a similar advantage”<sup>169</sup> and a decision “by which a benefit is conferred,”<sup>170</sup> and the Court ultimately settled on the description “favorable administrative act[s].”<sup>171</sup> The requirement of beneficial effect is not prominent in the English case law. Commentators nevertheless find that it “is implicitly and consistently applied.”<sup>172</sup>

Although this issue does not yet appear to have arisen in international investment awards, the requirement that conduct said to give rise to expectations have a beneficial effect on the addressee seems like a commonsense requirement for an international legal principle of protecting legitimate expectations. In any event, it seems unlikely as a practical matter that anyone would contend that his expectation of a negative regulatory outcome should be protected.

(c) *Individualized*

Legitimate expectations can only, or can at least more readily, be based on acts directed at one individual or a small group rather than acts or rules addressed more generally.

French law draws this line very clearly, recognizing “a distinction... between those rights which have been acquired through an individual measure and those conferred on the basis of a regulation.”<sup>173</sup> Individualized acts give rise to vested rights and are in principle inviolable, while more general acts, *actes*

<sup>167</sup> VwVfG, art. 49(1) (allowing free revocation of administrative acts that impose burdens); see Schwarze, *supra* note 103, at 890.

<sup>168</sup> Compare VwVfG, art. 48(1)(1) (withdrawal of administrative acts imposing burdens is discretionary—“kann” as opposed to “muß”) with VwVfG, art. 48(2)–(4) (imposing conditions on withdrawal of administrative acts providing benefit).

<sup>169</sup> Cases 42 and 49/59, Société nouvelle des usines de Pontlieue - Aciéries du Temple (S.N.U.P.A.T.) v. High Authority, 1961 E.C.R. 53.

<sup>170</sup> Case 111/63, Lemmerz-Werke v. High Authority, 1965 E.C.R. 677.

<sup>171</sup> Case C-90/95P, Henri de Compte v. European Parliament, 1997 E.C.R. I-1999, para. 35.

<sup>172</sup> Schönberg, *supra* note 118, at 73.

<sup>173</sup> Schwarze, *supra* note 103, at 875 (citing P. Auvret, La notion de droit acquis en droit administratif français, R.D.P. 1985, 67).

*réglementaires*, are only limited by rules prohibiting retroactivity. “[N]obody has a right to insist on an *acte réglementaire* being upheld, *i.e.* to oppose its being annulled for the future.”<sup>174</sup> The ECJ has reached a similar position by the application of rules of *locus standi*: “Any natural or legal person may, under the same conditions, institute proceedings against a decision addressed to that person or against a decision which, although in the form of a regulation or a decision addressed to another person, is of direct and individual concern to the former.”<sup>175</sup> Thus private parties may not normally challenge generally applicable regulations. It appears that German law draws a similar distinction between concrete, individualized decisions and abstract, general rule-making.<sup>176</sup> U.S. law does not confront this issue directly, but a general regulatory regime itself is normally not the basis for expectations that will be protected by property rights, and if anything the existence of such a regime will be seen as putting individuals on notice that the regime is likely to change.<sup>177</sup> Some English commentators discern in the case law a distinction between generalized administrative actions, such as rule-making or other more legislative activities, and quasi-judicial individualized determinations and conclude that legitimate expectations are more likely to be recognized in the latter setting.<sup>178</sup>

The limited substantive bite of rules on retroactivity may in part be attributable to this distinction between expectations based on individualized and expectations based on general acts: This distinction suggests that an expectation that the law will not be changed should usually not be protected, and such a generalized expectation is not based on the specific or individualized governmental conduct that typically gives rise to a legitimate expectation.

The recent investment awards also reflect heightened protection for individually targeted conduct. The expectations that have been protected were, in *Tecmed*, based on individualized communications and an agreement between the investor and the regulators,<sup>179</sup> and in *MTD* on government approval of

<sup>174</sup> Schwarze, *supra* note 103, at 882.

<sup>175</sup> Treaty establishing the European Community, art. 230 (ex article 173). *See also* ECSC Treaty, art. 33, second paragraph (restricting grounds for undertakings to challenge rule-making instruments only to misuse of powers).

<sup>176</sup> Schwarze, *supra* note 103, at 956.

<sup>177</sup> *E.g.*, *FHA v. The Darlington*, 358 U.S. 84, 91 (1958) (“Those who do business in the regulated field cannot object if the legislative scheme is buttressed by subsequent amendments to achieve the legislative end.”); *Usery*, 428 U.S. at 15–16; *Concrete Pipe and Products of California, Inc v. Construction Laborers Pension Trust for Southern California*, 508 U.S. 602, 645–46 (1999).

<sup>178</sup> Craig, *supra* note 106, at 614 (citing *Hamble Fisheries*, 2 All E.R. at 729 1995).

<sup>179</sup> *Tecmed*, *supra* note 1, paras. 123–51, 154–74.

foreign investment contracts to which the investor was a party.<sup>180</sup> *Nagel* may seem to be something of an outlier in this respect—there the investor could point to a contract with a State enterprise and several individual (albeit informal) contacts with government officials<sup>181</sup>—but the *Nagel* Tribunal ultimately ruled that not only did the contract not amount to a guarantee of anything, neither was the Government directly involved in the contract, suggesting that the finding on legitimate expectations in this case turned on other considerations. *ADF* too is consistent with a principle that individualized government action will be more likely to give rise to protected expectations. In *ADF*, the investor sought to ground its legitimate expectations on prior interpretations of various legislative enactments in cases to which the investor was not a party, a claim which failed.<sup>182</sup>

In addition to these recent awards, international law has addressed expectations about the persistence of a legislative environment in the related context of investment or concession contracts. In that context, an investor may secure an explicit contract provision that some or all of the relevant legal landscape will remain the same.<sup>183</sup> But such protection results only from that individual bargain with the State; a guaranty of legal stability is not implied from the application of international law to these agreements but arises only out of a specific contract term.<sup>184</sup> It would be surprising for a general principle of protecting legitimate expectations effectively to provide to all investors the protection that some had won through a bargained-for exchange.<sup>185</sup> Although

<sup>180</sup> *MTD*, *supra* note 20, paras. 159–66.

<sup>181</sup> *Nagel*, *supra* note 44, at 155–56.

<sup>182</sup> *ADF*, *supra* note 13, para. 72; *cf.* *CMS Gas Transmission Co v. Argentine Republic*, ICSID Case No. ARB/01/8, Decision on Objections to Jurisdiction, July 17, 2003, para. 27, 42 I.L.M. 788 (2003), available at [http://www.worldbank.org/icsid/cases/CMS\\_Decision\\_english.pdf](http://www.worldbank.org/icsid/cases/CMS_Decision_english.pdf) (in the jurisdictional context, looking not simply at whether the policy or law of a country has changed but whether “those general measures are adopted in violation of specific commitments given to the investor in treaties, legislation or contracts . . . not the general measures in themselves but the extent to which they may violate those specific commitments”).

<sup>183</sup> *E.g.*, *BP Exploration Co. (Libya) Ltd v. Government of the Libyan Arab Republic*, 53 I.L.R. 297, 332 (1979) (reproducing “stabilization clause”).

<sup>184</sup> *See* G.R. Delaume, *State Contracts and Transnational Arbitration*, 75 Am. J. Int’l L. 784, 805–06 (1981) (distinguishing effect of stabilization clause from effect of “internationalization” or application of international law to contract).

<sup>185</sup> *Cf.* *Thunderbird Separate Opinion*, *supra* note 5, para.102 (“Legitimate expectations—under Art. 1105 of the NAFTA or equivalent investment protection treaties—is never to be seen as an iron-clad guarantee—comparable to a long-term concession contract with a stabilisation guarantee—that policies will not change.”).



protection of legitimate expectations based on government conduct that does not rise to the level of a contract or formal promise may be desirable, a requirement that an expectation be based on some individualized government act seems an appropriate limitation.

One rationale that has been offered for this distinction between expectations based on targeted acts and those based on general acts is “both because an unequivocal representation made to a person carries a particular moral force, and because holding the public body to that representation is less likely to have serious consequences for the administration as a whole” than would the protection of legitimate expectations in a case involving a general norm or quasi-legislative policy choice, not to mention legislation itself.<sup>186</sup> This rationale seems to be equally persuasive in respect of an international legal principle of protection for legitimate expectations, as limiting claims for the protection of legitimate expectations to those measures which are directed to one or a small number of natural or legal persons rather than generally will limit the impairment of sovereignty that necessarily results from a successful claim for the protection of legitimate expectations. At the least, it is submitted that legitimate expectations should more readily be identified on the basis of individualized administrative conduct or communication than on the basis of general legislation or quasi-legislative administrative rulemaking.

(d) *Lawful?*

An *ultra vires* administrative act can in principle give rise to expectations that may be protected, although it should do so less readily than would lawful administrative conduct.

The question of expectations based on unlawful acts is one on which national legal systems are somewhat divided. For example, German law takes the position that *ultra vires* acts can give rise to legitimate expectations, but that expectations based on such acts are not to be protected by maintaining the act in force but by compensation,<sup>187</sup> an issue addressed specifically in sub-section 4 below. It is somewhat unclear in English law whether an *ultra vires* act can give rise to a legitimate expectation. Expectations purportedly based on acts that are outside the power of the person or institution that authors them have seemed especially problematic to the English courts,<sup>188</sup> but the apparent injustice

<sup>186</sup> Craig, *supra* note 106, at 614.

<sup>187</sup> Schwarze, *supra* note 103, at 887–92 (citing DVBl. 1957, 503; BVerwGE 9, 251 *et seq.*; BVerwGE 19, 188, 189 and further references).

<sup>188</sup> See, e.g., Schwarze, *supra* note 103, at 903.



that can result from a strict application of the *ultra vires* doctrine has led the English courts to develop a less than analytically satisfying set of “exceptions” to the *ultra vires* doctrine to avoid the conclusion that such acts would have no legal effect.<sup>189</sup> French law recognizes no difficulty in principle with basing expectations on *ultra vires* acts, although French law does allow the withdrawal of *ultra vires* acts within a specified time period, while withdrawal of lawful acts that create rights is, in principle, impossible.<sup>190</sup> European law is closer to French law, in that unlawful acts may be withdrawn within a “reasonable time.”<sup>191</sup> This question has not arisen in U.S. law.

In some ways this issue is less fraught in international law than it might be in national legal systems, where values such as administrative compliance with statute law are given priority. It is well settled that the provisions of municipal law may not be interposed as an excuse for failure to comply with international law.<sup>192</sup> This suggests that the compliance or non-compliance with municipal law of an administrative act that gave rise to expectations should not be determinative of the degree of protection, if any, those expectations will receive in international law. *MTD* reflects this approach. In *MTD*, the investors’ expectations based on government approval of a Project that turned out to contravene aspects of national urban policy<sup>193</sup> were given protection via the obligation of fair and equitable treatment despite their clear incompatibility with national law. Moreover, it might be more difficult for a foreign investor to evaluate the legality in domestic law of an administrative act directed at him. Nevertheless, it is undeniable that an international legal rule that protects expectations based on unlawful acts which might not be protected by national legal principles relating to legitimate expectations is likely to be controversial. A reasonable position might be that *ultra vires* acts, while they may give rise to legitimate expectations, will do so less readily than would lawful acts. This might be reflected in consideration of whether the expectations are reasonable (see the next sub-section) or in the balancing test discussed as the third step of the legitimate expectations analysis (sub-section 3 below).

<sup>189</sup> Craig, *supra* note 106, at 640.

<sup>190</sup> Schwarze, *supra* note 103, at 878–79.

<sup>191</sup> Cases 7/56 & 3–7/57, *Algera v. Common Assembly*, 1957 E.C.R. 39, 56.

<sup>192</sup> *E.g.*, *Treatment of Polish Nationals in Danzig*, 1932 P.C.I.J. (ser. A/B), No. 44, at 24 (Feb. 4).

<sup>193</sup> See *MTD*, *supra* note 20, para. 166 (acknowledging the Project was “against the urban policy of the Government”).

## 2. What Makes “Certain” Expectations Legitimate and Others Illegitimate?

### (a) Reasonableness

Legitimate expectations must be reasonable, both objectively and subjectively.

National legal systems are agreed in protecting only “reasonable” expectations. This analysis typically has both an objective and a subjective aspect. From an objective standpoint, the ECJ considers whether the alleged expectation is that of a diligent or prudent person,<sup>194</sup> which is a fairly strict standard.<sup>195</sup> Evidence that an expectation is subjectively unreasonable, in that for example it conflicted with other knowledge the individual had about the administration’s intentions,<sup>196</sup> will defeat a claim that a legitimate expectation was created.<sup>197</sup> Failure to satisfy conditions imposed by the decision in question<sup>198</sup> or by the statutory framework<sup>199</sup> will make an expectation that the decision will remain in force illegitimate because, without more, it is not reasonable to expect that non-fulfillment of those conditions will be excused. Another factor is whether revocation is explicitly permitted by statute or regulation—in such case, an expectation that the act would remain in force is unlikely to be reasonable.<sup>200</sup> Similarly, knowing failure to follow a prescribed procedure for obtaining an

<sup>194</sup> Case 78/77, *Lührs v. Hauptzollamt Hamburg-Jonas*, 1978 E.C.R. 169, para. 6; Case 265/85, *Van den Bergh en Jurgens v. Commission*, 1987 E.C.R. 1155, para. 44. *See also* Advocate General Van Gerven *in* Case C-136/93, *Transáfrica SA v. Administration of the Spanish State*, 1994 E.C.R. I-5757, para. 11; Eleanor Sharpston, *Legitimate Expectation and Economic Reality*, 15 *Eur. L. Rev.* 103, 156, 158–59 (1990).

<sup>195</sup> R.-E. Papadopoulou, *Principes généraux du droit et droit communautaire* 223, 236–37 (1996).

<sup>196</sup> *See* Case T-23/90, *Peugeot v. Commission*, 1991 E.C.R. II-653, para. 48.

<sup>197</sup> *See* Case 169/73, *Compagnie Continentale France v. Council*, 1975 E.C.R. 117, para. 23; Case T-141/94, *Thyssen Stahl v. Commission*, 1999 E.C.R. II-347, para. 510 (Nov. 3 1999); Cases T-46/98 and T-151/98, *Council of European Municipalities and Regions (CEMR) v. Commission*, 2000 E.C.R. II-00167, para. 78–79 (Feb. 3, 2000); Craig, *supra* note 106, at 619 (citing *Kingsley*, 1996 C.O.D. 241, 242).

<sup>198</sup> Case 121/83, *Zuckerfabrik Franken v. Hauptzollamt Würzburg*, 1984 E.C.R. 2039; Case T-73/95, *Oliveira SA v. Commission*, 1997 E.C.R. II-381; Case T-331/94, *IPK-München v. Commission*, 1997 E.C.R. II-1665; Cases T-194/97 and 83/98, *Branco v. Commission*, 2000 E.C.R. II-69 (Jan. 27, 2000), para. 94. *See* *VwVfG*, art. 49(2)(2).

<sup>199</sup> Case 54/77, *Herpels v. Commission*, 1978 E.C.R. 585, 598; Case 15/60, *Simon v. ECJ*, 1961 E.C.R. 115. *See* *VwVfG*, art. 49(2)(2).

<sup>200</sup> *See* *VwVfG*, art. 49(2)(1)(1) & (2).

assurance will prevent the formation of a reasonable expectation.<sup>201</sup> U.S. case law suggests that it will generally not be reasonable to expect that something which has already been the subject of legislative attention, in the form of an existing statutory regime, will not again make its way onto the legislative agenda.<sup>202</sup> Accordingly, an expectation that the law will require or allow something tomorrow based on nothing more than the fact that it was required or allowed today is generally not reasonable.

The good faith of the person claiming the expectation is also central to the inquiry. Administrative acts procured by deception and fraud will not give rise to legitimate expectations.<sup>203</sup> Nor will decisions that rest “upon wrong or incomplete information from the persons concerned.”<sup>204</sup> Failure to place “all cards face up on the table” and disclose all relevant circumstances will render a purported expectation illegitimate.<sup>205</sup> If the governmental act on which the expectation was based was procured through deception, duress or bribery, on the basis of substantially incorrect or incomplete information, was known to be unlawful, or it was wanton negligence not to know that it was unlawful, there is no legitimate expectation to protect.<sup>206</sup> And in general “[t]he courts will not readily infer a legitimate expectation where it would confer an unmerited or improper benefit which offended against considerations of fairness and justice.”<sup>207</sup>

Awards in which investors’ expectations have been protected have not always emphasized that those expectation were reasonable in the circumstances, but they are nevertheless broadly consistent with such a requirement. *Tecmed* considers this at length.<sup>208</sup> But the *MTD* Tribunal treated the issue of “[w]hether the Claimants acted responsibly or diligently” as a separate question of contributory fault,<sup>209</sup> and *OEPC* does not consider the reasonableness of the

<sup>201</sup> *R. v. Commissioners of Inland Revenue, ex parte Matrix Securities Ltd.*, 1 W.L.R. 334 (1994).

<sup>202</sup> *E.g.*, *FHA v. The Darlington*, 358 U.S. 84, 91 (1958).

<sup>203</sup> Cases 42 and 49/59, *Société nouvelle des usines de Pontlieue—Aciéries du Temple (S.N.U.P.A.T.) v. High Authority*, 1961 E.C.R. 53; *Case C-96/89, Commission v. Netherlands*, 1991 E.C.R. I-2461.

<sup>204</sup> Schönberg, *supra* note 118, at 80.

<sup>205</sup> *MFK Underwriting Agencies Ltd.*, 1 W.L.R. at 1569 (1990); *Matrix Securities Ltd.*, 1 WLR 334 (1994).

<sup>206</sup> VwVfG, art. 48(2)(3).

<sup>207</sup> Craig, *supra* note 106, at 619 (citing *Kingsley*, 1996 C.O.D. at 243).

<sup>208</sup> *E.g.*, *Tecmed*, *supra* note 1, paras. 141, 149–60.

<sup>209</sup> *MTD*, *supra* note 20, paras. 168–78.

investor's expectations in terms. Awards in which legitimate expectations were not identified generally do not address the issue of "reasonableness" in terms either, although in *GAMI*, *Nagel* and *Thunderbird* the Tribunals emphasized circumstances that would have made any expectations unreasonable. In *GAMI*, the government conduct in question was too uncertain to support an expectation of particular government conduct.<sup>210</sup> In *Nagel* the investor, having obtained no guarantees or a "binding commitment" from the government, could not reasonably have had such an expectation.<sup>211</sup> And the *Thunderbird* Tribunal detailed at length the circumstances that would have made any expectation of being able to engage in the gambling business in Mexico unreasonable:

It cannot be disputed that Thunderbird knew when it chose to invest in gaming activities in Mexico that gambling was an illegal activity under Mexican law. By Thunderbird's own admission, it also knew that operators of similar machines... had encountered legal resistance from [the regulators]. Hence, Thunderbird must be deemed to have been aware of the potential risk of closure of its own gaming facilities and it should have exercised particular caution in pursuing its business venture in Mexico.<sup>212</sup>

As for the good faith of the investor, it is here that the *Thunderbird* majority and separate opinion disagree. The majority of the Tribunal, finding that the investor's request to the government for an advisory opinion was "not a proper disclosure and that it puts the reader on the wrong track"<sup>213</sup> and "did not give the full picture, even for an informed reader"<sup>214</sup> also found that the government's advice to the investor based on that disclosure did not give rise to legitimate expectations.

The subjective and objective reasonableness and the good faith of the individual asserting that an expectation deserves protection are just, reasonable, and useful yardsticks for evaluating the legitimacy of any claimed expectation in international law.

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<sup>210</sup> *GAMI*, *supra* note 17, para. 100 (noting that investor could not rely on any contractual undertaking to support expectations), para. 110 ("GAMI has not shown that the government's self-assigned duty in the regulatory regime was simple and unequivocal.").

<sup>211</sup> *Nagel*, *supra* note 44, at 163.

<sup>212</sup> *Thunderbird*, *supra* note 5, para. 164.

<sup>213</sup> *Id.* para. 155.

<sup>214</sup> *Id.* para. 159.

*(b) Reliance*

There is some suggestion in national law that detrimental reliance is a necessary or at least a usual component of a legitimate expectation. German law recognizes that an expectation is “legitimate” or “worthy of protection if the beneficiary [of the act in question] has used up the benefit granted or has made arrangements in connection with it such as can no longer be rescinded or can be rescinded only at unacceptable cost.”<sup>215</sup> Similarly, U.S. courts have emphasized that reliance justifies the protection of certain expectations as property: “It is the purpose of the ancient institution of property to protect those claims upon which people rely in their daily lives, reliance that must not be arbitrarily undermined.”<sup>216</sup> And in the Takings Clause context U.S. courts generally only protect “investment-backed expectations,” which suggests reliance.<sup>217</sup> English law goes further and normally requires detrimental reliance to establish a legitimate expectation.<sup>218</sup> The policy in back of this requirement is that “if the individual has suffered no hardship there is no reason based on legal certainty to hold the agency to its representation.”<sup>219</sup> But neither French nor European law requires reliance to establish a legitimate expectation.<sup>220</sup>

Detrimental reliance has not featured as a decisive component of the analysis of legitimate expectations in recent investment awards, although in most, if not all of those cases, the investor will have been able to point to investment (or further or continued investment) in the host State at a point later in time than the government conduct said to give rise to a legitimate expectation. Reliance is mentioned as a possible factor weighing in favor of finding a denial of fair and equitable treatment in *GAMI*,<sup>221</sup> although the *GAMI* Tribunal did not find legitimate expectation to have been created. Moreover, the investor in *MTD* emphasized that it had “irrevocably committed” to the Project when

<sup>215</sup> Schwarze, *supra* note 103, at 894 (quoting VwVfG, art. 48(2)(3)).

<sup>216</sup> Board of Regents v. Roth, 408 U.S. 577 (1972); *accord* Usery v. Turner Elkhorn Mining Co., 428 U.S. 1, 17 (1975) (noting the significance of “reliance upon the current state of the law”).

<sup>217</sup> See Pennsylvania Coal Co. v. Mahon, 260 U.S. 393 (1972).

<sup>218</sup> R. v. Secretary of State for the Environment, *ex parte* NALCO, 1992 C.O.D. 282; R. v. Jockey Club, *ex parte* RAM Racecourses, 2 All E.R. 223 (1993); Matrix Securities Ltd., 1 W.L.R. 334 (1994). *But see* Re 56 Denton Rd, Twickenham, Middlesex, 1 Ch. 51, 56 (1953) (“reliance is not a condition for the finality of decisions”).

<sup>219</sup> Craig, *supra* note 106, at 619.

<sup>220</sup> Schönberg, *supra* note 118, at 78.

<sup>221</sup> *GAMI*, *supra* note 17, para. 91.

the Government changed its policy,<sup>222</sup> though this fact was not stressed by the Tribunal. The description of the legitimate expectations principle in the *Thunderbird* Separate Opinion seems to take for granted that reliance is the *sine qua non* of a legitimate expectations claim.<sup>223</sup>

It has been convincingly argued that detrimental reliance should not be required on grounds that even in cases where there is no reliance “[c]onsistency of treatment and equality are at stake, and these values should be protected irrespective of whether there has been any reliance as such.”<sup>224</sup> Others argue that requiring reliance “may induce individuals to incur expenses, which in turn makes it more difficult to reach a solution if an authority seeks to revoke or modify an inappropriate decision with the consent of the affected parties.”<sup>225</sup> These arguments have persuasive force, but are perhaps of less relevance in the investment treaty context. Accordingly it is submitted that the proper approach to the significance of reliance in establishing legitimate expectations in international law is that reliance tends to confirm that an expectation is legitimate, but should not strictly be required to establish a legitimate expectation.

### 3. What Would Constitute “Compelling Reasons” for Not Providing Protection?

In each of the legal systems being studied here, the answer to this question turns on an explicit or an implicit balancing test that weighs the public interest served by the action that disappoints legitimate expectations against the individual’s interest in the fulfillment of his expectations. For example, the English courts have noted that whether expectations are to be protected is “a function of expectations induced by government and of policy considerations which militate against their fulfillment.”<sup>226</sup> Thus, after expectations have been identified, the English courts typically go on to consider whether overriding considerations of public interest nevertheless require those expectations to be disappointed.<sup>227</sup> In French, German, and European law a balancing test plays

<sup>222</sup> *MTD*, *supra* note 20, para. 116.

<sup>223</sup> See, e.g., *Thunderbird* Separate Opinion, *supra* note 5, para. 1.

<sup>224</sup> Craig, *supra* note 106, at 619.

<sup>225</sup> Schönberg, *supra* note 118, at 78.

<sup>226</sup> *Hamble Fisheries*, 2 All E.R. 731 (1995).

<sup>227</sup> *R. v. Secretary of State for the Home Department, ex parte Kahn*, 1 All E.R. 40, 46 (1985); *R. v. Liverpool Corporation, ex parte Liverpool Taxi Fleet Operators’ Association*, 2 Q.B. 299, 308 (1972); *R. v. Secretary of State for the Home Department, ex parte Briggs, Green & Hargreaves*, 1996 C.O.D. 168.

the most explicit role in cases involving unlawful administrative acts. The courts in these systems will allow the withdrawal or revocation of unlawful administrative acts only after the public's interest in administrative action complying with the law is weighed against the individual's interest in having the decision upheld.<sup>228</sup>

Legal systems differ on the stringency of what an American lawyer might call the “level of scrutiny” represented by this balancing test. In the Due Process context U.S. courts look for “a legitimate legislative purpose furthered by rational means,”<sup>229</sup> and they seek “rough proportionality” between means and ends in Takings Clause cases,<sup>230</sup> neither of which is particularly searching review. By contrast, German courts look for “serious infringement” of the public interest or “a direct threat to the State, the public or important community interests,” concepts that are restrictively construed.<sup>231</sup> The English approach occupies something like the middle ground between these two:

The balance must in the first instance be for the policy-maker to strike; but if the outcome is challenged by way of judicial review, I do not consider that the court's criterion is the bare rationality of the policy-maker's conclusion. While policy is for the policy-maker alone, the fairness of his or her decision not to accommodate reasonable expectations which the policy will thwart remains the court's concern (as of course does the lawfulness of the policy). To postulate this is not to place the judge in the seat of the minister. As the foregoing citations explain, it is the court's task to recognize the constitutional importance of ministerial freedom to formulate and to reformulate policy; but it is equally the court's duty to protect the interests of those individuals whose expectations of different treatment has a legitimacy which in fairness outtops the policy choice which threatens to frustrate it.<sup>232</sup>

<sup>228</sup> Schwarze, *supra* note 103, at 881.

For the similar position in German law *see id.* at 894; BVerfGE 9, 251 *et seq.*; BVerfGE 19, 188, 189; *see also* F. Ossenbühl, *Vertrauensschutz im sozialen Rechtsstaat*, DÖV 1972, 28 *et seq.*

And in respect of European law *see* Schwarze, *supra* note 103, at 991–94 (stressing that revocation or withdrawal of unlawful administrative measures “must involve a weighing up of the interests in question, as required under the German and Netherlands systems”).

<sup>229</sup> *Pension Benefit Guaranty Corp v. RA Gray & Co.*, 467 U.S. 717, 729 (1984).

<sup>230</sup> *Dolan v. City of Tigard*, 512 U.S. 374, 391 (1994).

<sup>231</sup> VwVfG, art. 49(2)(3)-(4); Schwarze, *supra* note 103, at 890.

<sup>232</sup> *Hamble Fisheries*, 2 All E.R. at 731 (1995).



This comparison suggests that legitimate expectations, particularly those based on an unlawful administrative act, may not be entitled to protection when the public interest served by the act that disappoints the expectations outweighs the individual interest in having his expectations met.

Of the investment cases being considered here, those which did not identify legitimate expectations (*GAMI*, *Nagel*, *ADF*, *Waste Management II* and *Thunderbird*) of course had no occasion to consider the issue. Among those in which legitimate expectations were protected, *Tecmed* includes such an explicit balancing test:

[T]he Arbitral Tribunal will consider... whether such measures are proportional to the public interest presumably protected thereby and to the protection legally granted to investments... . to determine whether such measures are reasonable with respect to their goals, the deprivation of economic rights and the legitimate expectations of who suffered such deprivation. There must be a reasonable relationship of proportionality between the charge or weight imposed to the foreign investor and the aim sought to be realized by any expropriatory measure.<sup>233</sup>

The *Thunderbird* Separate Opinion recognizes that such a balancing process is part of the legitimate expectations principle:

Such protection is, however, not un-conditional and ever-lasting. It leads to a balancing process between the needs for flexible public policy and the legitimate reliance on in particular investment backed expectations.<sup>234</sup>

Including a balancing test as part of the principle of protecting legitimate expectations in international law is entirely consistent with the function of this principle as a general principle of law to balance competing rights on a case-by-case basis. Moreover, the recent awards (with the possible exception of *OEPC*, referring as it does without qualification to “an obligation not to alter the legal and business environment in which the investment has been made”<sup>235</sup>) do not suggest that protection for investors' legitimate expectations should be

<sup>233</sup> *Tecmed*, *supra* note 1, para. 122.

<sup>234</sup> *Thunderbird* Separate Opinion, *supra* note 5, para. 30.

<sup>235</sup> *OEPC*, *supra* note 21, para. 191.



absolute. Nor could an absolute protection be validated as a general principle of law. Accordingly, in evaluating legitimate expectations claims some weighing of the public interest said to countervail the investor's legitimate expectations is required.

The method by which this weighing is done in national law, and the way in which it was done in *Tecmed*, is to evaluate the "relationship of proportionality" between the investor's private expectations and the public interest. In striking this balance, it is submitted that something more searching than the bare rationality review conducted by U.S. courts under the Due Process Clauses is desirable: While a margin of appreciation for national decision makers is entirely appropriate,<sup>236</sup> this should not equate to abdication of the judicial function of protecting the interests of individuals detrimentally affected by changes in administrative policy or decisions and evaluating the fairness of those administrative decisions. In other words, the fact that some "public interest" is said to be served by a challenged measure should not be determinative of the outcome. Tribunals should evaluate whether that interest could equally be served by a measure that impinged less on legitimate expectations, and if so the legitimate expectation should be protected. International tribunals are by now practiced at the means-ends type evaluation that such review entails. For example, application of other provisions of investment treaties such as the guaranty of national treatment entails an evaluation of whether a State may have been able to achieve the legitimate non-discriminatory purposed offered as a justification for a challenged measure through other non-or less discriminatory means.<sup>237</sup> Review under such relative treatment standards is considerably more searching than is suggested by bare rationality review, and there is no reason to think this type of review would be less appropriate in the context of evaluating legitimate expectations.

#### 4. *What Does It Mean for "Expectations to Be Fulfilled"?*

Protection for legitimate expectations can take essentially two forms: compensation or in-kind, injunctive or specific relief.

National legal systems approach this question of "remedy" in a couple of different ways. Some systems assign the remedy according to the nature of the act that gave rise to the expectations. Thus in German law, the form that protection

<sup>236</sup> Peter T. Muchlinski, *Multinational Enterprises and the Law* 504 (1995); Nicolas Jan Schrijver, *Sovereignty over Natural Resources: Balancing Rights and Duties* 344–46 (1997).

<sup>237</sup> *E.g.*, *S.D. Myers v. Canada, Partial Award*, Nov. 13, 2000, paras. 252–56 available at [http://www.dfait-maeci.gc.ca/tna-nac/documents/myersvcnadapartialaward\\_final\\_13\\_11\\_00.pdf](http://www.dfait-maeci.gc.ca/tna-nac/documents/myersvcnadapartialaward_final_13_11_00.pdf)

for legitimate expectations takes generally depends on whether the government act that gave rise to the expectation was lawful or not: Protection for lawful acts that give rise to legitimate expectations generally entails their maintenance, while in the case of unlawful acts, “Article 48(3) VwVfG confers protection of legitimate expectations not by ensuring the maintenance of the measure, but by payment of compensation for material losses incurred.”<sup>238</sup> And in French law, legitimate expectations raised (or, in French nomenclature, vested rights created) by formal administrative decisions are protected by maintenance of the act in question, while expectations based on more informal administrative conduct like a representation are protected by compensation.<sup>239</sup>

In other systems, although there is in principle a choice of remedy, one or the other will practically predominate. Legitimate expectations are generally raised in the English courts in support of an application for a writ of certiorari to quash the measure said to be inconsistent with the expectations, and this was the remedy recommended by the Privy Council.<sup>240</sup> Legitimate expectations can also arise at the point of an application for leave to seek judicial review, where they form the sort of interest that justifies such review.<sup>241</sup> My research has revealed no English case in which legitimate expectations were the basis for a compensation claim, although commentators have raised the issue,<sup>242</sup> and “the negligent provision of false information by the administration may give rise to an obligation to pay compensation.”<sup>243</sup> In the United States, claims related to expectations are usually claims for injunctive relief, although it is possible that denial of substantive due process might give rise to a claim for damages,<sup>244</sup> and of course the “remedy” for a “taking” is just compensation.<sup>245</sup> There is interesting jurisprudence suggesting that in cases presenting claims under both the Takings and the Due Process Clauses, the due process analysis (typically giving rise to an injunctive remedy) should be undertaken before analyzing the taking and compensation question, which is to be evaluated only when the governmental

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<sup>238</sup> Schwarze, *supra* note 103, at 894.

<sup>239</sup> Schönberg, *supra* note 118, at 114; Conseil d'Etat, Oct. 18, 1957, Bouveret, Rec. 542.

<sup>240</sup> Attorney-General of Hong Kong v. Ng Yuen Shiu, 2 A.C. 629, 633, 639 (1983).

<sup>241</sup> *E.g.*, R. v. Secretary of State for the Home Department, *ex parte* Ruddock, 2 All E.R. 518 (1987).

<sup>242</sup> *See, e.g.*, Craig, *supra* note 106, at 619–50 (arguing against introducing compensation as an alternative to “enforcing” the expectation by, e.g., certiorari).

<sup>243</sup> Schwarze, *supra* note 103, at 901–02.

<sup>244</sup> *See* 42 USCA § 1983.

<sup>245</sup> U.S. Constitution, art. 5.

action being challenged has been found otherwise to be permissible.<sup>246</sup> This question is not settled in U.S. law, but it does suggest that a range of remedial possibilities might be appropriate for different cases.

International law generally recognizes a similar range of remedial possibilities. As the classic statement on this point in the *Chorzów Factory* case indicates, either restitution or a compensatory remedy is appropriate:

[R]eparation [for breach of an international obligation] must, as far as possible, wipe out all the consequences of the illegal act and reestablish the situation which would, in all probability have existed if that act had not been committed. Restitution in kind, or, if this is not possible, payment of a sum corresponding to the value which a restitution in kind would bear; the award, if need be, of damages for loss sustained which would not be covered by restitution in kind or payment in place of it; such are the principles which should serve to determine the amount of compensation due for an act contrary to international law.<sup>247</sup>

The priority expressed in this judgment might suggest that restitution in kind is the “normal sanction” for breach of an international legal obligation,<sup>248</sup> and that is the priority expressed in the International Law Commission’s 2001 Draft Articles on State Responsibility.<sup>249</sup> But it is a commonplace that compensation is by far the more frequent remedy. Indeed the ILC recognized that restitution may not be practicable or desirable,<sup>250</sup> that in fact it may be “wholly disproportionate” in a particular case,<sup>251</sup> and that in such a case compensation is to be preferred.<sup>252</sup>

<sup>246</sup> *Eastern Enterprises v. Apfel*, 524 U.S. 498, 545 *et seq.* (1998) (Kennedy, J., concurring) (reading earlier precedents to indicate that the Court “should proceed first to general due process principles, reserving takings analysis for cases where the governmental action is otherwise permissible”).

<sup>247</sup> Case concerning the Factory at Chorzów (Indemnity) (Ger. v. Pol.), 1928 P.C.I.J. (ser. A), No. 17, at 47 (Sept. 13).

<sup>248</sup> *Texaco Overseas Petroleum Co. and California Asiatic Oil Co. v. The Government of the Libyan Arab Republic*, Jan. 19, 1977, 17 I.L.M. 1, 36 (1978) (Professor Dupuy, Sole Arbitrator).

<sup>249</sup> See Draft Articles on Responsibility of States for Internationally Wrongful Acts adopted by the International Law Commission at its fifty-third session (2001), arts. 34 and 35 (hereinafter “*ILC Draft Articles on State Responsibility*”); see also ILC Commentaries to the Draft Articles on Responsibility of States for Internationally Wrongful Acts (2001) 238 (hereinafter “*ILC Commentary*”) (noting that “[restitution] comes first among the forms of reparation”), both are available at [http://www.un.org/law/ilc/texts/State\\_responsibility/](http://www.un.org/law/ilc/texts/State_responsibility/).

<sup>250</sup> *Id.* at 239.

<sup>251</sup> *Id.* at 242 *et seq.*

<sup>252</sup> *ILC Draft Articles on State Responsibility*, *supra* note 249, art. 36.

With respect to how international law should protect legitimate expectations a similar choice presents itself: Expectations might be protected by either a restitutionary, in-kind remedy such as an order to maintain or restore the act upon which the expectations were based, at least with respect to the individual to whom it was addressed (referred to as “juridical restitution”)<sup>253</sup> or by compensation for any damages caused when that act is rescinded or modified.

An analogy to the law on State contracts, and in particular to so-called “stabilization clauses” or promises not to change relevant provisions of national law, suggests that an expectation that law or regulation will not be changed should normally be protected, if at all, by compensation rather than by a restitutionary, injunctive, or in-kind remedy. Although one well-known case involving the stabilization of a State contract found that restitution was the appropriate remedy for breach,<sup>254</sup> the weight of arbitral authority and authoritative State practice favors compensation. It has been said in this context that all the State has normally bargained for is an obligation to indemnify the other contracting party if the law changes.<sup>255</sup> The enforcement of in-kind remedies has often been seen as too intrusive or insufficiently respectful of sovereignty. So, as the tribunal ruled in *Government of Kuwait v. Aminoil*, although a specifically enforceable commitment not to change the law is “juridically possible,” it will not be lightly inferred, and compensation will be the usual remedy for breach of a clause purporting to “stabilize” the legal regime.<sup>256</sup> It is hard to imagine that a claim based on legitimate expectations should be protected more robustly, or by a remedy that impinges more directly on sovereignty, than would a claim based on an explicit contract term.

Compensation is also the more usual remedy in those recent investment awards in which legitimate expectations were identified and protected (*Tecmed*, *MTD*, and *OEPC*), however, they do not exclude the possibility of a restitutionary award. In *Tecmed* and *MTD*, compensation was the remedy prayed for by the investor. Indeed, although the investor in *Tecmed* claimed restitution in kind as a “subsidiary” or alternative remedy, it primarily sought monetary damages and considered restitution in kind—extension of the operating permit to allow

<sup>253</sup> ILC *Commentary*, *supra* note 249, at 240.

<sup>254</sup> *Texaco Overseas Petroleum Co. /California Asiatic Oil Co. v. Government of the Libyan Arab Republic*, Jan. 19, 1977, 53 I.L.R. 389, 477, 479, 494 *et seq.*, 507–09 (1979).

<sup>255</sup> *BP Exploration Co. (Libya) Ltd. v. Government of the Libyan Arab Republic*, 53 I.L.R. 297, 331–53 (1979); *AGIP Co. v. Popular Republic of the Congo*, 21 I.L.M. 726, 735–36 (1982). *Cf.* *United States v. Winstar*, 518 U.S. 839 (1996).

<sup>256</sup> 66 I.L.R. 518, 589 *et seq.* (1982).

operations at the landfill to resume—“absolutely impossible”; the Tribunal agreed.<sup>257</sup> The *OEPC* case is interesting in that the investor sought the in-kind remedy of declarations that it was entitled to certain refunds of tax paid and that the State should effect the refunds. The *OEPC* Tribunal awarded these declarations and also awarded the amount of the outstanding refunds “as compensation due to the investor because of the breach of its rights under the Treaty,”<sup>258</sup> including the denial of fair and equitable treatment that resulted from the State’s failure to protect the investor’s reasonable expectations. Accordingly, the most appropriate form of protection for legitimate expectations, if any is to be afforded, is likely to be compensation.

## V. THE “APPROPRIATENESS” OF PROTECTING INVESTORS’ LEGITIMATE EXPECTATIONS

It will be recalled from the methodological discussion in Part II that before even a universally accepted principle is received in international law, one must evaluate its “appropriateness” for the international legal order. Key considerations are whether such a principle seems calculated to do justice between investors and host States and whether there is logical and practical necessity for such a principle in this context.

### *1. Will Protection for Legitimate Expectations Do Justice?*

Even having narrowed the scope of the analysis to one general factual context, it remains difficult to evaluate in the abstract whether a principle like protection for legitimate expectations will do justice. As the example of the *South West Africa* cases illustrates, reasonable people can differ on whether a principle serves the ends of justice in a particular case. Moreover, any absolute conclusions about “justice” depend on selection from among contending subjective conceptions of justice, which lies well outside the scope of this article.

Nevertheless, one measure of whether a principle is just is whether it seems to be even-handed as between the two parties to which it would be applied, something on which it is possible to reach tentative conclusions. One indicator that the principle of protection for legitimate expectations is or can be even-handed is that, in those systems that recognize the doctrine, legitimate expectations cannot be said to have worked a dramatic shift in favor of private or

<sup>257</sup> *Tecmed*, *supra* note 1, para. 183.

<sup>258</sup> *OEPC*, *supra* note 21, para. 208.

individual over public or general interests. In the U.S. and ECHR jurisprudence, in particular, claimants have rarely satisfied the courts that they had expectations worth protecting or sufficient to support a claim for compensation.<sup>259</sup> In the context of regulated industries especially, it has been difficult to establish that regulatory changes were not expected.<sup>260</sup> The investment awards that discuss legitimate expectations more often have found that such expectations were not created (*ADF*, *GAMI*, *Nagel*, *Waste Management II* and *Thunderbird*) than that they were to be protected (*Tecmed*, *MTD*, *OEPC* and *Thunderbird* Separate Opinion), which provides some anecdotal support for the view that protection for legitimate expectations will not unduly favor investors.

Moreover, a number of features of the principle of protection for investors' legitimate expectations detailed in this article can provide additional assurance of balanced application. The protection would be predicated on specific, unambiguous, and individualized governmental conduct. The protection would not apply to expectations unreasonably held or those not held in good faith. Moreover, the principle of protection for legitimate expectations explicated here would positively require tribunals to balance the investor's private interests with the public interests advanced by the State. And while European systems have been more willing to identify legitimate expectations than have U.S. courts, only very infrequently in any of these systems have claims based on those expectations survived the balancing test. This suggests that continued application of a principle of protecting investors' legitimate expectations is unlikely to be a development that dramatically or automatically shifts the advantage to investors in international investment disputes, but instead that the principle can be said to be even-handed as between investors and States, which is a fair proxy for determining whether the principle can be justly applied. That being said, the suggestion that the principle of protecting legitimate expectations should be applied in a way that explicitly favors investors, which seems to be

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<sup>259</sup> *E.g.*, *Pine Valley Developments Ltd. v. Ireland*, 14 E.H.R.R. 319, 340 (1992) (noting that while grant of planning permission might give rise to legitimate expectations, it did not in this case because the government was acting *ultra vires*); *Fredin v. Sweden*, 13 E.H.R.R. 784, 796 (1991) (ruling against owners of gravel pit whose permit was revoked because, due to explicit provision for revocation of permit after fixed time, they must have been aware of the possibility that they would lose the permit and because "it [was] clear that the authorities did not give them any assurances that they would be allowed to continue to extract gravel after this date.").

<sup>260</sup> *E.g.*, *FHA v. The Darlington Inc.*, 358 U.S. 84, 91 (1958) ("Those who do business in the regulated field cannot object if the legislative scheme is buttressed by subsequent amendments to achieve the legislative end."); *see also* *Connolly v. Pension Benefit Guaranty Corp.*, 475 U.S. 211, 235 (1986); *Concrete Pipe & Products of California Inc. v. Construction Laborers Pension Trust*, 508 U.S. 602, 645–46 (1993).

the purport of the *Thunderbird* Separate Opinion,<sup>261</sup> demonstrates that whether in fact this principle can be said to be even-handed will depend on how this balance is struck and how the range of detailed issues outlined in Part IV above are resolved. Any final view on whether this principle can be said to do justice between host States and investors must therefore await further development in the case law.

## 2. *Logical and Practical Necessity*

The discussion in Part II showed that one measure of the logical and practical necessity of recognizing a particular principle as a general principle of law is whether that principle usefully assists the resolution of disputes, in particular by filling a gap or resolving an overlap between different norms. That “legitimate expectations” have been invoked in so many different contexts in investment disputes—as an aspect of fair and equitable treatment, under the umbrella clause, as part of a regulatory expropriation analysis, and even in connection with the definition of “investment”—would tend to suggest the utility of this principle. Moreover, as *Tecmed* illustrates more substantively, there is ample scope for a general principle of protecting investors’ legitimate expectations to perform its gap-filling and overlap-resolving work in the law of foreign investment.

Such a principle could “fill a gap” in the way legitimate expectations did in *Tecmed* and other cases by giving content to the standard of “fair and equitable treatment.” While reference to fair and equitable treatment is common in bilateral and multilateral investment instruments, the terms “fair” and “equitable” are not further defined,<sup>262</sup> such that “the precise meaning of the fair and equitable concept is still, to some extent, a matter of conjecture.”<sup>263</sup> Accordingly, what is “fair and equitable” might be seen as a question to which sources of positive law do not provide an answer, one of the areas in which a general principle is designed to function. A general principle derived by the methodology set forth above, that is, drawn from the national laws of States reflecting diverse jurisprudential traditions, is a consensus foundation for what otherwise could be a troublingly subjective process of determining what is “fair”

<sup>261</sup> See *Thunderbird* Separate Opinion, *supra* note 5, paras. 33–36, 47, 50.

<sup>262</sup> See Rudolf Dolzer & Margrete Stevens, *Bilateral Investment Treaties* 58 (1995) (“Nearly all recent BITs require that investments and investors covered under the treaty receive ‘fair and equitable treatment,’ in spite of the fact that there is no general agreement on the precise meaning of this phrase.”).

<sup>263</sup> Stephen Vasciannie, *The Fair and Equitable Treatment Standard in International Investment Law and Practice*, 70 *Brit. Ybk. Int’l L.* 99, 130 (2000).



or “equitable.”<sup>264</sup> Moreover, it is a small step from accepting a general principle of law as guidance on standards of *procedural* fairness that are not specified by treaty or norm-creating State practice<sup>265</sup> to accepting that a general principle such as the protection of legitimate expectations might give content to vague or unarticulated standards of *substantive* fairness. Accordingly, giving content to the notions of “fair” and “equitable” treatment would seem to be a problem tailor-made for the deployment of a general principle of protection for investors’ legitimate expectations.

The principle of protecting investors’ legitimate expectations could also play a role in resolving an overlap that persistently bedevils the law of investor-State relations: the endemic conflict in regulatory expropriation cases between the State’s sovereign regulatory or “police powers” prerogative and an investor’s right to be compensated when regulatory measures have the effect of expropriating its investment. As *Tecmed* acknowledged, two basic rules govern the resolution of regulatory expropriation claims: (i) “A state is responsible as for an expropriation of property... when it subjects alien property to taxation, regulation, or other action that is confiscatory, or that prevents, unreasonably interferes with, or unduly delays, effective enjoyment of an alien’s property or its removal from the state’s territory”<sup>266</sup>; but at the same time (subject to qualifications not relevant here) (ii) “[A] state is not responsible for loss of property or for other economic disadvantage resulting from bona fide general taxation, regulation, forfeiture for crime, or other action of the kind that is commonly accepted as within the police power of states.”<sup>267</sup> The first rule implies, on the one hand, that

<sup>264</sup> *Id.* at 101 (“the precise meaning of the concept is sometimes open to enquiry, not least because the notions of ‘fairness’ and ‘equity’ do not automatically connote a clear set of legal prescriptions in some situations”).

<sup>265</sup> *Cf.* Tubman, *supra* note 52, at 123; Brownlie, *supra* note 56, at 18.

<sup>266</sup> Restatement (Third) of the Foreign Relations Law of the United States § 712, cmt. g (1987); *accord* *Starrett Housing v. Islamic Republic of Iran*, 4 Iran-U.S. C.T.R. 122 (1983), 23 I.L.M. 1090, 1115 (1984); DeSabra, 28 Am. J. Int’l L. 602 (1934); G.C. Christie, What Constitutes a Taking of Property Under International Law?, 38 Brit. Ybk Int’l L. 307, 309 (1962); *cf.* *Tecmed*, *supra* note 1, paras. 114–17.

<sup>267</sup> Restatement (Third) of Foreign Relations Law, *supra* note 266, at § 712, cmt. g; *accord* *Sedco v. National Iranian Oil Co.*, 9 Iran-U.S. C.T.R. 248, 275 (1985); Louis B. Sohn & Richard R. Baxter, Responsibility of States for Injuries to the Economic Interests of Aliens, 55 Am. J. Int’l L. 545, 551, 554 (1961) (Draft Convention on the International Responsibility of States for Injuries to Aliens); Pamela B. Gann, The U.S. Bilateral Investment Treaty Program, 21 Stan. J. Int’l L. 373, 399 n.120 (1985); *cf.* Rudolf Dolzer, Indirect Expropriation of Alien Property, 1 ICSID Rev.—FILJ 41, 62 (1986) (“the various domestic [legal] orders [also] uniformly indicate, in principle that no compensation is due when the measure is necessary in order to protect the public from a danger arising from the property; the police power in its various forms generally overrides property rights”); *Tecmed*, *supra* note 1, para. 119.



some regulatory measures give rise to an obligation of compensation, while the second indicates, on the other hand, that some exercises of a State's "police powers" or regulatory authority are privileged, immune from the requirement of compensation altogether. The interplay of these rules is particularly incoherent because the question of degree or substantiality of impact has been described as the touchstone of determining whether regulation "goes too far" and becomes expropriation,<sup>268</sup> a sliding-scale approach that might make sense of the first basic rule, but makes a nonsense of the second. There is an evident need for a principle of reconciliation, and, as *Tecmed* illustrated, the principle of protecting investors' legitimate expectations can perform that function by seeking "a reasonable relationship of proportionality" between the individual rights protected by rules of *de facto* expropriation and the collective interests served by privileged exercises of the police power.

## CONCLUSION

This article argues for the recognition of a general principle of law that the legitimate expectations of investors should be protected. It attempts to delineate, on the basis of the methodology for identifying a general principle of law, what might be the contours of such a principle. Central to this analysis is a comparative survey of the protection afforded individual expectations in the national law of a number of countries from different public law traditions and the European Union. This survey, taken together with the recent investment awards that have invoked investors' legitimate expectations, suggests that, pursuant to a general principle of law:

1. Legitimate expectations can arise as a result of overt government conduct that, while it could take various forms, is specific and unambiguous and beneficial to the individual to whom it is directed. Legitimate expectations will not normally and certainly not easily be based upon legislation or legislative-type regulations addressed generally, but will derive from targeted and individualized government conduct. In other words, recognizing a general principle of protection for legitimate expectations will not automatically allow individuals to insist upon the maintenance of existing legal or regulatory regimes. The fact

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<sup>268</sup> J.H. Herz, *Expropriation of Foreign Property*, 35 Am. J. Int'l L. 243, 251 (1941); S.D. Myers v. Canada, Partial Award, Nov. 12, 2000, 40 I.L.M. 1401, para. 282 (2001) ("Expropriations tend to involve the deprivation of ownership rights; regulations a lesser interference."); *Revere Copper and Brass v. Overseas Private Investment Corp.*, 17 I.L.M. 1321, 1349 (1978).

that an act that gave rise to an expectation is unlawful as a matter of national law will not be fatal to a claim of protection for legitimate expectations, although that fact may weigh against providing the requested protection.

2. Only expectations that are subjectively and objectively reasonable, in the light of substantive or procedural conditions imposed by the administration and the individual's knowledge and good faith, will be legitimate. One factor reducing the reasonableness of an expectation may be the fact that the expectation relates to an area or industry that is already heavily regulated. Detrimental reliance on the administrative act said to give rise to the expectation may help establish the legitimacy of the expectation, but should not be required in every case.

3. Even expectations that are identified as legitimate may not be protected if a plausible public interest actually furthered by the challenged measure outweighs the individual's interest in fulfillment of his expectations. This will depend upon a case-by-case evaluation of whether the public interest may be achieved by means that do not disappoint legitimate expectations. And though national administrative authorities will be given a margin of appreciation, international tribunals should not be overly deferential to national authorities when evaluating the fairness and proportionality of administrative decisions that disappoint legitimate expectations.

4. While in theory legitimate expectations could be protected by a flexible menu of remedies, including orders to maintain in force the administrative act on which legitimate expectations are based or temporary or permanent exemption from compliance with administrative measures inconsistent with legitimate expectations, compensation for damages caused by the disappointment of legitimate expectations will more often be the appropriate remedy.

The recognition of such a principle of protection for investor's legitimate expectations would seem to be a useful and appropriate development in the law governing investor-State relations. The principle of protecting legitimate expectations responds to the instinctive sympathy of tribunals for investors' reliance on particularized communications and assurances from the State, which might have induced investment or expectations about the future regulatory and legal landscape in which investment would take place. At the same time, though, it disciplines those instincts. A rigorous application of the principle along the lines set forth in this article would ground applications of open-ended treaty standards such as "fair and equitable treatment" in shared conceptions of fairness and equity. It would subject a claim of reasonable reliance to thorough scrutiny, and it would accommodate both investors' rights and sovereign prerogatives in an explicit balancing test. In contexts such as regulatory expropriation,

where all too often phrases like “police power” or “taking,” obscure rather than illuminate the resolution of investment disputes,<sup>269</sup> the principle of protecting legitimate expectations as explicated here might discourage tribunals from simply asserting investors’ rights or sovereign prerogative or picking between them with no explanation. It is thus submitted that recognition of the principle of protection for legitimate expectations could facilitate the transparent and (more) predictable consideration of the abstractions and normative compromises inherent in the resolution of investment disputes and thus it should be welcomed as a development of the international law governing investor-State relations.

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<sup>269</sup> See Ben Weston, “Constructive Takings” Under International Law: A Modest Foray into the Problem of “Creeping Expropriation,” 16 Va. J. Int’l L. 103, 111 (1975) (“such words and phrases, with all their normative overtones, tend more often to describe a result than to define the process by which the result is reached. Without facilitating discrimination between fact and legal consequence, they assume the answer to the principal question that is at issue in the first place—the compensation question—and, in so doing, divert attention from the many variables that can and do bear critically upon it”).

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THE INTERNATIONAL SOCIETY AS A  
LEGAL COMMUNITY

by

HERMANN MOSLER

*Judge of the International Court of Justice*

SIJTHOFF & NOORDHOFF 1980  
Alphen aan den Rijn, The Netherlands  
Germantown, Maryland, USA

based on the application of legal rules in accordance with a fixed procedure and are binding on the parties to the dispute.<sup>27</sup>

These criteria also apply to some extent to arbitral tribunals and other decision-making bodies but in the case of a court they must all be present.

In its judgment in the *North Sea Continental Shelf* case, the International Court of Justice presupposed the existence of a concept of what constitutes a court in saying: "Whatever the legal reasoning of a court of justice, its decisions must by definition be just, and therefore in that sense equitable."<sup>28</sup> The same Court had a similar a priori concept of an international tribunal and, without giving specific reasons, characterised the Administrative Tribunal of the International Labour Organisation as "an international tribunal".<sup>29</sup>

1 (3). *Principles to Be Applied to International Legal Relations (e.g. Good Faith, Estoppel, Proportionality, "Legal Notions")*

Let us now take a look at some of the other principles applying to legal relations amongst the member States of the international community. Unlike the principles just discussed, these are not substantive or procedural rules but operate so as to regulate the conduct of all kinds of relations between subjects of the law.

(a) The most important of these is the principle that legal relations are to be conducted in good faith. This applies not only to the actual performance of legal obligations properly undertaken but also to any other part of legal relations such as the earliest stages of negotiations and, indeed, to any conduct to which legal significance could reasonably be attached by other subjects of international law. To illustrate this last point, I would refer to the earlier discussion on the question of the conduct of State representatives in dealing with the representatives of other States.<sup>30</sup>

It is quite clear that to act in good faith is as important in the international community as it is in municipal law and this requires no great elaboration. But it might be useful to illustrate the point with a few examples rather than to talk in abstract terms and I should like to deal with two cases, both taken from the Second World War:

The first case was decided in 1959 by the Italian-United States Conciliation Commission. Article 78, paragraph 9 *a*, subparagraph 2, of the Italian Peace Treaty of 1947 refers to legislation "in force" in Italy. The question was whether this included legislation of the so-called Italian Social Republic of the former dictator Mussolini which, in the

Separate OpinionIn the Arbitration under Chapter XI of the NAFTA and the UNCITRAL  
Arbitration Rules: Thunderbird ./ Mexico1) Summary

1. I concur with my colleagues on several significant issues of the case:

- The questions of jurisdiction, admissibility, control and waivers;
- the rejection of the expropriation (NAFTA Art. 1110) claim;
- the rejection of the “denial of administrative justice” claim;
- the rejection of the NAFTA governments’ position that pursuant to Article 1102 Claimant needs to prove that the government had a direct intention to harm the foreign investor because it is foreign is required for Art. 1102 and needs to be proven by claimant;
- the general view that the principle of legitimate expectation forms part, i.e. a subcategory, of the duty to afford fair and equitable treatment under Art. 1105 of the NAFTA. We also seem to concur on the general conditions for this claim – an expectation of the investor to be caused by and attributed to the government, backed-up by investment relying on such expectation, requiring the legitimacy of the expectation in terms of the competency of the officials responsible for it and the procedure for issuing it and the reasonableness of the investor in relying on the expectation. I do, however, not concur with the application of this standard to the specific factual situation in light of the purpose, specific content and precedents of the legitimate expectations standard as it should be applied under investment protection treaties based on recent relevant jurisprudence.

2. I have found the rejection of the national treatment (non-discrimination) under Art. 1102 more difficult. Guardia, Thunderbird’s

competitor with comparable operations, continued to operate through success with procedural appeals (“amparos”) before Mexican courts and through the lesser success of SEGOB in enforcing against him as compared to its – most effective – enforcement against Thunderbird. He was the domestic investor that was the “most comparable” and “best treated” by the integral Mexican (administrative and judicial) system. That creates a presumption of discrimination which Mexico has to rebut by showing and proving “legitimate reasons” for such distinct, but more favourable treatment. But I have in the end accepted the view of my colleagues denying a breach of Art. 1102. However, I have been able to identify “discriminatory elements” in the greater energy, focus and effectiveness of the enforcement activities by the SEGOB against Thunderbird – which had arranged (or at least tried to arrange) a clearance of its activities as compared to the main and most successful Mexican competitor, Mr Guardia (who had always taken a non-cooperative approach. But I have not come in the particular circumstances to the conclusion that the much more favourable position enjoyed by Guardia in terms of de-facto practice and effectiveness of enforcement created a corresponding right for Thunderbird under Art. 1102 to continue its gam(bl)ing operations or to receive an equivalent amount of damages. I have been able to solve this dilemma by taking into account such “discriminatory elements” in the enforcement of the Mexican gambling law in the context of the balancing that is, in my view, required between legitimate expectations of a foreign investor and an equally legitimate public interest in preserving a large “regulatory space” in particular in the field of gambling regulation under Art. 1105 of the NAFTA.

3. I will discuss in this separate opinion both the normative scope and contours of the legitimate expectation concept as it should be construed under Art. 1105 of the NAFTA and their significance in the particular factual context. The facts that emerged in this arbitration and on its record provide, as always, not a complete picture of the events. But what has emerged can only be assessed, including through presumptions and other rules of evidence, on the basis of the

particular features of the legitimate expectations concept<sup>1</sup>. Since the arbitration has, as often or always, not elucidated all relevant facts, one needs to rely on standard practice of rules of evidence, burden of proof and presumptions to determine when the claimant and when the respondent has to bear the respective burden. In addition, as recently explained again by the *Methanex v US* award, what is unknown but relevant has to be dealt with by inference, i.e. by taking the “dots” that are available, drawing explanatory lines between them<sup>2</sup> and then determine what explanation can be inferred by relying on burden of proof allocation, prima facie evidence and arbitral determination of the evidence. They need to be assessed not only from the lofty spheres of commercial arbitration law, but also with a real-life understanding of the “coal-face” of foreign investment practices.

4. My disagreement is based on a different weight which needs to be accorded to this principle in the particular context of an investment promotion and protection treaty which protects interests different from those involved in an ordinary commercial relationship involving two equal private parties. Commercial arbitration is a suitable mechanism for resolving the disputes of equal parties on equal footing and without need for the purpose of taking into account the position of the weaker party; nor is there any policy purpose underlying commercial arbitration – such as to protect and promote investment, enhance transparency and the “rule of law”, create employment or enhance trade opportunities. In commercial arbitration, rules including the caveat emptor and due diligence principle are deeply ingrained in the culture, approaches and principles applied consciously or subconsciously by the tribunals. By contrast, international investment law is aimed at promoting foreign investment by providing effective protection to foreign investors exposed to the political and regulatory

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<sup>1</sup> On the burden of proof and persuasion by respondent government for factual allegations and their legal implications that weaken the investor’s claim see *Biloune v. Ghana*, 95 ILR 183 (1994), para. 29

<sup>2</sup> *Methanex v US*, Final Award, at pp. 211, 212



risk of a foreign country in a situation of relative weakness<sup>3</sup>. The main principles underlying the NAFTA (preamble, Art. 102) as developed in the most recent and authoritative jurisprudence by arbitral tribunals require that in case of doubt, the risk of ambiguity of a governmental assurance is allocated rather to the government than to a foreign investor and that the government is held to high standards of transparency and responsibility for the clarity and consistency in its interaction with foreign investors. If official communications cause, visibly and clearly, confusion or misunderstanding with the foreign investor, then the government is responsible for pro-actively clarifying its position. The government can not rely on its own ambiguous communications, which the foreign investor could and did justifiably rely on, in order to later retract and reverse them– in particular in change of government situations

5. Investors need to rely on the stability, clarity and predictability of the government's regulatory and administrative messages as they appear to the investor when conveyed – and without escape from such commitments by ambiguity and obfuscation inserted into the commitment identified subsequently and with hindsight. This applies not less, but more with respect to smaller, entrepreneurial investors who tend to be inexperienced but provide the entrepreneurial impetus for increased trade in services and investment which NAFTA aims to encourage. Taking into account the nature of the investor is not formulation of a different standard, but of adjusting the application of the standard to the particular facts of a specific situation.

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<sup>3</sup> All multilateral and most bilateral treaties expressly mention this objective; the 2005 World Bank Development Report provides an authoritative explanation of the role of investment protection in terms of signaling good-governance standards in the host state. See also *Tecmed v Mexico*, at para 122 citing the European Court of Human Rights (in the case of *James and others*, February 21, 1986, pp. 19-20; <http://hudoc.echr.coe.int>: “...non-nationals are more vulnerable to domestic legislation: unlike nationals, they will generally have played no part in the election or designation of its authors nor have been consulted on its adoption.”

6. It is with these principles in mind that I have come to assess the – never absolutely clear and straightforward – factual background of the case and the presumptions and burden of legal justification and proof differently from my colleagues. They rather see the glass of the investor half empty, I rather see it half full. They imply a very high level of due diligence, of knowledge of local conditions and of government risk to be taken by the investor. I rather see the government as responsible for providing a clear message and of sticking to the message once given and as reasonably understood by the investor. They view the investor as having a duty to be close to perfect in its dealings with the government, I consider the government to have a duty to be transparent and consistent, and as responsible for the message conveyed: i.e. how such conduct was reasonably understood by the investor. They interpret the “Oficio” on its face value; I suggest it should be construed in light of its context, history and the objectively identifiable common intentions of both parties and as it was – reasonably – understood by the recipient, i.e. Thunderbird. They attach no importance to the combination of an official comfort letter followed by acceptance by the chief regulator of the investor’s operation to the end of the term of the government’s term; I view the governments accepting conduct subsequent to the comfort letter as reinforcing and clarifying the investor’s understanding of the key message conveyed by the comfort letter. My colleagues see no discrimination whatsoever in the fact that the chief Mexican competitor goes on providing the same type of services the claimant offered while claimant loses all appeals and gets shut down; I see here by way of inference, presumption and burden of proof on the government discriminatory elements of enforcement which reinforce the government’s obligation to respect the messages the comfort letter and the subsequent accepting conduct have reasonably conveyed to the investor.
  
7. I would have come to a quite modest obligation of the government of Mexico to pay a part of those investment expenditures assumed by Thunderbird to the extent such costs can be reasonably and directly

related to reliance of Thunderbird on positive assurances and accepting conduct by the competent Mexican authorities. I therefore find the claimant's argument and evidence on detrimental reliance more persuasive, but I then find the respondent's argument on compensation more convincing; in effect, my compensation assessment would have been at less than 0.5 % of the compensation claimed.

8. I also do not concur with the tribunal's decision to deviate from established practice not to allocate attorney costs to the losing investor claimant. In my view, such a deviation would have required an in-depth and extensively reasoned justification.

2.) Main Principles underlying the Application of the "Investment Disciplines" in Chapter XI of the NAFTA to the Thunderbird – Mexico dispute

9. It is likely to lead to highly divergent outcomes if the key NAFTA disciplines at issue here – 1102, 1105 and 1110 – are not applied with a common understanding of the pertinent principles of legal interpretation and application to a specific factual situation. Let me therefore highlight the key principles and methodological approaches I consider most relevant to define for the interpretation and application to the factual situation, the relevant "context" and "purpose" of these principles:
10. First, the applicable law is – Art. 1131 – "this Agreement" (i.e. the whole NAFTA, not just Chapter XI) and "applicable rules of international law", guided by the authoritative article 31 of the Vienna Convention on the Law of Treaties ("Vienna Convention") where the elements of "good faith", "ordinary meaning", "context" and "object and purpose" are the main principles of treaty interpretation. These principles – plus the Vienna Convention's reference to "subsequent conduct" – should also guide the interpretation of the crucial "Oficio" of August 2000.

11. The Preamble of NAFTA emphasises as authoritative interpretation guidelines, namely the need for **“clear rules”**, **“predictable commercial framework for business planning and investment”**, **“promotion of trade in.. services”** and **“creation of new employment opportunities”**.

Art. 102 NAFTA: Highlights the purpose to **“facilitate cross-border movement of ..services”**, **transparency, promotion of fair competition, increasing substantially investment opportunities**<sup>4</sup>;

Art. 1115: To assure **“equal treatment** among investors of the parties”

12. While the forms and procedures of international commercial arbitration are relied upon<sup>5</sup>, one needs, for the application of such rules, to bear in mind that their purpose is to govern the procedure, but not to inject substantive principles, rules and legal concepts used in international commercial arbitration into the qualitatively different investment disputes between a foreign investor and a host state. International commercial arbitration assumes roughly equal parties engaging in sophisticated transnational commercial transactions. Investment arbitration is fundamentally different from international commercial arbitration. It governs the situation of a foreign investor exposed to the sovereignty, the regulatory, administrative and other governmental powers of a state. The investor is frequently if not mostly in a position of structural weakness, exacerbated often by inexperience (in particular in the case of smaller, entrepreneurial investors). Investment arbitration therefore does not set up a system of resolving

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<sup>4</sup> This interpretation method has been properly applied in the Metalclad v Mexico award; the contrary view of an enforcement court in Vancouver (suggesting that principles of the NAFTA outside Chapter XI should be ignored) has, rightly, not found any support.

<sup>5</sup> See the references in Art. 1120 ff to the various arbitration rules to be used.

disputes between presumed equals as in commercial arbitration, but a system of protection of foreign investors that are by exposure to political risk, lack of familiarity with and integration into, an alien political, social, cultural, commercial, institutional and legal system, at a disadvantage. Legal principles for and methodological approaches to examining the factual situation, habits, natural instincts and styles from commercial arbitration are therefore no suitable guideposts for investment arbitration. The relevant legal texts and the factual situation at issue have therefore to be seen in the light of the close link between **investment promotion** – to get foreign businessmen to come with their capital and efforts into a new, alien and inherently difficult and high-risk situation – and **investment protection**, i.e. the protection against governmental risk offered by investment treaties to increase the attractiveness of the host state economy<sup>6</sup>.

13. Secondly, while public international law still provides the main principles (in particular Art. 31 of the Vienna Convention, which moreover is an expression of an international consensus on interpretative principles), one needs to bear in mind that investment treaties such as the NAFTA, deals with a significantly different context from the one envisaged by traditional public international law: At its heart lies the right of a private actor to engage in an arbitral litigation against a (foreign) government over governmental conduct affecting the investor. That is fundamentally different from traditional international public law, which is based on solving disputes between sovereign states and where private parties have no standing. Analogies from such inter-state international law have therefore to be treated with caution; more appropriate for investor-state arbitration are analogies with judicial review relating to governmental conduct – be it international judicial review (as carried out by the WTO dispute panels and Appellate Body, by the European- or Inter-American Human Rights Courts or the European Court of Justice) or national administrative courts judging the disputes of individual citizens' over alleged abuse by

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<sup>6</sup> World Bank, Development Report 2005, 175-185; see also *infra* the citation to Elihu Root.

public bodies of their governmental powers<sup>7</sup>. In all those situations, at issue is the abuse of governmental power towards a private party that did and could legitimately trust in governmental assurances it received; in commercial arbitration on the other hand it is rather a good-faith interpretation of contractual provisions that is at stake. Abuse of governmental powers is not an issue in commercial arbitration, but it is at the core of the good-governance standards embodied in investment protection treaties. The issue is to keep a government from abusing its role as sovereign and regulator after having made commitments of a more formal character (contracts and licenses) or of a less formal character (i.e. the assurances by explicit communication or by meaningful conduct that form the basis of the legitimate expectations principle under Art. 1105 of the NAFTA).

14. The disappointment of legitimate expectations must be sufficiently serious and material. Otherwise, any minor misconduct by a public official could go to the jurisdiction of a treaty tribunal. Their function is not to act as a general-recourse administrative law tribunal. The introduction of direct investor-state arbitration (“arbitration without privity; “transnational arbitration”) since the late 1980, resulted in a “discontinuity” which is not as yet fully appreciated and requires attention in cases such as this one. In former times, investment treaties provided for an intergovernmental arbitration process only; governments therefore had to “sponsor” private claims. Such governmental sponsorship provided an important “filter” for screening claims and for avoiding that investment treaties were used for a multitude of claims that did not justify the machinery of an international treaty to come into play: The risk of opened “floodgates” and the spectre of treaty-based procedures for a single instance of misconduct<sup>8</sup> of an individual official. Modern treaties with direct investor-state arbitration rights no longer have such in-built “filters”. The construction of key legal terms must therefore provide sufficient filtering so that the treaty is only available to material, substantive and

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<sup>7</sup> Also: Gaillard, *Jurisprudence du CIRDI*, 2004, at p. 7

<sup>8</sup> In the hearing this was referred to as a “bad hair day”

serious breaches and not for the every-day grievances arising from an individual's interaction with the machinery of government. Cases of administrative misconduct which are not serious enough, in terms of materiality of a breach, amount of damage or lack of instant remedy,<sup>9</sup> do not justify triggering the operation of the heavy and costly treaty machinery under Chapter XI.

15. Finally, I wish to highlight the need to pay attention and respect to the consolidating jurisprudence coalescing out of pertinent decisions of other authoritative arbitral tribunals, in particular the more recent decisions applying the NAFTA and international investment treaties which have a similar methodology, procedure and substantive content to NAFTA Chapter XI. While there is no formal rule of precedent in international law, such awards and their reasoning form part of an emerging international investment law jurisprudence<sup>10</sup>. This is again a significant difference from commercial arbitration where there is little authoritative and persuasive precedent, largely because the awards are exclusively formulated for the private parties and because they are generally not publicly available. Investment treaty tribunals should

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<sup>9</sup> J. Paulsson, *Denial of Justice in International Law*, 2005, at p. 109 citing *Generation Ukraine v Ukraine* at para 20.30 requiring a "reasonable, not necessarily exhaustive effort" by the investor to obtain correction".

<sup>10</sup> Brower-Brueschke, *The Iran-US Claims Tribunal*, 1998, 651-654; E. Gaillard, *Use of General Principles of International Law in International Long-term contracts*, *Intl Bus. Lawyer*, May 1999 at p. 217: "arbitral tribunals have a strong tendency to use precedents established by arbitral awards rendered in similar circumstances". This approach has to be a fortiori much stronger in public, transparent and public-policy involving investment arbitration than in commercial arbitration; Gaillard, *La Jurisprudence du CIRDI*, 2004, p. 8, 153; this does not prevent one tribunal disagreeing from another one, but it should preclude a tribunal from departing, without in-depth reasoning if at all, from an established jurisprudence ("jurisprudence constante"), see *SGS v Philippines*, at para. 97 (footnotes omitted) :

"In the Tribunal's view, although different tribunals constituted under the ICSID system should in general seek to act consistently with each other, in the end it must be for each tribunal to exercise its competence in accordance with the applicable law, which will by definition be different for each BIT and each Respondent State. Moreover there is no doctrine of precedent in international law, if by precedent is meant a rule of the binding effect of a single decision..... It must be initially for the control mechanisms provided for under the BIT and the ICSID Convention, and in the longer term for the development of a common legal opinion or jurisprudence constante, to resolve the difficult legal questions..".

therefore place themselves in the centre of emerging international investment law rather than at or beyond the margin:

“To place one decision in a long tradition of similar decisions give the entire tradition of consistency, an “integrity” that is a central feature of law as such”<sup>11</sup>.

16. While individual arbitral awards by themselves do not as yet constitute a binding precedent<sup>12</sup>, a consistent line of reasoning developing a principle and a particular interpretation of specific treaty obligations should be respected; if an authoritative jurisprudence evolves, it will acquire the character of customary international law and must be respected. A deviation from well and firmly established jurisprudence requires an extensively reasoned justification. This approach will help to avoid the wide divergences that characterise some investment arbitral awards – not subject to a common and unifying appeals’ authority. Otherwise, there is the risk of discrediting the health of the system of international investment arbitration which has been set up as one of the major new tools in improving good governance in the global economy<sup>13</sup>. But it also is also mandated by the reference to applicable rules of international Law (Art. 1131 NAFTA) and thereby Art. 38 of the Statute of the International Court of Justice: An increasingly continuous, uncontested and consistent modern arbitral jurisprudence is part of the authoritative source of international law embodied in “judicial decisions” (Art. 38 (1) (d)) and will develop, with an even greater legally binding effect, into “international custom (Art. 38 (1) (b)), in particular as an arbitral jurisprudence defines in a contemporary treaty and factual context the “general principles of law” (Art. 38 (1)(d)).

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<sup>11</sup> P. Norton, *Modern tribunals and the international law of expropriation*, 85 AJIL 474 (1991), p. 497 ff.

<sup>12</sup> See also Art. 59 of the Statute of the International Court of Justice

<sup>13</sup> World Bank Development Report, 2005, “A Better Investment Climate for Everyone”, pp. 175 – 180.



### 3.) Specific Approaches to the Factual Situation of the Thunderbird – Mexico Dispute

17. This case presents neither solely a legal or solely a factual issue, but a situation where the factual situation has to be closely scrutinised, but always with the view of the legal rules and principles that are applicable. The application of a legal rule to a factual situation always involves a certain feed-back between the way the legal rule is defined and the way the factual situation is viewed. The adjudicator's personal and cultural pre-understanding will inevitably play a role as much as competent professionals will try to minimise and make transparent such a pre-disposition.

18. At issue here is a foreign investment in gambling or, as industry advocates would now call it, "gaming". This industry has a bad press in many cultures and is not accepted in several religions, including as I understand Canon law, fundamentalist Protestant attitudes and Islamic law. The negative view towards gambling businesses may be the reason underlying the change in attitude that took place between the outgoing Mexican PRI and the incoming PAN government in 2001. It has also been relied upon by respondent in order to colour the case<sup>14</sup>. The former PRI government considered more extensive legalisation of gambling to create employment and re-attract Mexican demand for such services in Las Vegas; the latter seems to have been, to some extent, more closely attached to an attitude negative towards gambling. As far as this dispute is concerned, I have advocated a fully neutral and professional approach, without inherent bias for or against this particular industry. There has been no evidence in this dispute about any of the negative effects of gambling often alleged to accompany such entertainment services – crime, prostitution, money-laundering or similar undesirable by-products justifying an extra-rigorous approach. That liberalisation was in the relevant period under consideration in Mexico is also indicated by a study commissioned by

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<sup>14</sup> Reference: Transcripts of Hearing in April 2004, 92 ff; 1165 ff.

the Mexican Congress on the implications of liberalisation<sup>15</sup> Under the WTO/GATS Schedules of Specific Commitments, certain countries have made specific commitments to liberalize gambling services, namely by offering non-discriminatory treatment to foreign gambling services establishing themselves on the domestic market; recent WTO panel and Appeals Body cases have treated gambling as any normal entertainment services industry as has the European Court of Justice<sup>16</sup>. This indicates that gambling services, in particular if not typically accompanied by criminal by-products, have to be treated as a fully legitimate investment.

19. There is therefore no general or compelling reason to approach gambling investment with a negative attitude compared to other types of investment. All evidence in this particular case points towards operations of computer-programmed slot machines with a "skill" stop button; they have a certain attraction and entertainment value for many people. But from the record of this case and from personal observation of such facilities one now finds throughout the world, it seems not possible to either win or lose large amounts of money in a normal period of time spent. Such video-arcades with gambling machines can not be compared to the high-stakes traditional casinos. None of the criticism of "high gambling" applies here: There is no suggestion of children left destitute because of fathers' gambling, of

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<sup>15</sup> Los casinos en México y sus principales efectos Servicio de Investigación y Análisis sociales: Un análisis de opinión pública División de Política Social SIID Dr. (c) Juan Martín Sandoval De Escurdia DPS, 55 noviembre 2002; available from the internet. Mexico was, as the report for the Mexican Congress shows, under competitive pressure from the US which pulled in a large amount of Mexican gambling business. While "Gambling was illegal in 49 of 50 American states 30 years ago,. Today, all but two of them allow gambling in some form" – C. Caldwell, Financial Times 27/8/2005.

<sup>16</sup> See most recently the WTO Appeals Body decision in *Antigua/Barbuda v US* case of 7 April 2005 ; WT/DS285/AB/R following on the earlier panel decision; The ECJ, in established jurisprudence (*Schindler, Laara and Gambelli* case) accepted that gambling is an economic activity and a service that falls under the Treaty's guarantees of freedom to provide services, most recently: ECJ Case C-243/01 (*Gambelli and Others*, 2003) at paras 44-46; for an overview of WTO and ECJ jurisprudence: *Sofie M.F. Geeroms, Cross-Border Gambling on the Internet under the WTO/GATS and EC Rules Compared: A Justified Restriction on the Freedom to Provide Services?* in: *Cross-Border Gambling on the Internet, Challenging National and International Law*, Research conducted by the Swiss Institute of Comparative Law, Vol. 47 / 2004.

family assets dispersed, but a rather mundane activity of putting coins repeatedly into multi-coloured slot machines. As a result, Thunderbird's operation should be viewed and treated as a normal operation of entertainment services, without any in-built bias against them and in favour of governmental closure.

20. The same applies to the corruption hint insinuated by respondent in its submission on the "success fee" paid to Aspe & Arroyo, two of Thunderbird's lawyer-lobbyists, for negotiating the "oficio" of August 15, 2000. Such insinuations are now frequently employed by both claimant investors and respondent governments. They should be disregarded – explicitly and implicitly, except if properly and explicitly submitted to the tribunal, substantiated with a specific allegation of corruption and subject to proper legal and factual debate for the tribunal. That is simply the implication of the "fair hearing" principle. In contrast to, for example, the WTO dispute system and other international adjudicatory bodies, there is in current investment arbitration only one level of fact-finding. If a tribunal should be influenced by insinuations, there is no appeal instance (at present) in the NAFTA arbitral system which can correct a factual finding or assumption that has a bearing on the ultimate award. It is therefore particularly important for a tribunal not to get influenced, directly or indirectly, by "insinuations" meant to colour and influence the arbitrators' perception and activate a conscious or subconscious bias, but to make the decision purely on grounds that have been subject to a full and fair hearing by both parties. Cards should be placed, "face up", on the table rather than be waved around, with hints and suggestions. If the Mexican government had wanted to prove bribery it had the opportunity both to raise it and to try to prove it by providing its officials involved in the transaction for cross-examination; but it chose not to produce them.

Legitimate Expectations (Detrimental Reliance) under Art. 1105 of the NAFTA

21. At issue in dispute – and the main area where I disagree with my colleagues – is whether the conduct of the Government, i.e. SEGOB, the federal gambling directorate, has individually or in its aggregate, created a legitimate expectation for Thunderbird that it could carry out legally its business of computer-driven slot machines involving some measure of skill and human intervention. In this context, the government's duty to avoid ambiguity towards foreign investors, to send clear messages and to pro-actively correct any misperception manifestly created, to take into account the investor's need for predictability of government conduct and key attitudes is engaged, also its obligation to take its prior assurances into account when "closing" the facilities. It is not sufficient that Thunderbird had an "expectation", and that this expectation contributed in a significant way to its readiness to commit risk capital and effort, but the expectation must also have been "legitimate", i.e. it must have been created by government officials in an official way (i.e. attributable to the government of Mexico), they must have been competent (or at least appeared, credibly, to be competent) for the trust-inspiring action. The procedure for issuing the assurance ("comfort") letter must have been legitimate and it must have been "reasonable" for Thunderbird to rely on that letter<sup>17</sup>.

22. The following are the key distinct factors on which the determination of "legitimate expectation" under Art. 1105 of the NAFTA must rest:

- First: The letter "oficio" or "criterio" of August 2000, to be read in conjunction with the following: (i) the request ("solicitud") by claimant; (ii) the prior, prolonged, informal and preparatory discussions with the competent government officials who later commended the investor's "cooperative" approach in contrast to the Mexican competitors' confrontational approach and who

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<sup>17</sup> An excellent overview, with particular emphasis on civil law systems in Spanish speaking countries such as Mexico, is Hector Mairal, *La Doctrina de los propios actos y la administracion publica*, Buenos Aires, 1994; on the requirement that the expectation must be reasonable, Mairal, p. 90, 91. On the requirement that the reliance be reasonable: D. Anderson, *Compensation for interference with property*, 6 EHLR (1999) 543-558, text at note 80

encouraged Thunderbird to pursue this cooperative approach;  
and (iii) the subsequent legal advice by its legal adviser in  
September 2000 (I do not concur with the majority's reasoning:  
paras. 158-163);

- Second: The accepting conduct of SEGOB subsequent to the issuance of the "oficio" in August 2000 which did not raise any questions, did not require any further information, did not inspect or review the operations and which tolerated and did not interfere in Thunderbird's operation until a new (more anti-gambling minded) government and a new SEGOB director (on the uncontested facts available in the record more anti-Thunderbird-minded) came into office about six months later;
- Third: The conduct of SEGOB under its new director which targeted less the long-established slot machine operations at various locations of Mr Guardia, and certainly had no success (if there was a serious effort) in factually preventing them from operating but which targeted with priority and soonest after taking office Thunderbird's operation, though (or perhaps because) Thunderbird had gone the legal way and obtained an "interpretative assurance" which did give green light to Thunderbird, or at least seemed to them to give such green light. (The majority award – paras 174-179 – has no problem with both the relative enforcement intensity and its ultimate success against claimant but not against the Mexican competitor and does not deal with the question if the issuing of the "oficio" has anything to do with the later enforcement and closure)<sup>18</sup>.

23. It is in the combination of these three inter-related and consecutive measures of SEGOB – solicitud, oficio and subsequent conduct - that I

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<sup>18</sup> The tribunal majority here follows SEGOB in considering the Oficio as meaningless as obtained with insufficient disclosure and as not clearly approving the type of operations carried out. In consequence, the Oficio is for the tribunal of no consequence for the later enforcement actions of the – new government-controlled – SEGOB.

find a breach of legitimate expectations under NAFTA Art. 1105 in contrast to the tribunal which finds the “Oficio” of August 2000 not clear enough and tainted by insufficient disclosure, attaches no significance to either the preparatory discussions of Thunderbird with SEGOB where a cooperative approach was encouraged, nor to the subsequent accepting toleration of Thunderbird’s slot machine operations for over six months and which finds no elements of discriminatory treatment in the enforcement intensity, focus and effectiveness of SEGOB as between Thunderbird (rapidly closed after the new government and then the new SEGOB director took office) and Guardia – who continues, it seems, to this day, winning injunctive relief (“amparo”) and maintaining at least several of his long-standing slot machine operations.

24. To understand my different application of the principle of “legitimate expectation” under Art. 1105 of the NAFTA to the factual situation it is necessary to understand its background and scope which is far from simple or un-ambiguous.

25. First the doctrinal structure: “Legitimate expectation” is not explicitly mentioned in Art. 1105 nor in other similar investment treaties. It is, however, considered to be part of the “good faith” principle which is a guiding principle (also a general principle of international law)<sup>19</sup> for applying the “fair and equitable treatment” standard in Art. 1105, a standard that is repeated, more or less identically, in most of the other over 2500 investment treaties in force at present<sup>20</sup>. In the current

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<sup>19</sup> See Bin Cheng, 120 ff. who considers that one of the applications of the principle of good faith is crystallised in the doctrine of “estoppel”, the common law term for “legitimate expectations” (venire contra factum proprium).

<sup>20</sup> A recent OECD study on the “fair and equitable standard” mentions “good faith” as a combination of elements: respect of basic expectations, transparency and lack of arbitrariness and quotes the Tecmed v Mexico case to illustrate this link, p. 37-39., - Working papers on international investment number: Fair and equitable treatment standard in international investment law September 2004. Older precedent and modern arbitral jurisprudence (Metalclad v Mexico; Tecmed v Mexico; MTD v Chile; Occidental v Ecuador) have not as yet been examined in this study. Legitimate Expectation has been employed as early as the Aminoil v Kuwait award; Amoco v. Iran – see I. Seidl-Hohenveldern L’Evaluation des dommages dans les arbitrages transnationaux, *Annuaire Francais de Droit International*, 1987

dispute both parties (and the tribunal) assume the existence of such a standard under Art. 1105<sup>21</sup>. They can, correctly, rely on the recognition of “good faith” principle – either as a separate obligation or, arguably mainly, as a major interpretative principle that is applied ancillary to a principal obligation (such as “fair and equitable treatment”)<sup>22</sup>. “Good faith” is explicitly mentioned in Art. 31 of the Vienna Convention<sup>23</sup>. This principle has been applied in intergovernmental relations to reinforce an obligation, to prevent a state to invoke formal law against a claim when it has caused the other state to rely on the way it would exercise rights, and to deny a legal argument to a state when its previous conduct indicated it would not rely on such argument<sup>24</sup>. To cite Derek Bowett in an authoritative statement<sup>25</sup>:

“Representations .. may be made expressly or impliedly where, upon a reasonable construction of a party’s conduct, the conduct presupposed a certain state of act to exist. Assuming that another party to whom the statement is made acts to its detriment in reliance upon that statement or from that statement the party making the statement secures some advantage, the principle of good faith requires that the party adhere to its statement whether it be true or not. It is possible to construe the estoppel as resting upon a responsibility incurred by the party making the statement for

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at p. 28 mainly, it appears, to correct an otherwise too formal legal approach; similar, in the Shufeldt award, a similar approach was used to hold the government to a commitment when the formal contract was not legally valid, but the government had tolerated the operations based on such commitment and had benefited from them by way of taxes and otherwise – as in this case.

<sup>21</sup> Generation Ukraine v Ukraine: Para.20.37;

<sup>22</sup> There is a discussion if “good faith” is a separate obligation under international law or rather a guiding principle for interpretation of distinct obligation – so the US government in its Rejoinder in the Methanex v US case ([www.state.gov/s/l/c5822.htm](http://www.state.gov/s/l/c5822.htm) at pp. 25-26). But this controversy is not material here. At issue is the application of the good faith principle to support the existence of a legitimate expectation standard as subcategory of the “fair and equitable treatment” obligation.

<sup>23</sup> Bin Cheng, *General Principles of Law*, Grotius, Cambridge, 123 et seq

<sup>24</sup> ICJ Nuclear Tests Case, ICJ Reports 1974, 253 at p. 268

<sup>25</sup> Estoppel before international tribunals and its relation to acquiescence, 33 BYIL 176 (1957) cited as authority in Reisman/Arsanjani, ICSID Journal 2004 at p. 340

having created an appearance of act, or as a necessary assumption of the risk of another party acting upon the statement”

26. But such international inter-state rules are difficult to apply in the context of a foreign investor’s reliance on host state assurances as to its law (i.e. a specific interpretation) or as to the way its authorities would proceed<sup>26</sup>. But what can be used from international, inter-state law is the concept that “good faith” and “legitimate expectation” under Art. 1105 of the NAFTA trump the application of domestic law – such as Mexican gambling law as interpreted by the – then – new Mexican government<sup>27</sup>. The good-faith and legitimate expectations principle control, for the relationship between the parties (e.g. Mexico and Thunderbird), the way the Mexican gambling law has to be interpreted<sup>28</sup>. Governments can not, against a determination that under the international law-based “fair and equitable treatment” principle a legitimate expectation of a specific interpretation has emerged, invoke a dominant contrary interpretation under domestic

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<sup>26</sup> Different from inter-state relations, also within the WTO, with NAFTA investor-state disputes, the parties are on an unequal footing as to conditions of competition, because the host State even if bound by the fair and equitable treatment standard is less vulnerable than the investor to the application of that standard in the specific case at hand, because the investor lacks the retaliatory power of a trading partner. Therefore it is important to interpret more broadly under NAFTA Chapter XI than under the WTO Agreements the legitimate expectations an investor may have with respect to a host state’s assurances..

<sup>27</sup> In international law, as Brownlie has said, “references to the ‘principles of good faith’ are, first, and foremost, indications that the national law of the respective parties is not to apply.” The assumption, so Brownlie is that “the applicable law should be applied in a manner which is compatible with the shared expectations of the parties. I. Brownlie, Ian, Some Questions Concerning the Applicable Law in International Tribunals, in: *Theory of International Law at the Threshold of the 21<sup>st</sup> Century, Essays in Honour of Krzysztof Skubiszewski*, Jerzy Makarczyk (ed.), The Hague, Kluwer Law International, 1996; Reisman/Arsanjani, *ICSID Review* 2004, at p. 339: “If the investor has relied on that statement, as in public international law, it is difficult to see how domestic law can then be used by the state to avoid responsibility.”

<sup>28</sup> The Government of Kuwait v. Aminoil award, 1982 (66 International Law Reports (1982) at 518) says: Thus, to the extent that Article III, 2 of the Arbitration Agreement calls for interpretation, such an interpretation ought to be based on that provision which not only was freely chosen by the Parties in 1973, but also reflects the spirit which has underlain the carrying on of the oil concession in Kuwait.”.



law<sup>29</sup>. The implication of this analysis is that the principle of “legitimate expectation” under Art. 1105 of the NAFTA overrides any dominant interpretation of applicable Mexican law on the legality of the operation at issue if SEGOB can be considered to have given – reasonably and legitimately – such an assurance. Mexico is not compelled by the treaty to change its law or the dominant interpretation of the law at a certain point of time; it is simply obliged to provide financial compensation if its officials have created an investment-backed legitimate expectation with a specific investor that another, or earlier, interpretation would prevail.

27. The principle of protection of “legitimate expectation<sup>30</sup>” or, in common law, estoppel<sup>31</sup>, has also been applied in comparative contract law, mainly to deny formal rights invoked by a party if such invocation contradicts previous statements and conduct that made the other party trust in the particular expectation so created<sup>32</sup>. But contract law – presuming the existence of two equal parties in a commercial contract – is less relevant than comparative public law with respect to the judicial review of governmental conduct. For example, in its well-established jurisprudence, the European Court of Justice held “legitimate expectations” to be a key principle of the relation between

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<sup>29</sup> That has also been the conclusion of the MTD v Chile tribunal where a protected legitimate expectation was found to exist, though the building project contravened national planning law.

<sup>30</sup> “Venire contra factum proprium”, “Vertrauensschutz”

<sup>31</sup> Cave v Mills (1962) Court of Exchequer, 7 Hurlstone & Norman, p. 193 at p. 927 (cited from F. de Trazegnies, LA VERDAD CONSTRUIDA: Algunas reflexiones heterodoxas sobre la interpretación legal, TDM 2005 ([www.transnational-dispute-management.com](http://www.transnational-dispute-management.com)))

<sup>32</sup> See references in Hector Mairal, Actos Proprios, Buenos Aires, 1994; this use of the concept of “estoppel” seems related to “laches” (“acquiescence”) where prolonged and informed acquiescence will lead to a barring of a claim or an implied waiver, Corpus Juris Secundum, June 2005, 30 A CJS Equity at para. 136. also Fernando de Trazegnies, La Verdad construida, algunas reflexiones heterodoxas sobre la interpretación legal, in: TDM 2005 ([www.transnational-dispute-management.com](http://www.transnational-dispute-management.com)). Trazegnies examines the principle in light of its Roman (and mediaeval) law antecedents and in particular Latin American, Argentine and Peruvian practice: “no es admisible que un contratante o parte en general actue unas veces en un sentido y otras en otro, afirme ciertos hechos en una situación y los niegue en otra, reconozca y acepte ciertas interpretaciones .. y las desconozca en otra similar, simplemente porque en una le conviene y en otra no le conviene” (at p. 10/11)

state and individuals<sup>33</sup>. The principle requires public authorities (including the European Commission) to respect legitimate expectations it has created with individuals, in particular if such expectations have become the basis for investment<sup>34</sup>. In ECJ jurisprudence, the public authority can not lightly reverse course once it has created such investment-backed legitimate expectations, but has to take its prior conduct into account when planning to reverse its course with a detrimental effect on individuals/ investors. The principle has also been recognised in the jurisprudence of the European Court of Human Rights, here in particular to define the existence of legally protected “acquired rights”<sup>35</sup>. European law does not prevent a public authority from reversing its course, but requires a balancing process where the strength of the individual’s interest is balanced against the need for flexibility in public policy<sup>36</sup>:

“An expectation is then legitimate and ought to be protected if “taking a new and different course will amount to an abuse of power” – “Once the legitimacy of the expectation is established, the courts will balance the requirements of

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<sup>33</sup> The principle of “legitimate expectation” is independent from the “fundamental rights” underlying EU law, Case 120/86 *Mulder* (1988) ECR 2321, paras. 23-26; Case 170/86 *von Deetzen* (1988) ECR 2355, paras. 12-15.

<sup>34</sup> See case C-17/03 of June 2005 at para 73 : “The principle of the protection of legitimate expectations is unquestionably one of the fundamental principles of the Community (see, *inter alia*, Case C-104/97 *P Atlanta v European Community* [1999] ECR I-6983, paragraph 52, and *Joined Cases C-37/02 and C-38/02 Di Lenardo and Dilexport* [2004] ECR I-6945, paragraph 70” . in *Marks & Spencer v Commissioners of Customs and Excise*, 2002, ECR I-6235 the ECJ held that the protection of legitimate expectations applies so as to preclude a national legislative amendment which retroactively deprives a taxable person of the right enjoyed prior to that amendment”; that principle should equally apply to a fundamental re-interpretation of national law that was specifically and formally conveyed to that person who relied on it for making a substantial investment.

<sup>35</sup> *Kopecký v. Slovakia*, at para. 35, 28 September 2004 *Djidrovski v. the former Yugoslav Republic of Macedonia* at para .68 , 24 February 2005 ; case of *s.a. Dangeville v.France* , 16 April 2002.

<sup>36</sup> S. Schonberg, *Legitimate Expectations in Administrative Law*, OUP, 2001; J. Schwarze, *European Administrative Law*, 1992, 880 ff. ; Advocate General Jacobs opinion in ECJ case *RAcke v Hauptzollamt Mainz*, Case C 162/96, at para 95: “Moreover, under Community law, the protection of legitimate expectations may be limited by some overriding public interest”.

fairness against any overriding interest relied upon for the change of policy".<sup>37</sup>

28. The principle of legitimate expectation is also recognised in several developed systems of administrative law<sup>38</sup>. The common principles of the principal administrative law systems are in my view an important point of reference for the interpretation of investment treaties to the extent investment treaty jurisprudence is not as yet firmly established. But its exact scope and implication are not well established<sup>39</sup>. There are contradictions between the principle that public administrations have to be utterly clear in their dealing with individuals and to respect any legitimate expectations they have been responsible for and the concept that only confidence in un-ambiguous assurances by public authorities are protected<sup>40</sup>. Legitimate expectations in EU law can be created by informal statements, including sufficiently precise oral representations and by government conduct, either by itself or in combination with written assurances<sup>41</sup>. Noteworthy is a reference in Schonberg's comprehensive study to the need for a more subjective approach that takes into account the experience and size of investors –

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<sup>37</sup> R v North and East Devon Health Authority, 2000, 3 ALL ER 850, para. 57

<sup>38</sup> Schonberg, 2001; De Smit, Woolf & Jowell, *Judicial Review of Administrative Action*, fifth Ed, London 1995, 867 ff; P. Craig, *Administrative Law*, 1994, 611-650; for Latin American countries: Ana I. Piaggi: *Reflections on the basic principles of the Law*, in Marcos A. Córdoba (Director): *Treatise on good faith in the Law*. La Ley. Buenos Aires, 2004. T. I, p. 118.; also: Concurrent vote of Dr. Cançado Trindade in Consultative Opinion 16/99. Inter-American Justice Court, 1 Oct. 1999 – “allegans contraria non audiendus est”. French Law (see Schonberg, op.cit. p. 116 ff.) solves the issue by a extensive recognition of rights acquired by administrative act and protected against retroactive revocation. German law recognizes the principle of Vertrauensschutz as a general principle of administrative law, flowing from the guarantees contended in constitutional law, Hartmut Maurer, § 2 Nr. 17, 15<sup>th</sup> ed, Munich 2004.

<sup>39</sup> This method of interpretation is also anchored in the explanation of the fair and equitable standard in the new US BIT model (2004) with its reference to the “principle of due process embodied in the principal legal systems of the world”, Art. 5 (2) (a); see also the reference to state practice and the jurisprudence of arbitral tribunals in *Mondev v US*, 42 ILM 85, at para. 119.

<sup>40</sup> Case T-123/89 (*Chomel v Commission* (1990)), para 26.; Schonberg, op. cit. p. 120 ff; as noted in para. 28 of this opinion, Schonberg suggests that the principle of legitimate expectation has to be applied with due regard to the particular circumstances – with smaller and less experienced companies deserving greater protection as large companies with the ability to mobilise substantial legal expertise.

<sup>41</sup> P.Craig, *Substantive Legitimate Expectations in Domestic and Community Law*, CLJ 289 (1996) with a review of relevant ECJ case law.

with greater protection for smaller and less experienced investors<sup>42</sup>.

The principle is recognised in the Spanish and Latin American civil law systems<sup>43</sup> and presumably forms – as part of the overall principle of “good faith” – part of Mexican civil and administrative law<sup>44</sup>.

29. Legitimate expectation has also been recognised as an important principle guiding the interpretation of other obligations in international economic law. A certain measure of recognition of this principle can be inferred from several WTO panel decisions:<sup>45</sup> “The protection of legitimate expectations of Members regarding the conditions of competition is a well-established GATT principle, which derives in part from Article XXIII, the basic dispute settlement provisions of GATT (and the WTO).”<sup>46</sup> In the main, the principle is here used to protect negotiated concessions from being undermined by conduct of member states contrary to the purpose and spirit of such concessions.<sup>47</sup>

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<sup>42</sup> Schonberg, *op. cit.* at p. 128

<sup>43</sup> Hector Mairal, *La doctrina de los propios actos y la Administracion Publica*, Depalma, Buenos Aires, 1994; Piaggi, *supra*; Trazegnies (2005) *supra*; Cancado Trindade in the *Opinión Consultiva 16/99*, Inter-American Court, 1 October 1999, cited *alter Trazegnies*, 2005: “el que elga lo contrario (de un alegato o un hecho propio anterior) no debe ser escuchado.”

<sup>44</sup> S. Zamora et.al. 2004, *Mexican Law*, Chapter 17 discusses the concept of “bad faith” – conduct contrary to what was conveyed (“dolo”); I understand from Pedro Coviello, *La Proteccion de la Confianza del Administrado*, Buenos Aires 2004, p. 446 that Mexican author Alvaro Carlos Estrado, *Responsabilidad patrimonial del estado*, 1997, pp. 124-125 discusses the application of the principle of legitimate expectation and good faith in Mexican law, but I have been unable to trace this book.

<sup>45</sup> *India-Patents*, Panel Report para 7.20; *India-Patents*, AB Report 43-45; *EC-Lan* Panel report para 8.25; *US-Section 301*, panel report para 7.67; *Italy-Agricultural Machinery*, GATT 1947 Panel report paras. 5, 12, “provide equal conditions of competition”; *Canada-Autos*, GATT 1947 panel report paras. 10.76, 10.77, 10.80, “less Favourable as Formally Different or Formally Identical Treatment which Modifies the Conditions of Competition,”; *EEC-Oilseeds I*, GATT 1947 panel report, paras. 147-148, 152. See: Marion Panizzon, “Good Faith in the Jurisprudence of the WTO, A Study on the Protection of Legitimate Expectations, Good Faith Interpretation of the WTO Agreements and Fundamental Fairness in Dispute Settlement”, Manuscript submitted to publication April 2005,.

<sup>46</sup> *India-Patents*, Panel Report, para. 7.20.

<sup>47</sup> The WTO AB has associated what it calls the “GATT-specific” principle of protection of legitimate expectations with the general principle of law of good faith to prohibit the US from abusing the injury-test in anti-dumping law, by distributing the funds collected from anti-dumping duties to those of the US businesses, which had voted in favour of introducing and sustaining US anti-dumping duties against EU imports of steel. The US thereby created an incentive to apply trade remedies, which the WTO Anti-Dumping Agreement’s “threat of injury” clause does not foresee, and which the Panel implied, was contrary to good faith. See

30. While this brief survey of general international, international economic (including EU), comparative contract and comparative administrative law does not specify exactly the contours of this principle, it suggests that under developed systems of administrative law, a citizen – even more so an investor - should be protected against unexpected and detrimental changes of policy if the investor has carried out significant investment with a reasonable, public-authority initiated assurance in the stability of such policy. Assurance on a particular interpretation of often open-ended statute against an unexpected detrimental change of such interpretation is in this context particularly relevant<sup>48</sup>. Such protection is, however, not un-conditional and ever-lasting. It leads to a balancing process between the needs for flexible public policy and the legitimate reliance on in particular investment-backed expectations. The consulted authorities are indicative of contemporary state practice and the minimum standards of comparative national and international law. The “fair and equitable standard” can not be derived from subjective personal or cultural sentiments; it must be anchored in objective rules and principles reflecting, in an authoritative and universal or at least widespread way, the contemporary attitude of modern national and international economic law. The wide acceptance of the “legitimate expectations” principle therefore supports the concept that it is indeed part of “fair and equitable treatment” as owed by governments to foreign investors under modern investment treaties and under Art. 1105 of the NAFTA. It is before this international and comparative law background that one needs to make sense out of several recent investment treaty awards which have applied the legitimate expectations principle, both under Art. 1105 of the NAFTA and the equivalent provisions of applicable bilateral investment treaties. These awards – *Metalclad v Mexico*, *Tecmed v. Mexico*,

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US-Offset Act («Byrd Amendment»), Panel Report, paras. 7.63-7.64, US-Offset Act («Byrd Amendment»), Appellate Body Report, paras.

<sup>48</sup> Mairal, op. cit. 140, 150 ff. ; Schonberg, op. cit. p. 109 with reference to *HTV v Price Commission*, 1976 ICR 1970, 1985: “a public authority which had led traders to rely on one interpretation of a statutory provision could only adopt another interpretation if there was an overriding public interest in doing so”.

Occidental v. Ecuador, Waste Management v Mexico II<sup>49</sup> and MTD v. Chile<sup>50</sup> – may not have explained the doctrinal background of the principle, its scope and contours specifically, but these authoritative precedents have contributed towards establishing the “legitimate expectation” as a sub-category of “fair and equitable treatment” in the for this dispute here most pertinent investment treaties (including NAFTA Chapter XI’s Art. 1105)<sup>51</sup>.

31. While these cases for the first time appear to consider “legitimate expectation” as a definite subcategory of the “fair and equitable treatment” obligation, there are precursors. In most of them, legitimate expectation is used as a principle to specify the scope and content of primary legal obligations. In *Revere Copper and Brass v OPIC*, the tribunal identified the “assurances given in good faith to such aliens as an inducement to their making the investments” as contributing to the creation of a protected right<sup>52</sup>. In *ME Cement v Egypt*, legitimate expectation was used to delineate future profitability of a license, for the purpose of calculating compensation<sup>53</sup>. In *Nagel v. Czech Republic* (p. 33), the concept of a legitimate expectation was used to distinguish the existence of a protected acquired right from a mere hope or legally irrelevant personal expectation<sup>54</sup>. The tribunal’s reasoning suggests that the less formal “personal communications”, the less likely is the emergence of a legitimate expectation; this means that the greater the formality of an assurance, the greater its ability to trigger a legitimate expectation. That criterium is pertinent to the highly formalised “Oficio” issues in this case by SEGOB. In *ADF v US*,

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<sup>49</sup> Award published in 43 ILM 967 (2004)

<sup>50</sup> I understand there is an annulment request with respect to the MTD v Chile award.

<sup>51</sup> F Orrego Vicuna, Regulatory authority and legitimate expectations, Intl Law Forum, Vol. 5, 2003, 188-197; C Schreuer, Fair and equitable treatment in arbitral practice, in: J. World Investment, 2005, at p. 374; B. Sabahi, Protections of Legitimate Expectations, TDM 2005 ([www.transnational-dispute-management.com](http://www.transnational-dispute-management.com) – forthcoming).

<sup>52</sup> Award of August 24, 1978, 17 ILM 1321 (1978) at p. 1331.

<sup>53</sup> *ME Cement v Egypt*, ICSID website, paras 127-129

<sup>54</sup> SCC Case 49/2002; The lack of formality of representations in informal personal contacts with government officials was seen by the tribunal as a reason to deny the existence of an acquired right and legitimate expectation, p. 156: “[Mr X] may, in good faith, have been over-optimistic in interpreting the informal signals he received from his influential personal friends and contacts within the ...Government.”

the tribunal discussed the claimant's expectation allegedly created by existing case law; but it denied the existence of a "legitimate expectation" because the expectation was not created by "any misleading representations made by authorised officials of the US federal government but rather, it appears probable, by legal advice received.. from private counsel"<sup>55</sup>. That case suggests, e contrario, that it is representations from authorised officials that provide the foundation for legitimate expectations if these representations become reasonably the basis for the investor's commitment of capital<sup>56</sup>. In *Mobil Oil v Iran*, legitimate expectation was used to calculate compensation for the break-down of negotiations for a termination agreement<sup>57</sup>; it functions in this context as the protection of an interest that has not yet grown into a full-fledged legally binding contract, but is still worthy of protection – similarly to the *Shufeldt*-case<sup>58</sup>. The key feature of these cases is that a proto-contractual interest is protected, albeit, in terms of compensation, at a significantly different and lower level than would be available to a full-fledged, contractually validated legal interest. In *SPP v Egypt*, the tribunal held that "certain acts of Egyptian officials"... were "cloaked with the mantle of government authority and communicated as such to foreign investors who relied on them in making their investment. Whether legal ... or not these acts.. created expectations protected by established principles of international law"<sup>59</sup>.

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<sup>55</sup> *ADF v US*, Award of January 9, 2003, para 189;

<sup>56</sup> So also B. Choudhury, *Defining fair and equitable treatment in international investment law*, 6 *J World Investment & Trade*, 296 at p. 309; the European Court of Justice in established jurisprudence holds that "comfort letters" bind the Commission unless new facts emerge, see: V. Korah, *Comfort letters* – 1981 6 *ELRev* 14;

<sup>57</sup> *Mobil Oil v Iran*, 16 *Iran-US CTR* 3, 43-44 (1987)

<sup>58</sup> *Shufeldt* case, *Claim USA v Guatemala UNRIAA 2* (1949) 1081; the case dealt with concession activities carried out without a legally valid concession instrument; nevertheless, the award considered the government to be bound as it had tolerated the activities for a prolonged period and had been quite ready to benefit from it – by way of taxes and related benefits. Similarly, in the ICSID case of *Biloune v. Ghana* (95 *ILR* 183 (1994) at pp. 207, 210) conduct – in the form of an about 12 months' toleration of the process of setting up and constructing a restaurant was seen as sufficient to create not only a legitimate expectation (a formal assurance was alleged but contested), but justify a farther-reaching claim of "constructive expropriation".

<sup>59</sup> *SPP v Egypt*, 3 *ICSID Reports* 189, paras. 82-83, of 20 May 1992

32. A review of these cases suggests that conduct, informal, oral or general assurances can give rise to or support the existence of a legitimate expectation. But the threshold for such informal and general representations is quite high. On the other hand, a legitimate expectation is assumed more readily if an individual investor receives specifically formal assurances that display visibly an official character and if the official(s) perceive or should perceive that the investor intends, reasonably, to rely on such representation (the element of “investment-backed expectation”). The strongest way to build a legitimate expectation is if both formal and official elements are followed and reinforced by conduct that carries the same message as the investor reads – and can reasonably read – into an interpretative assurance or “comfort letter”. That is as well the implication of both the relevance of subsequent conduct for interpreting a formal declaration of treaty under Art. 31 (3) (b)<sup>60</sup> and the method of interpretation for contracts and unilateral legally relevant declarations in comparative contract law of civil-law countries (such as Mexico).<sup>61</sup> A most recent analysis suggests that specific “expectations that have been created by the acts, statements or omissions of the relevant public authorities” are “close parallels” to the requirement to accord “treatment that is fair and equitable”<sup>62</sup>.

33. As mentioned, the essential difference for the application of the “legitimate expectation” concept under Art. 1105 of the NAFTA and

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<sup>60</sup> “There shall be taken into account, together with the context:

(b) any **subsequent practice** in the application of the treaty which establishes the agreement of the parties regarding its interpretation”;

<sup>61</sup> Zweigert/Koetz An Introduction into Comparative Law, Vol. II, 1977, pp. 71-76 which highlights that in civil law it is not the exclusive focus on the literal face value of a written document, but rather “what the other contractor must in the circumstances have understood him to mean” – “in accordance with good faith with reference to normal commercial usage” (p. 75). The tribunal’s emphasis on reading the “Solicitud” and “Oficio” merely on its “face value” is application of the traditional legal formalism which even in its “home”, English common law, is no longer practised with this sort of context-excluding rigidity, Zweigert-Koetz, p. 80, 81.

<sup>62</sup> S. Fietta, Expropriation and the fair and equitable standard, BIICL Fifth Investment Treaty Conference, 9 September 2005, forthcoming on TDM ([www.transnational-dispute-management.com](http://www.transnational-dispute-management.com)). The CMS v Argentina tribunal emphasised the “specific commitment” by government as the basis for a claim (at para. 277, award on the merits).



comparable investment treaties from commercial contract law as applied in international commercial arbitration is that the two parties in investment disputes are not in an equal position<sup>63</sup>. If the parties are in an equal position, a much higher degree of due diligence is justified, as for example in inter-state relations under conventional international law, in WTO law or in transnational commercial relations, as usually adjudicated in international commercial arbitration. Strong parties in an equal position can be expected to deploy more expertise and due diligence to minimise ambiguity in their dealings with each other. Nor can the same requirements as in national judicial review of administrative actions be applied as the foreign investor is in a much more vulnerable, exposed position than a national citizen confronting his administration before national courts. Investment treaties throughout – witness the Preamble and Art. 102 of the NAFTA – are meant to compensate for this weaknesses of foreign investors by a regime of intensified protection. Such special protection for foreign investors is required in order to encourage investment, to compensate for the foreign investors' structural handicap when entering a foreign society and to help governments enhance the quality of their governance systems. As Elihu Root said, in 1910, about the foreign investor:

“He will naturally be at a disadvantage in litigation against citizens of the country. He is less familiar than they with the laws, the ways of doing business, the habits of thought and action, the method of procedure, the local customs and prejudices.”<sup>64</sup>

And recently Jan Paulsson:

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<sup>63</sup> This feature also distinguishes investment arbitration from the WTO – thus justifying a higher-level of protection; the observation by Schonberg (*supra*, at p. 128) about the need to take into account the specific background of in particular inexperienced investors) suggests that the subjective perception of the assurance by the particular addressee needs to be taken into account – rather than how an ultra-competent and perfect large corporation would have and should have understood the assurance addressed to it by the public authority.

<sup>64</sup> Cited from Jan Paulsson, *Denial of Justice in International Law*, 2005 at p. 23

“Whatever the rosy rhetoric about the equality of treatment of nationals and foreigners, the very fact of being foreign creates an inequality. The foreigner’s obvious handicap – his lack of citizenship – is usually compounded by vulnerabilities with respect to many types of influence: political, social, cultural.”<sup>65</sup>

34. All international investment treaties aim at attracting foreign capital in a situation where the domestic investor is in a much better position: It is as a rule more expert in dealing formally and informally with the government apparatus; there are often hidden forms of collusion between administrators and local businessmen. What happens in such government-business relationships is usually not visible – it is a “black box” into which foreign investors – and arbitral tribunals – have great difficulties in penetrating<sup>66</sup>. So if “**fair competition**” aimed at (Art. 101 (1)(b) NAFTA) and an “**increase of substantial investment opportunities**” (Art. 101 (1)(c) NAFTA) is to be achieved, there must be an extra attention to “**clarity**” and “**predictability**” for “**business planning and investment**” (NAFTA preamble). The protection of legitimate expectations standard thus says that such competitive opportunities as are protected under Art. 101(1) (b) NAFTA shall not be offset by measures which are in effect detrimental to the “business planning and investment” of the investor. NAFTA Chapter XI is to attract foreign investors to the host state in spite of their greater exposure to the political risk, including the risk of camouflaged domestic competitor-government alliances; the special protections of Chapter XI NAFTA serve as the principal instrument for such an investment promotion policy. As the World Bank Development Report for 2005, the authoritative policy instrument on foreign investment and economic development, formulates the relevant standard for government promises and administrative conduct<sup>67</sup>:

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<sup>65</sup> Op.cit. at p. 149

<sup>66</sup> Note here the observations by the Feldman v. Mexico tribunal, para 180, and its efforts to develop a method of presumptions to deal with the “black box” of domestic investor/competitor with officials collusion.

<sup>67</sup> The World Bank Development Report (2005), at p. 176, highlights the importance of government promises and administrative conduct to be “credible” – in order to support

“Can firms rely on them, with confidence, when making their investment decisions?”

35. Enforcing rules making such promises effective is both in the long-term and comprehensive interest of the host state and of the investor (at p. 179 ff). The use of the disciplines of investment treaties – here the legitimate expectation principle under fair and equitable treatment – is a “potentially powerful tool to enhance the credibility of (governments’) contract and policy commitments”. As the World Bank Development Report puts it:

“Governments and firms can both benefit. Governments benefit from a commitment device that can address concerns from investors, and thus help them attract more investment at lower cost, and also reduce the risk of any later dispute becoming politicized. Firms benefit from reduced risks and a more reliable mechanism for protecting their rights if the relationship with the host government deteriorates.”

36. These objectives of the NAFTA – both the general objective of enhancing the attractiveness of the host state for foreign investors and the instrumental tool of using greater transparency, clarity and predictability to enable better investment planning – have therefore to guide the process of both defining the conditions of the “legitimate expectations” principle under Art. 1105 and of applying it to the particular facts of a specific situation<sup>68</sup>. They are essentially different

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investment – “ (p. 179). It views the use of investment treaties and their “disciplines” as a “potentially powerful tool to enhance the credibility of their contractual and policy commitments”

<sup>68</sup> On the significance of the investment promotion-by-protection objectives of the NAFTA to govern the interpretation: *Metalclad v. Mexico*, para. 75: “ensure the successful implementation of investment initiatives” and “promote .. cross-border investment opportunities”; *Pope-Talbot, Award on Merits I*, para. 77: “The legal context includes the trade and investment liberalizing objectives of the NAFTA”, i.e. the investment liberalizing

from the approach to the “legitimate expectations” concept in commercial and contract law adjudicated through international commercial arbitration. The UNCTAD survey on the “Fair and Equitable Treatment” for investment treaties<sup>69</sup> therefore highlights that the “concept of transparency overlaps with fair and equitable treatment in at least two significant ways”, one being that “the investor will need to ascertain the pertinent rules concerning the state action; the degree of transparency in the regulatory environment will therefore affect the ability of the investor to assess whether or not fair and equitable treatment has been made available..”.

37. The most relevant NAFTA (and ICSID) awards have translated these authoritative objectives and instruments provided by the NAFTA and similar investment treaties into an emphasis on “transparency” and a concept of “legitimate expectation” that takes up, but further develops the meaning of this concept in conventional international, comparative contract, administrative and European and WTO law jurisprudence. One can observe over the last years a significant growth in the role and scope of the legitimate expectation principle, from an earlier function as a subsidiary interpretative principle to reinforce a particular interpretative approach chosen, to its current role as a self-standing subcategory and independent basis for a claim under the “fair and equitable standard” as under Art. 1105 of the NAFTA. This is possibly related to the fact that it provides a more supple way of providing a remedy appropriate to the particular situation as compared to the more drastic determination and remedy inherent in concept of regulatory expropriation. It is probably partly for these reasons that “legitimate expectation” has become for tribunals a preferred way of providing protection to claimants in situations where the tests for a “regulatory taking” appear too difficult, complex and too easily assailable for reliance on a measure of subjective judgment.

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objectives are the main “purpose” of the Treaty as relevant for interpretation under Art. 31 (1) of the Vienna Convention.

<sup>69</sup> 1999, at p. 51

38. In **Maffezini v Spain**, the tribunal linked the fair and equitable treatment obligation with transparency. The lack of transparency with a financial transaction carried out on government orders and detrimental to the investor was considered the core of the breach of this obligation<sup>70</sup>.

39. In **CME<sup>71</sup> v. Czech Republic<sup>72</sup>**, the tribunal found a breach of the fair and equitable treatment discipline in the reversal of its previous position on the legal situation of CME. CME had, held the tribunal, a legitimate expectation that its legal position recognised by the Czech regulator would be maintained and not be changed, without bona fide purpose, to undermine its business, in particular favouring domestic investors. Such a change of the regulator's position on statutory interpretation created an opportunity for the squeeze-out of the investor by its local partner (and competitor). It is the "evisceration of arrangements in reliance upon which the foreign investor was induced to invest" by the new or subsequent government authorities which was at the core of the determination that there was a breach of the investment treaty. As in the current case, the change of legal interpretation by the regulatory agency on which the foreign investor relied allowed a domestic competitor, favoured de-facto, to flourish.

40. The **Metalclad v. Mexico** tribunal interpreted "transparency" to mean:

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<sup>70</sup> Award on the merits, para 83; November 13, 2000. ICSID website: "The lack of transparency with which this loan transaction was conducted is incompatible with Spain's commitment to ensure the investor a fair and equitable treatment".

<sup>71</sup> The tribunal relied here on Detlev Vagts, *Coercion and Foreign Investment Rearrangements*, 72 AJIL 17 (1978) where he suggests that "cancellation .. of the authorisation to do business in which the investor relies... " to establish expropriation. One should probably see the breach of legitimate expectation as a former of less intensive breach than expropriation; investment-backed legitimate expectation is one of the standards to define expropriation, particularly in the form of "regulatory taking" (action tantamount to expropriation), but it requires also a very severe interference in the property right and its economic value. The difference between the lesser-intensity breach and the more intensive breach in the form of expropriation should lie primarily in the compensation – full value in expropriation, reliance damage in the case of a non-expropriatory breach of the fair and equitable treatment obligation.

<sup>72</sup> *CME v Czech Republic*, partial award of 13 September 2001 paras 133, 611

“that all relevant legal requirements for the purpose of initiating, completing and successfully operating investments made, or intended to be made, under the Agreement should be capable of being readily known to all affected investors.. There should be no room for doubt or uncertainty on such matters. Once the authorities of the central government.. become aware of any scope of misunderstanding or confusion in this connection, it is their duty to ensure that the correct position is promptly determined and clearly stated so that investors can proceed with all appropriate expedition in the confident belief that they are acting in accordance with all relevant laws”.

The tribunal held that the investor was entitled to rely on the representations of the federal officials (para 89) and the Respondent “failed to ensure a transparent and predictable framework for Metalclad’s business planning and investment. The totality of these circumstances demonstrate a lack of orderly process.. in relation to an investor.. acting in the expectation that it would be treated fairly and justly”. The duty in Metalclad (as in the later MTD v Chile case) is not just a passive duty to ambiguous messages, but to pro-actively take clarificatory action when the government agency knows or should know that the investor has misunderstood the relevant signalling from the government.

41. In *Tecnicas Medioambientales (TecMed) v. Mexico* (para 154), the tribunal held:

“Part of these expectations is the foreign investor’s assumption that the state receiving the investment will act consistently, without any ambiguities, and transparently with the foreign investor so that the investor may know in advance (and thus plan its activities..) not only the rules or regulations.. but also the policies pursued by such rules... and

the administrative practices or guidelines that are relevant. "The foreign investor also expects the host state not to act in a contradictory manner; this means .. that the state will not arbitrarily reverse prior or pre-existing state-made decisions or approvals upon which the investor relied and on the strength of which it took on its commitments and planned and set in motion its .. operation". And it referred to the standard of a "reasonable and impartial man".

42. In **Occidental (OEPC) v. Ecuador**, the tribunal examined the government's responses to queries by the investor and found that the official response to such queries was a:

"wholly unsatisfactory and thoroughly vague answer"

and it considered that the "legal and business framework" did not meet the "requirement of stability and predictability" (paras 190-191).

43. In **Waste Management v. Mexico II** (para 98) the tribunal considered that Art. 1105 was breached by:

"a complete lack of transparency and candour in an administrative process. In applying this standard it is relevant that the treatment is in breach of representations made by the host state which were reasonably relied on by the claimant".<sup>73</sup>

44. The recent **CMS v Argentina** (Merits) award confirms the principles developed in *Metalclad* and *Tecmed v. Mexico*. It draws a close link between the fair and equitable treatment standard, the government duty to provide clear and un-ambiguous signals to the investor and the

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<sup>73</sup> This explanation of the legitimate expectations standard was subsequently relied upon in *MTD v Chile*, para 114.

treaty objectives to promote investment<sup>74</sup>. It concurs with my explanation of established jurisprudence according to which the breach of legitimate expectations created by specific assurances now constitutes a self-standing subcategory of the “fair and equitable treatment” standard under Art. 1105 of the NAFTA<sup>75</sup>.

45. This is further confirmed in **Eureko v Poland** (2005); the award quotes (at para 235) with approval the Tecmed v Mexico (para 154) statement that:

“This provision of the Agreement, in light of the good faith principle established by international law, requires the Contracting Parties to provide to international investments treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment”

and determines that the “discriminatory conduct by the Polish Government is blunt violation of the expectations of the Parties in concluding the SPA..” (at para. 242)<sup>76</sup>

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<sup>74</sup> CMS v Argentina, 2005, at paras. 273-280; that a failure to implement a regulatory programme could constitute a breach of a legitimate expectation was also confirmed in GAMI v Mexico, paras 97, 108, but only provided in the case (not found to exist here) that, first, the investor was made to trust that such regulatory action would be taken, that it relied on such assurances, that the government was solely responsible for the lack of implementation of promised regulatory action and that a minimum threshold was reached. In Gami, the government conduct was too unspecific to be able to create a legitimate expectation.

<sup>75</sup> So also Stephen Fietta, 9 September 2005 BIICL conference presentation, at p. 7; R. Dolzer Fair and Equitable Treatment: A Key standard in investment treaties, *International Lawyer* 39 (2005), 87 at p. 105 with a reference suggesting that in analogy to the legal effect of unilateral statements in state-to-state international law assurances given to foreign investors may create legal significance and, at p. 106, that one of the two pillars of foreign investment law is the “protection of the investor’s legitimate expectation”.

<sup>76</sup> An not identified recent award in an East European investment dispute relating to oilfield development reported by K. Hober, , OGEL 5-2003, p. 37, 28 ([www.gasandoil.com/ogel](http://www.gasandoil.com/ogel)) also relies on the legitimate expectation of the investor in connection with a joint venture that the state would not subsequently interfere and hamper the on-going operation and implementation of the investment project.



46. These statements on the required clarity mirror established jurisprudence of the European Court of Justice. For example, in **Opel Austria v Commission** (1997, at para 124):

“According to the case-law, moreover, Community legislation must be certain and its application foreseeable by individuals. The principle of legal certainty requires that every measure of the institutions having legal effects must be clear and precise and must be brought to the notice of the person concerned in such a way that he can ascertain exactly the time at which the measure comes into being and starts to have legal effects. That requirement of legal certainty must be observed all the more strictly in the case of a measure liable to have financial consequences in order that those concerned may know precisely the extent of the obligations which it imposes on them”<sup>77</sup>

47. The implications of the obligation to be clear and avoid ambiguity is that the government agency has to bear the risk of its own ambiguity. This allocation of the risk of ambiguity requires that the investor did and could reasonably have confidence in the assurance, not as an ultra-perfect lawyer equipped with a hindsight vision facility, but as a reasonable businessman in the position of the investor would do in the particular circumstances. “Hindsight, of course, is notoriously lucid”<sup>78</sup>; but foresight lacks the sharpness of hindsight. Investors’ lack clairvoyance and need to make rapid decisions on the basis of the way facts are and can reasonably be perceived at the time they become

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<sup>77</sup> With further references to ECJ decisions upholding the principle of legitimate expectations, paras. 78, 90 and 93: “ The principle of good faith is the corollary in public international law of the principle of protection of legitimate expectations..”. See also *CNTA v Commission*, Case 74/74 (1975) ECR 533 paras. 42-4: on the protection by legitimate expectations by traders relying on the continuation of specified regulatory conduct, without an “overriding matter of public interest” and without “adopting transitional measures which would at least permit traders either to avoid the loss..”. On the need for transitional arrangements in case of the existence of a protected legitimate expectation see also ECJ in the *Marks & Spencer v. Customs and Excise* case, *supra*, at para 34 ff, 38.

<sup>78</sup> Reisman/Sloane, *Indirect Expropriation and its valuation in the BIT Generation*, 74 *BYIL* (2003-2004) 126, 132

known – not the way they appear after years of litigation. Lord Mansfield, in 1761 said:

“The daily negotiations and property of merchants ought not to depend upon subtleties and niceties, but upon rules easily learned<sup>79</sup>”

48. Lord Denning, in *HTV v Price Commission*, said that “a public authority which had led traders to rely on one interpretation of a statutory provision could only adopt another interpretation if there was an overriding public interest to do so.<sup>80</sup>”

49. The European Court of Justice has recently confirmed its jurisprudence on “legitimate expectation” and “legal certainty”<sup>81</sup>:

“With regard to the principle of legal certainty, this requires in particular that rules involving negative consequences for individuals should be clear and precise and their application predictable for those subject to them (see, to this effect, *Case 325/85 Ireland v Commission* [1987] ECR 5041, *Case C-143/93 Van Es Douane Agenten* [1996] ECR I-431, paragraph 27; and *Case C-63/93 Duff and Others* [1996] ECR I-569, paragraph 20)”

50. The conclusion that the risk of ambiguity falls square on the shoulders of the assurance-issuing public authority, is reinforced by the traditional international law principle that the construction of a legal instrument in need of interpretation and with elements of ambiguity should be “in dubio contra proferentem”, i.e. that the drafter and the authority issuing a legally relevant statement has to bear the risks of

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<sup>79</sup> *Hamilton v Mendez* (1761) 2 Bur. 1214

<sup>80</sup> 1976 ICR 170, 185; quoted from Schonberg, *Legitimate Expectations in Administrative Law*, OUP at p. 109, note 14 – with further references. Dissappointment of legitimate expectations would be seen as an abuse of power and an element of procedural fairness.

<sup>81</sup> *Case C-17/03, VEMW v Directeur DUTE*, June 2005

ambiguity<sup>82</sup>. This rule is primarily concerned with interpretation of unilateral legal acts – such as the “interpretative assurance” given by SEGOB to Thunderbird. Related to the “contra proferentem rule” is the legal principle “Nemo audiatur propriam turpitudinem allegans<sup>83</sup>”: It implies in the context of the transparency and clarity obligation on governments under NAFTA that a public authority which has evaded – as bureaucratic behaviour often does – the clarity of expression required by investors, then it can later not rely on the obfuscation it intentionally or negligently deployed to avoid the legal consequences of the legitimate expectation thus created and protected by Art. 1105 of the NAFTA. A change of interpretation of the law has to be reckoned with, but it becomes suspicious and “must be viewed with the greatest scepticism if their effect is to disadvantage a foreigner”<sup>84</sup>.

51. The most relevant Unctad reports – authoritative UN surveys that can not be accused of investor sympathy – tie transparency explicitly to the “fair and equitable treatment” discipline<sup>85</sup>:

“This interpretation suggests that where an investment treaty does not expressly provide for transparency, but does for fair and equitable treatment, then transparency is implicitly included in the treaty (UNCTAD, 1999a, p. 34). Secondly, where a foreign investor wishes to establish whether or not a particular State action is fair and equitable, as a practical matter, the investor will need to ascertain the pertinent rules concerning the State action; the degree of transparency in

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<sup>82</sup> Ignaz Seidl-Hohenveldern, *German Yearbook of International Law*, 23 (1980), 412 – identifying not only the allocation of such risk to the “drafting” authority, but also to the party which holds, in the relationship, the “superior” position – as held SEGOB in its relation with the applicant for the “oficio”, Thunderbird. *Oppenheim’s International Law*, 9<sup>th</sup> Edition, Vol. I, - 1279: “ If two meanings are admissible, the provision should be interpreted contra proferentem, i.e. which is least to the advantage of the party which prepared and proposed the provision...”. Also C. Schreuer, *The Interpretation of Treaties by Domestic Courts*, 45 *BYIL* 298 (1971)

<sup>83</sup> Reisman/Sloane, 2004, 146

<sup>84</sup> Paulsson, 2005, at p. 200; similarly on comparative law of judicial review of administrative conduct Mairal, p. 140, 150, 152; Schonberg, *op. cit.* at p. 109

<sup>85</sup> UNCTAD, *Fair and Equitable Treatment*, 1999, at p. 59-60; also: Unctad, *Transparency*, 2004 at p. 71

the regulatory environment will therefore affect the ability of the investor to assess whether or not fair and equitable treatment has been made available in any given case.”

52. Hector Mairal, in his authoritative study of “legitimate expectation” (Actos propios) for Latin American civil law systems, emphasises that ambiguity in an official representation can not free the public administration from the “legitimate expectations” effect if such ambiguity appears intentional and contrived in order to leave to the administration two options while appearing to provide predictability to the individual; if the administration is in a relationship with the individual which obliges it to be clear that imposes an extra duty of transparency and clarity upon it<sup>86</sup>. Schonberg, in his study on comparative law on legitimate expectation has in this context pointed out correctly that smaller and less experienced investors deserve greater protection than large and experienced companies<sup>87</sup>.

53. Similarly, in two recent arbitral awards, an interpretation of ambiguous treaty language in light of the treaty’s investment promotion objective was preferred over a restrictive interpretation that would have allocated the risk of ambiguity to the investor<sup>88</sup>. While these statements have been made in the context of treaty interpretation,

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<sup>86</sup> Mairal, -. 73 : “Cuando el declarante es negligente al incurrir en la ambigüedad y existe entre las partes una relacion (.. ) que obliga a ser explicito”. Mairal on the same page also recognises a frequent government practice : “ que la Administración recurre con gran frecuencia a la ambigüedad or sencillamente a la oscuridad en sus relaciones con los particulares”.

<sup>87</sup> Schonberg, op. cit. supra

<sup>88</sup> CSOB v Slovak Republic, para 57, decision on jurisdiction, May 24, 1999 on ICSID website; SGS v v Philippines, decision on jurisdiction, 2004, para 116: “The BIT is a treaty for the promotion and reciprocal protection of investments. According to the preamble it is intended “to create and maintain favorable conditions for investments by investors of one Contracting Party in the territory of the other”. It is legitimate to resolve uncertainties in its interpretation so as to favour the protection of covered investment”; also Loewen v. US (5 January 2001, para 40 ff): “The text, context and purpose of Chapter Element combine to support a liberal rather than a restricted interpretation... and: citing Ethyl v Canada, award of 1998, 38 ILM 708 —“ that is an interpretation which provides protection and security for the foreign investor and its investment and to “increase substantially investment opportunities”. MTD v Chile holding that the treaty standards had to be interpreted “in the manner most conducive to fulfil the objective of the BIT to protect investments and create conditions favourable to investments”, para 104.

they express a principle that is equally relevant to interpretation of official communications between government and investor, arguably even more so as different from a bilateral treaty, an official communication from government to a foreign investor is not a bilateral agreement, but a unilateral communication solely under the responsibility of the issuing government agency.

54. These observations describe the legal contours of the principle of “legitimate expectations” under Art. 1105 NAFTA. But it is helpful to take an even closer look at the decision and underlying rationale of the arbitral tribunal in the very recent MTD v Chile case which should be considered the most relevant authoritative precedent:

55. In MTD, a Malaysian investor planned an investment in housing in Chile. The government made at a high political and administrative level positive noises; it assured the investor of its welcome. It signed a formal investment contract which, however, did not include any specific approvals for the investment project at issue, but rather formalised the grant of foreign exchange and tax-stability related investment guarantees; this investment contract also clarified that it was not a substitute for specific zoning permits and other applicable authorisation requirements. The investor was thus made to believe in the positive attitude of the government. Chile issued, at a senior governmental level, a formal endorsement of the project though the project could not be done under the regulatory framework as it stood at the time of such endorsement. The investor was unaware of this, was not made aware of this and the minister responsible for the sector was not even invited to the relevant meetings. Without the investor’s knowledge, other government authorities that were opposed to the project, took active steps to counter local support of the project and in the end ensured the project could not go ahead due to the lack of required zoning permits. The difference to Thunderbird is that the contradiction was there not simultaneous, but in the consecutive actions of government. The MTD tribunal did recognise that a “rigorous due diligence” by the investor – inexperienced and new to Chile –

would probably have identified the crucial obstacles to his investment plan (para 117):

“A wise investor would not have paid full price up-front for land valued on the assumption of the realization of the project” (para 242),

but:

“Chile has an obligation to act coherently and apply its policies consistently independent of how diligent an investor is” (paras 165-166)

56. The tribunal considered such contradictory conduct by the competent government authorities to constitute a breach of the “legitimate expectation” principle – as sub-category of the duty to fair and equitable treatment. It found that the “investment promotion” obligation was not just a prescription for passive behaviour or avoidance of prejudicial conduct, but had a “pro-active” meaning. Relying on *Tecmed v. Mexico* and *Waste Management II*, the tribunal found a breach of the legitimate expectations of the investor in the governments failure to “act consistently”, to be “free from ambiguity and totally transparent with the foreign investor so that it may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant practices and directives” (para 114). The tribunal took account (also in terms of mitigating the compensation claim) of the “unwise business decisions or .. lack of diligence of the investor” though “counsel for Chile in effect argued for the notion that the claimant was foolish to have relied upon representation of the government”<sup>89</sup>. In *MTD*, the formal approval of the financial arrangements for the project and official signals about its desirability were in contradiction to urban policy and regulation; the fact that this contradiction was not conveyed to *MTD* before it committed its investment, constituted the breach of the fair and equitable obligation; this situation is not that different from the

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<sup>89</sup> See a case comment by Ian Laird on the *MTD v Chile* case, [www.transnational-dispute-management.com](http://www.transnational-dispute-management.com), 2004

positive "Oficio" of August 2000, confirmed by continuing acceptance of the operations by SEGOB, but then, and in contradiction to the earlier actions and positions taken by the former government, followed by the targeted and prioritised enforcement of the Mexican gambling law against Thunderbird by another, new, set of officials and political forces acquiring powers under the new government.

57. The MTD award supports the view that even if government assurances were ambiguous and an extra-careful investor could have found this out, the government still owes a duty of consistency and protection of legitimate expectations to the foreign investor. This is not a passive duty, but a pro-active duty (as in *Metalclad v. Mexico*) to ensure investors are not misled and are made to realise where the "true" directions of government policy for the issue at stake lie. This approach is in contrast with the "caveat emptor" and "due diligence" approach in commercial arbitration, but also, to a lesser extent though, to some statements in for example comparative administrative law where the risk of ambiguity in the governmental assurance is either assumed by the citizen, or at least balanced against a duty on the public agency to provide un-ambiguous statements. The MTD v Chile award thus reinforces a reading of the legitimate expectation principle that is distinct for investment disputes. It acknowledges the structural weakness of the investor – in MTD as in Thunderbird we have entrepreneurial investors without extensive country experience - when confronted with a foreign country that wishes to attract such investment. Such a pro-active duty to ensure the foreign investor does not succumb to a visible misunderstanding is even more acute in cases where there are substantial indicators of "black box" collusion between administrative agencies and powerful domestic competitors. This conclusion has a bearing in particular on my point No. 2 – subsequent accepting conduct by SEGOB – for assuming the existence of a "legitimate expectation" by Thunderbird protected by Art. 1105 of the NAFTA.

58. It is with these interpretative guidelines that I will now examine the factual situation.

5.) Did Thunderbird have a "legitimate expectation" that it could operate its "skill" slot machines in Mexico?

59. The issues are essentially if the "Oficio" ("official response" or "criterio" (translatable as "legal opinion" in this context) of 15 August 2000 and the subsequent conduct by SEGOB can be qualified as creating a "legitimate expectation" with Thunderbird that it could legally operate its slot machine facilities. The majority of the tribunal rejects this interpretation; I respectfully disagree. The relevant meaning of investor and government conduct and communications with each other can not only be determined from within the "four corners" of the legal documents, but must be appreciated with an approach that recognises realistically the practicalities of the foreign investment process. The legal documentation has to be understood before the context in which the investor-government interaction takes place. The interpretation of the key document – the official, authoritative, unilateral assurance in the format of the "Oficio" – needs to rely on international and comparative (civil law) methodology applicable to contractual, and where distinct, unilateral, documentation. That means that the text has to be assessed as it represents a "meeting of the minds" of both parties and in particular as it was, reasonably and for both parties manifestly, understood by the investor to whom the "comfort letter" was addressed, taking into account the history of their interaction, the context, the purpose and the subsequent conduct of the parties<sup>90</sup>.

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<sup>90</sup> Art. 31 of the Vienna Convention on Treaties; on civil law contract interpretation: Zweigert/Koetz, *An Introduction to Comparative Law*, Vol. II, 1977, at page 73 "...one should seek out the common intention of the parties rather than adhere to the meaning of their words; in case of doubt, a contract should be construed so as to have validity." And "what matters is not what real intention lay behind what one contractor said but what the other contractor must in the circumstances have understood him to mean" (p.75). "The judges must use the principle of commercial good faith and the guidelines of the intention expressed in the contract for the relationship" and (p.80): "the evidence of witnesses is held to be admissible whenever the contract clause in question is obscure or ambiguous"



60. In light of the differing opinions on the legal value and meaning of the "Oficio", one needs to bear in mind the burden of proof situation: Thunderbird has to prove that the Oficio conveyed to it, from the perspective of a reasonable foreign businessman in the gambling industry and in the specific context of the interaction between Thunderbird and SEGOB, the message that it could operate the software-driven video poker machines it imported. Mexico, on the other hand, has to prove that the Oficio was tainted by insufficient, but mandatory disclosure by Thunderbird. This is a high threshold because, first, Mexico has to counter the presumption of the validity of official acts of government which respect for government requires; secondly, it has total control over all the documentation and witnesses – its own past and present SEGOB officials who alone can testify about what they knew and did not know. We therefore have to measure the evidence to see if Thunderbird has met this burden of proof, and, if so, Mexico has met its burden of proof.

#### The "Solicitud": Request for negative clearance

61. It is not contested that Thunderbird was very keen to get a "negative clearance", "green light" or an in its sense, positive interpretative assurance from the government that its "skill" machines were not covered by the Mexican gambling law. It rejected the strategy of Mr Guardia who kept his profitable slot machine operations alive by using a sequence of mostly successful, mainly injunctive appeals, and seems in whatever way have managed to defeat any attempt at effective enforcement. This is characteristic of the way a foreign investor approaches a business the legality of which is not certain: A domestic investor, often with tacit allies in the administrative and judicial institutions, can afford more easily a blatantly illegal conduct. A foreign investor will want more legal certainty – and in Thunderbird's case that seems also to have been urged by its venture investors. It thus took the most "legal" course by asking SEGOB, and trying to persuade it, to

assure it that its “skill” machines – in effect combining chance and skill – were not covered by the law.

62. Thunderbird’s proposed interpretation - that machines involving a substantial amount of skill (in addition to chance) could be considered legal - was not implausible<sup>91</sup>. As all other players in the industry, it used the label of “skill machines” to highlight the involvement of skill in order to make the point for the interpretation of the Mexican Gambling Act it advocated. Witness Watson reports that former Gobernacion Secretary Labastida, had informally supported the approach to get a comfort letter (Oficio) from the government that confirmed and repeated the “skill” argument already, reportedly, raised in a litigation in “northern Mexico”<sup>92</sup>. SEGOB does seem to have a certain administrative and interpretative discretion, both with respect to interpreting the law and with respect to directing enforcement efforts<sup>93</sup>. The older and the more obsolete a law, as the 1940’s Mexican Gambling Law, the more grows the need and the space for interpretation. Thunderbird had – this is not contested – received encouragement from a very senior Mexican politician – formerly the Minister in charge of Gobernacion (Labastida) -to go forward. Liberalisation of the 1943 gambling law was considered in Mexico during the end of the PRI government in order to bring it in line with modern developments outside Mexico and to re-attract gambling

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<sup>91</sup> See the testimony by Mexico’s expert Prof Rose, p. 791 “clearly require some skill”; “certainly skilful players will do better “ (p. 793); referring to a court that said: “this is a game of skill if you have the time to sit and play it” (794) and referring (p. 795) to the “learning curve whether the more you play it the better you do and a learning curve should be fairly steep at the beginning” and (p. 796) “the more you play those games, the better you’re going to do”.

<sup>92</sup> Watson, p. 404: “ Mr La Bastida stated in general terms that he was aware of the skill game litigation that had taken place in northern Mexico; that in light of the outcome of that he felt that the letter (i.e. the Oficio) which Gobernacion had issued to us was appropriate .. because of some precedent”.

<sup>93</sup> Prof Rose testified for Mexico about the role of the regulatory agency’s powers and the widely interpreted concept of “predominantly” skill or chance – pages 766, 768, 769, 773, 774, 775; Alcantara (pp. 880, 881) testified that action would – if it were to depend on him (“believe me”) be taken “right away”, but that he acted merely as a subordinated officer to higher authorities in Gobernacion that decided on how to focus and prioritise enforcement – namely the “government unit of Gobernacion” (p. 881. p. 922: “I follow instructions. I don’t decide things on my own” (p. 922). Respondent has not made available any testimony from Lic Alcantara’s superiors who “called the shots” on enforcement matters.

income and employment that had moved to the Caribbean, Las Vegas and US Indian reservations<sup>94</sup>. As Mexico's expert testified on the potential to liberalise the gambling regulation in Mexico:

"There was a great movement right before President Fox was elected" (i.e. in 2000, the year the "Oficio" was issued).

63. There were no particular public order concerns with the type of coin-operated, computer-programmed video-slot machines. The then Mexican PRI government had the choice of either changing the law in a formal, time-consuming and politically costly process or to try out a more low-profile liberalisation by introducing and then testing a re-interpretation of the law to relax its margins. Thunderbird's description of its machines as "not involving chance" was factually – with the hindsight of this tribunal's expertise – incorrect, but it was a qualification for interpretative purposes that was also used by other operators (including Guardia), possibly suggested by Mexican experts. The issue of skill versus chance was well known to SEGOB from its confrontational interaction with Guardia and in several other litigations since 1998<sup>95</sup> as a suggestion to stretch the prohibition of the 1943 Gambling Law. As the report of the discussion with former Gobernacion Secretary Labastida indicated, the concept of liberalisation by "stealth" through re-interpretation of the "skill concept" is likely to have been common currency among senior officials and politicians with some knowledge of gambling regulation in Mexico. It was also the standard

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<sup>94</sup> Mexico's expert Prof Rose testified (p 776) on the prospect for liberalisation of Mexico's gambling law in the end days of the PRI government: "There was a great movement right before President Fox was elected and then some sort of scandal or political issue hit, and the government had to back away". This is consistent with the study for the Mexican Congress, op.cit. of 2002 and the testimony of Thunderbird expert Watson on his discussion with former Gobernacion Secretary Labastida (p. 404, 423-424) which indicates a positive attitude towards the relaxation of the gambling prohibitions by using the issue of "implication of skill" as an opening. That testimony – consistent with Mexico's expert Rose's comment – also suggests that the "Oficio" was using a re-interpretation of the skill concept in "skill game litigation.. in northern Mexico" appropriately (p. 404, bottom).

<sup>95</sup> Cross-Examination of Lic Alcantara at p. 852, testifying that the "skill" issue arose since 1998, in particular (page 874) with Guardia, then accelerated in several litigations.

criterium operators and regulators used when desiring to relax more prohibitive gambling regulation<sup>96</sup> .

64. It is in this light that we have to see the August 3, 2000 request (“solicitud”) by Thunderbird for an authoritative opinion (“criterio”). Thunderbird’s “solicitud” makes it clear that such a “comfort letter” by SEGOB is desired to provide legal certainty for the investment envisaged – and it is not contested that Thunderbird had such an intention and that SEGOB officials understood this perfectly well<sup>97</sup>. In interpreting a unilateral declaration under international law, the relevant ICJ jurisprudence has emphasised the “significance of the intention behind the unilateral declaration made by a state”<sup>98</sup>. It is therefore not a free-standing abstracted from its context text as it appears to a tribunal years after the event, but the intention as it was conveyed and, moreover, as it was – reasonably - understood by the specific investor in that specific situation that counts. Literal interpretation purely on an isolated text is a traditional common law method (itself not applied strictly any longer and least in situations of ambiguous declarations); but it is not appropriate to our situation where, next to the NAFTA, Mexican law, and thereby also interpretation method, is applicable. The relevant ICJ jurisprudence deals mainly with unilateral declarations “erga omnes”. Here we do not have a declaration erga omnes, but a governmental representation made in the context of a specific relationship. In that specific relationship, the reading of the interpretative assurance letter needs to be guided by what both parties involved understood the purpose and

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<sup>96</sup> Testimony Prof Rose, p. 766

<sup>97</sup> Testimony, among others, by CEO Mitchell and Watson all confirm that getting an interpretative and official assurance and support letter was crucial for Thunderbird, see only (among several other indications) Watson, p. 417 “so we cautioned him and told him that it would probably be far better if he sought some type of clarification from SEGOB in order to go forward” and (418) “ I understood ... we needed to look carefully and work with Gobernacion”.

<sup>98</sup> Reisman/Arsanjani, The question of unilateral governmental statements as applicable law in investment disputes, ICSID Review 328, at p. 331 with reference to the ICJ case of the Temple of Preah Vihear.

factual background of the letter<sup>99</sup>. The “face” of the letter is largely gibberish if not read before the context, the parties’ common intention and the meaning that was intended to be conveyed and that was reasonably so understood by the addressee of the “Oficio”. Even if there was a divergence – i.e. if SEGOB had a more modest intention with the assurance letter, then the – reasonable – perception of the investor as the relevant specific addressee of the letter has to prevail. The reason is that it is the investor that is to be encouraged by the assurance letter, the investor that comes with capital and exposes its capital to government risk. It is therefore the investor’s confidence that is to be reinforced by the Oficio. To quote Reisman & Arsanjani:

“.. the inclination of an international tribunal to infer that a unilateral act has given rise to a binding obligation will probably be reinforced if the state making the declaration expects to receive clear benefits on the basis of the declaration”<sup>100</sup>.

65. Different from the majority (see para 157), I see no lack of required disclosure: Thunderbird disclosed clearly that at issue were video slot machines and identified them in a way that for a knowledgeable Regulator it was clear that these were video-gaming devices. I accept Mexico’s suggestion that these were most likely refurbished gaming devices used by Thunderbird in the US. But this does not detract from the fact that for somebody with experience in the gambling industry it was clear that these were video-gaming devices. The reference to BESTCO should have alerted the most sleepy gambling regulator that these were video gambling machines produced by one of the largest US producers of such devices. One can not assume, again, that the Mexican gambling regulator who according to its own statements had fought for years with Mexican businessman Guardia over video-gaming

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<sup>99</sup> So the International Court of Justice in the Nuclear Tests Case (Australia v France) 1974 ICJ 253, 269 which held that to determine the legal value and meaning of a unilateral declaration: “it is from the actual substance of these statements, and from the circumstances attending their making, that the legal implications of the unilateral act must be deduced, at para. 269.

<sup>100</sup> Op. cit., at p. 336; Mexico has – as in the relevant much earlier Shufeldt case – continued to benefit from the investment made in terms of employment, taxes and levies.

machines labelled as “skill” machines would not have been aware both of BESTCO as a major supplier of such machines. A short look at BESTCO’s website and a google search confirm this<sup>101</sup>. The same applies to the reference to “SCI-Support Consultants” as an identifiable manufacturer of video slot gambling machines, class III, deployed on US Indian reservations. The reference to BESTCO and SCI is therefore not misleading; it is a clearly identifiable reference to video slot machines. It is consistent with the result of the cross-examination, namely that SCI (K. McDonald) probably refurbished Thunderbird and other operators’ video slot machines previously used in US Indian reservations<sup>102</sup>.

66. Its letter otherwise needs to be seen not as a detailed factual description of the functioning of the machines (which it was not asked to provide), but as development of the legal argument as it had emerged in earlier litigation and already indicated in the discussions with ex-Gobernacion Minister Labastida. It made the legal argument that the machines were either only skill-based (para 3, which was overshooting reality), but it then referred in order to suggest as reason for legalisation, that “**skills and ability is involved** (para 6). This qualification for legal purposes is correct and it advances from the earlier reference that the machines were “only” skill-based. The issue was here to propose to SEGOB a legal qualification to help the

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<sup>101</sup> Top two listings in a Google search for BESTCO and gaming (August 2005):

[The Best Games are from BestCo Electronics](#)

BestCo Electronics offers new and refurbished redemption games including 8-line games, video poker, cherry master and more. Game accessories, parts and ...

[www.bestcoelectronics.com/](http://www.bestcoelectronics.com/) - 15k - [Cached](#) - [Similar pages](#) [BestCo Electronics](#)

BestCo is one of the largest manufacturers and developers of video gaming ...

Manufacturing, Sales & Service of games and accessories including boards, DBA, ...

[www.casinovendors.com/VendorPage.cfm/81151.html](http://www.casinovendors.com/VendorPage.cfm/81151.html) - 10k - [Cached](#) –

SCI: <http://www.cniga.com/members/associate.php>: Support Consultants – can be identified via Google associated with Thunderbird, witness Kevin Mc Donald: Its listing indicates: “SCI manufactures, distributes, refurbishes and services standard and custom video slot machines for the Native American gaming market. SCI specializes in parts repair and combination Class III/ Bingo products.

<sup>102</sup> I accept the point brought out in the presentation and cross-examinations conducted by respondent that the “model qualifiers” for the BESTCO and SCI machines were ad-hoc identifiers rather than normal trade names, but that would also be consistent with the idea that it was machines refurbished ad-hoc for Thunderbird’s use in Mexico.

liberalisation by “stealth” through a cautious interpretative strategy – that the machines were “skill” machines because they were used “in entertainment where skills and ability is involved”.<sup>103</sup> Thunderbird’s “Solicitud” described the character of these machines in a light so as to make it easy to subsume them under the label “skill” machines<sup>104</sup> - a term that was used, for reasons of suggesting compatibility with the law, throughout the industry in Mexico<sup>105</sup>. Its statement – that “chance and wagering is not involved” was involved, is technically not correct. However, it should be seen not as a scientific analysis but as rather a legal-interpretative term suggesting (or repeating a suggestion informally made by SEGOB as can be inferred from Waton’s testimony on the discussion with Labastida) how the law could be interpreted to allow such machines.

67. Virtually all games, indeed all human activity, involve some element of skill and chance (including say chess or football);<sup>106</sup> only some games – presumably the more mechanically and machine-based chance-oriented games – have in practice been prohibited in Mexico. As Mexico’s principal expert Prof Rose put it:

“The second, element (sc. in gambling law), chance has caused the most problems in the courts. Part of the problem is that if every human activity is mixed skill and chance, the

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<sup>103</sup> That key statement is contained in paragraph 6 of the Solicitud; it does not follow any factual description, but refers to the investor’s need for “certainty” that the operation is “legal” under the Ley de Juegos y Sorteos”.

<sup>104</sup> Technically, the machines combined chance and skill – at the beginning of a player’s competence, chance presumably prevails, while then – so Mexico’s expert Professor Rose (see supra) – there is a “steep learning” curve so that the role of skill increases significantly. The skill component consists mainly of probability calculation, possibly also of some element of physical alertness. The abundance of technical manuals for playing poker and their emphasis on understanding probability analysis suggests that skill plays a role and can be greatly enhanced by learning. Otherwise, there would be no point in using these manuals to enhance skill and thereby the probabilities of winning. To rely on the Supreme Court of California – after N. Rose, *Gambling and the Law*, p. 81: It “pointed to the large body of books and periodicals discussing strategy for playing the game. “The existence of such a large amount of literature designed to increase the player’s skill is a persuasive indication that bridge is not predominantly a game of chance”.

<sup>105</sup> Confirmed by the witnesses from both sides, Alcantara and Watson, see supra.

<sup>106</sup> Also testimony of Mexico’s expert Prof Rose, 793 ff

question is simply where you draw the line”<sup>107</sup>. And: “In England, any skill at all takes a game out of the prohibited lottery category. California outlaws slot machines if any chance enters into the payoff, but then states that devices that are predominantly skill are legal”.

68. So the legal-interpretative view that is put forward does not amount in my view to a lack of disclosure, but rather reflects the particular interpretative strategy, a strategy that Professor Rose describes in detail as the interpretation normally put forward to justify liberalisation<sup>108</sup>. In his extensive study on gambling law – and I have to take this as authoritative as he has been put forward by Mexico as the principal authority on gambling law – he describes courts that recognised video poker as a game of skill and other courts which did not do so. But putting forward a legal view based on several respected US courts in Illinois and Pennsylvania – that video-poker is a game of skill or a game predominantly of skill<sup>109</sup> – can not constitute a deception. Thunderbird was not asked or expected to provide a dispassionate academic study on comparative regulatory approaches on video poker machines to the Mexican Regulator, but did suggest, and was expected to do so, its view on how the machines could and should be legally qualified. It naturally advocated an interpretation that was in its favour rather than develop the reasoning for an opposing view. Nothing else is expected of professional advocacy, including in interaction with an industry Regulator.

69. The tribunal thus views as factual statements – and in this respect incorrect and lacking in required disclosure – what I consider is not a factual and technical statement, but a legal qualification of the

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<sup>107</sup> I. Nelson Rose, *Gambling and the Law*, , p. 79, 80

<sup>108</sup> *Ibidem*, p. 79-82, 90-95.

<sup>109</sup> N. Rose, *Gambling and the Law*, p. 94: “Is video poker a game of skill? The Illinois court thought so, but other courts have not been so charitable. Trial courts have given mixed results...” “Pennsylvania is typical of the confusion over these machines. Various trial courts in the state came to various decisions; some finding video draw poker machines were gambling devices per se, other courts holding that they were games of skill”.



machines made with the very intention to suggest an interpretation that would extend the boundaries of the 1943 law. I should add that I do not consider the "Solicitud" as the most technically perfected document. Thunderbird did not highlight the fact that "chance" was inevitably involved in playing such machines (but as Prof Rose testified and we all know, chance is involved in any activity), but it did reduce its original claim that "no chance was involved " to, later in the Solicitud, that "skill" was involved (i.e. that it was not exclusively a skills game). That some level of "skill" is involved has not been disputed in the case; the tribunal has come so far as to suggest that a "considerable degree of chance" was involved, without, however, being willing and feeling competent to quantify specifically the "degree of chance" (See para 136).

70. Thunderbird did not say these were refurbished Thunderbird videopoker machines; it did not say that Guardia was using the same type of machines. It did not invite SEGOB to inspect the machines nor did it provide manuals. But SEGOB did request further information when it wanted to – such as later in 2000 when a request for a similar "Oficio" was launched by Mr Gomez. That Thunderbird did not provide the information Mexico now thinks they should have provided is, in my view not material. They were under no duty to do so. If SEGOB had felt in summer 2000 there was a need for more, it should have requested Thunderbird to provide whatever it considered relevant. If Mexico now raises them in arbitration, but did not raise them during the informal and formal process of Solicitud and Oficio, this suggests that it changed its mind on information requirements under the impact of a new government and the arbitration. Relevant non-disclosure – deception – would only then have been material if SEGOB had requested such information and Thunderbird had in response provided false information.

71. The signs were there – it must have been clear to anybody involved – that Thunderbird was testing the waters with a cooperative approach to government for video-slot machines issuing prizes (or US Dollars, as

a prize that eschewed offering Mexican pesos – legal tender – as prizes). From the prolonged period of informal consultations – the claimant’s factual assertion is not contested<sup>110</sup> - the presumption arises that SEGOB officials knew what was at issue – and most probably suggested or at least approved of the very low-profile and discreet description. I can not agree that the tribunal “cannot rely on presumptions or inferences, let alone speculation concerning that background” and interpret the 3 August 2000 Solicitud on its “face value” (para 150). The significance and the meaning of the Solicitud and the Oficio can only be understood when the itself undisputedly convoluted and ambiguous text is read before the background of the parties’ interactions, their level of knowledge, their role and relationship (regulator vis-à-vis clearance seeking investor) and interests. That is standard interpretation of contracts and related instruments, and in particular in civil-law countries such as Mexico<sup>111</sup>. Not only does Oficio have to be interpreted on the basis of the parties common intentions and the context of their interaction, but also with the principle of good-faith which emphasises transparency, clarity and discourages the abuse of intentional ambiguity to allow a government to first make the recipient and investor believe one message and then turn around and claim it really had sent the opposite message. In addition, as we have – as mostly in litigation – a not completely verified factual situation, it is normal and necessary to use inference and presumptions to derive from the evidence that is available what was most likely to have happened.

72. The “solicitud” did not come out of the blue; the normal way to go about such matters is to informally sound out, negotiate and prepare in such an evidently very sensitive matter both the “solicitud” and the

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<sup>110</sup> Crosby, p. 26; Mitchell, p. 290; Crosby, p. 37: “and the fact they came back with a refining of the standard indicates knowledge on their part of that they were intending to do..” Mitchell’s testimony – so far never contested – was that informal consultations had gone on for a prolonged period, and then intensified through lawyers Aspe and Arroyo (with a more technical role for Ruiz Velasco, their formal legal adviser on Mexican law) throughout summer 2000.

<sup>111</sup> F. De Trazegnies, *La verdad construida, Algunas reflexiones heterodoxas sobre la interpretación legal*, in TDM 2005 ([www.transnational-dispute-management.com](http://www.transnational-dispute-management.com))

“oficio”. This has to be the common-sense assessment of the situation. That would make eminent sense in terms of the “stealth liberalisation by interpretation at the law’s margins” strategy that can be easily identified. If the unlikely course of action had been that SEGOB was surprised by a request coming out of nowhere and then reacted a little bit confusedly, as must be Mexico’s and the tribunal’s understanding, then it was up to Mexico, using its control over SEGOB officials, to prove a course of event that would be strikingly different from the way interaction between an investor and a regulating agency normally proceed.

73. Whatever the defects of the letter (and with hindsight and professional perfectionism a technically perfect “solicitud” separating a technical description from suggested legal qualification could have been written), I do not concur that by not providing manuals, complete technical specifications and not forcing SEGOB to inspect and test the machines physically,<sup>112</sup> Thunderbird failed with its disclosure duties in a way that any response would be invalidated. SEGOB was not a group of widows and orphans to whom shoddy goods are deceptively sold at the door and which requires the special protection of the law: It was the chief gambling regulator in Mexico; it had battled with Mr Guardia about precisely this type of machines since at least 1998<sup>113</sup>; its legal battles with Guardia had been at the centre of SEGOB activities. According to the chief witness on this issue put forward by Mexico, the issue of the “skill versus chance machines” had been at the forefront of its litigation activity – including five Supreme Court decisions. It is therefore not conceivable that when SEGOB received the Solicitud it did not think of the issue of using the “skill involvement” for relaxing the Mexican

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<sup>112</sup> Mexico’s counsel suggested proper disclosure should have included the “slot that you can put US \$”, “manuals and operating instructions”; a “machine to show how these machines worked or even photographs of these machines”, p. 99-100. But that seems to be second-guessing ex-post the Mexican gambling regulator’s role. They had to know, and presumably did know, what information they needed and wanted. They could have easily obtained any information they wanted from Thunderbird as they controlled the process of the for Thunderbird vital “green light clearance”.

<sup>113</sup> Alcantara, 874, 917 (“there have been a number of decisions by the Supreme Court, one in 1998, and four other ones in 2000”)

gambling law prohibition. The machines itself – and that is essential – were identified in a way that allowed SEGOB to know they were video-slot machines used in the US for class 3 gambling.

74. If SEGOB had had the slightest doubts about the nature of the operations, it had the duty to investigate. The preparation of an administrative decision is not the responsibility of the applicant, who does what the government requires of him, but of the Regulator. It is not – as implicit in the majority's award – the obligation of private applicants to tell the national chief regulator how to run its business, but the public authority has to advise applicants what information it requires. This is even more so as SEGOB had enough time; the time between the receipt by SEGOB of the *Solicitud* and the delivery of the *Oficio* is quite short; the claimant's narrative of several weeks (if not months) of informal discussions between SEGOB and its lawyer-lobbyists Aspe & Arroyo has not been contested. It is also the way such business is conducted practically and in reality. One does not write out of the blue a request to a government agency, but the rules of the art of interaction with the regulator normally involve an informal period ("sounding-out") with the formal inputs and outputs (*Solicitud* and *Oficio*) only as the ultimate official documentation of an informal process of consultation. Again, with full sensitivity of the controversial skill-chance issue created by years of litigation, with clear indicators of a wish to liberalise gambling policy by interpretation rather than full-fledged legislative change, one has to expect the Regulator knew exactly what the issues were. It must have considered a physical inspection superfluous – much as later Mexico felt a physical inspection of the machines was not necessary for its principal expert, Prof Rose to develop his views later presented to the tribunal. Respondent can not now argue that its federal Gambling Regulator needed more information which should have been provided by Thunderbird without being asked to do so when its NAFTA defense unit considered such information for a foreign gambling law expert not necessary.

75. The consequence is that Mexico has not met the incumbent burden of proof that there was deception of SEGOB by insufficient disclosure. It should have brought the SEGOB officials involved to the tribunal. Since it did not do so, the inference must be allowed that it considered that production of these key witnesses to the events would not have supported its argument of deception – nor its argument about the meaning conveyed with the Oficio.
76. SEGOB therefore knew full well what these machines were like and what issues they raised; the over two years of litigation occupying SEGOB's core attention focused on one issue: The question if slot machines with stop-functions (video-poker) could be exempted from the Gambling Law because of the publicly and in litigation alleged "skill" character<sup>114</sup>. I suggest that SEGOB therefore understood the issue at stake quite possibly much better than Thunderbird itself. The uncontested evidence on the interaction between Thunderbird and SEGOB officials suggests that the officials had encouraged Thunderbird to seek a clearance – rather than the confrontational strategy with Guardia which must have cost SEGOB a large amount of resources and loss of face. If SEGOB had had any doubts about the machines, they could have easily asked Thunderbird to provide more information and inspect the machines – which were available in the offices of Baker McKenzie in Mexico City. The fact that they did not suggests that SEGOB had not the slightest problem in terms of awareness. The confrontation with Guardia and other Mexican operators must have provided to SEGOB all relevant technical understanding and legal sensitivity. They must have known how such machines functioned and how skill and chance played a role, both from a technical and legal/regulatory perspective. It is not proper to consider a large country such as Mexico with a fully developed legal and administrative system, a 60+ years old gambling law and an experienced regulatory agency

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<sup>114</sup> Alcantara, p. 893; p. 852: Question: When does this skill phenomenon arise for skill machines? Answer: There was a first event, isolated event around 1998-1999. Then from 2000 onwards, we saw a number of litigations take place.; p. 874, referring to the 1998 case: "That was the first site where the Gobernacion detected the operation of these type of machine"

as acting, on the highest level of this specialised regulator, as un-informed, naïve, inexperienced and not aware of the key issues relevant at the time in their line of business. We have to consider SEGOB as a competent regulator of its industry which knew what it was doing. The respect for government owed by international tribunals requires also respect for its officials and regulatory agencies – and with this respect, naturally, comes responsibility.

77. Nor did SEGOB have any doubts – or could have any doubts – that the investor was asking for an assurance in the light of its interest to invest under conditions of greater legal certainty in a “grey area” of the law where the competent government agency’s authoritative interpretation would make the decisive difference<sup>115</sup>. If SEGOB had had any doubts about either what machines were being envisaged, their technical character and the way they functioned, or the interpretative challenges they raised, they could have easily – and should have under the transparency and avoidance of ambiguity rule – requested Thunderbird to amend and back-up its “solicitud”. That they did not do this indicates that SEGOB saw the letter – as Thunderbird intended – not as a technical description of the machines, but as a request to confirm the legal qualifications that Thunderbird, after informal consultations, proposed or was recommended to propose. The same approach was practised by Mexico in the arbitration. Not only did SEGOB never feel it was necessary to inspect and test the machines, but respondent, in its defense, did exactly the same: It let its principal (but foreign) expert, Professor Rose, opine on the machines, their functionality and the legal implications under Mexican law in great

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<sup>115</sup> See testimony Watson, supra; the same was expressed by CEO Mitchell, never seriously contested by Mexico. Plus, it is in the very logic of foreign investment that serious commitment of capital in a grey area of the law needs to be risk-managed, and such risk management is best done by getting a comfort letter/interpretative assurance from the competent regulatory agency. This is indeed common practice in other areas of high-value foreign investment in areas of substantial political risk, as e.g. in the Sakhalin oil-gas investment process in Russia where a similar “comfort/interpretative” letter was informally negotiated and in the end issued by the Russian Prime Minister (direct information).

detail, but never felt it necessary to let him see, inspect, review and test the machines (which were in Mexico's hands)<sup>116</sup>:

Question: "Did counsel for Mexico indicate that they had it in their ability to provide a machine for your review if you could work out the logistics? Answer Rose: "I don't think we ever really got to that stage".

The Mexican approach throughout this case - be it SEGOB at the Oficio-stage, newly directed SEGOB in the prohibition phase or Mexico in the defense stage - has been that the functionality of the machine was self-evident, and no need for in-depth inspection and examination was necessary<sup>117</sup>. If, after all the controversy on skill and chance, Mexico still felt it was not necessary to let their principal expert examine the machines physically and directly, then the conclusion to be drawn is that at no time was there any doubt with SEGOB about how the machines functioned and what legal issues they raised. The "lack of disclosure" by Thunderbird argument hence can go nowhere: Re-examining the machines in August 2000 - as during the subsequent NAFTA arbitration from 2002 to 2005 - would have been to "bring coal to Newcastle" or "owls to Athens". SEGOB and Mexico's counsel never thought it was necessary to examine the machines in detail - and the tribunal, I suggest, should not theorise on SEGOB's ignorance as SEGOB and Mexico's counsel, then and now, act in a way that indicates that they have a perfect understanding of the machines at issue.

To sum up: Since I view the Solicitud as a proposal for a legal qualification of the machines as not being covered by the Mexican gambling law, I can not view the claimant's Solicitud as lacking in required disclosure of the technical nature of the machines. There can be no deception of SEGOB if

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<sup>116</sup> Testimony Rose, 747, 748:

<sup>117</sup> This attitude about the self-evident nature of the machines is also reflected by the remark attributed to the new SEGOB Director Guadalupe Vargas in 2001 when he reportedly said: "What I see are slot machines" ("lo que veo son tragamonedas"), Particularised statement of Claim, p. 90; statement by P. Watson, 15 August 2003, p. 5, para 26, p. 45 (not as far as I can see contested).

SEGOB was or must have been aware of the nature of the machines, the legal issues raised, the precedential litigation and if the Solicitud in essence was conceived as and understood as a legal advocacy. The facts were evident and knowledge of them was shared by both parties; what was at issue was the legal qualification. Even Mexico's chief expert describes the moment in time when the Oficio was issued as "a great movement right before President Fox was elected" for liberalisation of the gambling law. And he equally provided the explanation for the subsequent reversal of SEGOB's position under the new PAN government:

"then some sort of scandal or political issue hit, and the government had to back away".

78. Nothing can be more persuasive for explaining Mexico's attempt to liberalise by stealth, through the "oficio" interpretation and its subsequent reversal (at the cost of the investor) than Professor Rose, Mexico's own chief expert and authority on comparative gambling law.

"Oficio" (or "Criterio") of August 15, 2000 – the Interpretative Assurance or Comfort letter

79. The formal letter that emerged is an extreme case of bureaucratic obfuscation: While protecting the "back" of the officials that signed and authorised that letter by ambiguous references, sometimes to machines where chance does not "intervene" (there is hardly any game where chance does not at least have a minor role – so Mexico's principal gambling law expert Rose<sup>118</sup>), sometimes to machines which "predominantly" ("preponderante") involve chance<sup>119</sup>, the main "operative" message of the letter is: Yes – go ahead with the machines

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<sup>118</sup> P.774: questioning the assumption that for example in chess chance plays no role;

<sup>119</sup> Rose – though never very clearly – suggests that it is never easy to draw the line between "predominantly skill" and "predominantly chance" and that the skill of the player (which improves by application and learning) has a lot to do with it: "The line is drawn fairly hard in terms of you have to have a lot of skill" and on video poker ("does clearly require some skill" (791); "certainly skilful players will do better" (793) and on using the "learning curve" to identify skill (p. 795) while recognising that videopoker (as used here) has a undeniable skill component and that the more players learn and play, the better they get (796).



if they are as you qualified them, but bear in mind that machines which involve “predominantly” chance are not allowed. A very rigorous analysis, done with hindsight of 4 years of national and international litigation and with the sophisticated expertise of my respected colleagues examining closely the Oficio word for word (paras. 159, 160), can plausibly come to the conclusion that the literal text of the letter did not give unambiguous clearance if chance was involved in the operation of the “skill” machines<sup>120</sup>. Chance is evidently involved to a substantial extent, as it is in every respect of human activity, so my colleagues have some justification in suggesting this letter was not the un-ambiguous and clear assurance to Thunderbird that it could go ahead.

80. On the other hand, if the letter is read from the perspective of the addressee and a “reasonable businessman” of the relevant trade without the benefit of 4 years of litigation, and over twenty lawyers and experts poring over every word in the letter, a different message emerges. The letter does not say: Your machines (which SEGOB knew perfectly well) are not allowed nor did it say: We think your machines are the same as Guardia’s machines (which SEGOB knew or should have known) and as you know they can not be operated in Mexico. It did give a positive signal – you can go ahead; its qualification (“as you described the machines”) refers back to “legal” interpretation given by Thunderbird in its “solicitud” to the machines. Possibly, it plays intentionally with ambiguity in the “solicitud” which was meant to convey the legal qualification but could also be read as meaning the “factual” or “technical” description. Most importantly, and at first sight out of the blue, comes the reference that machines that are “predominantly” involving chance are forbidden. The use of the “predominant” criterium inevitably leads to the conclusion that if an operation that is “predominantly chance” is forbidden, then an operation that is “predominantly skill” is allowed. Predominant means

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<sup>120</sup> Mexico’s chief counsel, p. 1150: “maybe when you get to a very fine level of detail, it might be possible to establish a certain or view a certain contradiction in the letter from Gobernacion”.

“more than 50%”. There is a zero-sum relationship between skill and chance. Something that is more skill, is less chance and vice versa. The “predominant” criterium is – as Professor Rose testified and wrote – the key issue around which legalisation and liberalisation of gambling regulation turns:

“There is the difference between whether it is a game of skill or a game of chance, so if it’s predominantly skill, it is not gambling. If it is predominantly chance, then it is gambling”.<sup>121</sup>

81. Using the “predominant” criterium is referring to a crucial gambling regulatory standard. A reference to “predominantly chance” as an indicator of prohibition is therefore automatically a reference to “predominantly skill” as an indicator of legality. I have therefore trouble with the tribunal’s rejection of the “e contrario” argument (para 160), in particular as Mexico’s chief counsel (same as counsel for Mexico later, in the hearing, accepted quite explicitly the e contrario argument as inevitable logic<sup>122</sup>:

Question by President: “But does it address also the question predominantly, now the **reverse**, predominantly skilled? .. It says one thing, but does it also say the other thing.

Answer: You might interpret it as predominantly ability and skill and not betting

Question: So, you would say you can interpret this?

Answer: Yes, sir

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<sup>121</sup> P. 751; Rose, *Gambling and the Law*, p. 80: On California: “devices that are predominantly skill are legal”

<sup>122</sup> Question of president to Mexico’s chief counsel and answer, p. 1161 ; also: Cross-Examination of A. Attallah, p. 207: Question by Mexico’s counsel: “Again, the obverse of this, of course, would be to be a skill machine, the skill machine, the skill would have to be the predominant factor in operation, would’n’t it” and p. 209: “ and what I am suggesting to you and trying to see if you agree , is basically what this is saying that to be lawful, a game would have to require – the principal factor in the game would have to be skill in order to meet this test: do you agree?”

82. It is virtually impossible to determine if the machines involve chance under or over 50%; at best, it depends on the level of player skill which, so respondent expert Prof Rose, increases in a “steep learning” curve, i.e. with a rapid increase once a serious effort at learning is made<sup>123</sup>.

83. With the introduction of the criterium of “predominantly skill or chance”, SEGOB shows the way how the boundaries of the Mexican gambling law’s prohibition on games of “chance” can be relaxed. That is fully consistent with the report of witness Watson’s conversation with ex-Gobernacion Secretary Labastida supporting the “appropriateness” of using the “skill issue” from a “northern Mexican litigation” to relax the gambling prohibition. The “Oficio” can therefore be read as suggesting to Thunderbird that it should not qualify its machines as “only skill” (reflecting the label of “skill machines” used for presentational purposes), but as “predominantly skill”. While “no chance at all” is a criterium that can not be met (by any game), with “**predominantly skill**” the door is open to discretionary assessment. A gambling industry person can only hear when the term “predominantly skill” emerges the message: “Yes – allowed” – as Mexico’s chief expert Prof Rose said in describing the Californian approach<sup>124</sup>:

“devices that are predominantly skill are legal”

A dispassionate expert or a tribunal careful weighing up facts ex-post and after intensive litigation may come to a more nuanced conclusion. That what is relevant for interpreting the conveyed meaning and message by SEGOB to Thunderbird is not what a dispassionate expert or a meticulous tribunal would or should understand, but what the addressee of the

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<sup>123</sup> Prof Rose’s testimony is lengthy and never unequivocal; but in sum he concedes that in video-poker and related games skill plays a role; that the more players play and learn, the better they get, that the skill consists mainly in the ability to make rapid probability calculations taking into account prior experience and that the predominant criterium is fuzzy and can not easily be pinned down and that it is and can be used to introduce liberalisation – pages 773-791.

<sup>124</sup> Rose, *Gambling and the Law*, p. 80

message – the Thunderbird gambling industry investors and promoters – could reasonably understand at the time the message was conveyed.

84. SEGOB's and Thunderbird's interaction can not be construed on the sole basis of the text of the "Oficio" as would be read in isolation by sophisticated international lawyers, but they need to be read as the "people in the business" – the gambling regulator and gambling professionals – would read them. In proper methodology for construing contractual text and text of unilateral declarations addressed to investors as we have here, it is the "horizon" and perception of a reasonable person in the trade that counts. And here "predominantly skill" means – let us simply trust Mexico's chief expert in this matter: "Yes".

85. With this criterium, a large leeway of discretionary interpretation is opened: Do video-slot machines running on software involve skill at 10%, at 51%? There is no fully objective determination possible; player skill and experience determine the relative proportions of chance and skill. In capturing the main message conveyed by the text in its particular context, we need to acknowledge the desire by Thunderbird to get legal clarification for its investment. That was perfectly known to SEGOB. We need also to appreciate that SEGOB knew and must have known all about the technical nature of the machines and the legal sensitivity, tested in many litigations and administrative procedures. The August 15, 2000 "criterio" ("oficio") has then to be seen as SEGOB giving a green light (at the end of a long tunnel darkened by ambiguity and obfuscation). The numerous reservations can be explained by the usual self-defensive strategies of bureaucracies<sup>125</sup>. Some of the reservations – i.e. "predominantly" skill-involving versus "involving no chance at all" – are contradictory. But the ultimate message for a reasonable businessman in that situation was the answer to his question: Can we operate these machines which you know?: Yes, you can, just be careful and note that

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<sup>125</sup> See on the strategy of intentional bureaucratic ambiguity Mairal, *op.cit. supra*.

you – we – have to present this as something that can be qualified as “predominantly” – but not exclusively – skill-involving. That explanation fits perfectly with Mexico’s expert Rose’s reference to the window of opportunity for relaxation of the rules that existed just in 2000 (before President Fox was elected) and closed rapidly thereafter. What counts for the legal assessment of the letter is not the text per se, but the way it could be and was likely to be understood by Thunderbird to whom the message was conveyed. It was how Thunderbird could, reasonably, have understood the response of SEGOB to its request – the reasonable perception of the addressee of the message.

86. Thunderbird was no “Fortune 100” multinational company with hundreds of lawyers and country analysts at its disposal. It is a small entrepreneurial company where entrepreneurial activism was not matched with commensurate expertise and caution. But NAFTA would lose its objective of mobilising investment opportunities if its requirements were only suited to very large, expert, well resourced and suitably super-cautious companies. The vigour and dynamics of entrepreneurial drive would be lost; this is not compatible with the cited objectives both from Art. 102 and the Preamble of the NAFTA. If SEGOB had wanted to keep Thunderbird from operating its – clearly identified – machines, it should have said so and it could have said so easily, clearly and unequivocally.

87. This conclusion, I suggest, is the one most consistent with real-life practices and expectations. It takes into account that a private investor will rarely look at what looks like and is intended to be a positive response with the “rigorous due diligence” and the fine comb of an ultra-cautious litigation lawyer based on hindsight, but will look towards the essential message. It was: “You can go ahead – bear in mind: Such types of games in Mexico need to be presented as “predominantly skill-involving””. While a text-book approach would always require that official opinions be very clear, the messy reality of business life in most places and most times is that bureaucrats tend to

use obfuscation for self-protective purposes in sensitive situations even if they want to be supportive. Disputes would not go to arbitration and investment treaties were not necessary if every investor would at any stage in its business manage to execute a legal transaction so that there were no doubts whatsoever over a government's intention. To the contrary, ambiguity is the name of the game in dealing with governments and the task of international investment protection comes into play not in the case of the perfectly executed and documented transaction, but in the imperfect one of real life.

88. It is here that the legal criteria identified earlier for "legitimate expectations" need to be applied: The tribunal's majority relies on the ambiguity<sup>126</sup> and lack of clear, unconditional and un-reserved text of the letter. But if we apply the principle that the risk of ambiguity has to be allocated to the drafting government, that a government agency can not rely on intentionally inserted obfuscation to extract itself from the key message the investor relied upon and that the drafter and the public authority in a position of superiority over the foreign investor has to be clear, unambiguous and consistent – then the positive message that a reasonable businessman could have taken from the "Criterio" of August 10, 2000 must prevail over the manifold reservations and contradictions my esteemed colleagues rely on. Similarly, based on the rules developed in particular in the *Metalclad v Mexico* and *MTD v Chile* cases, but also reflected in other precedents on the duty of governments' to provide pro-actively legal certainty to investors, one can conclude that if SEGOB did not want to accept Thunderbird's type of operation, it should have said so, clearly, and if it saw that Thunderbird did not get the message properly, it should have repeated the message and ensured it was clearly conveyed and understood<sup>127</sup>.

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<sup>126</sup> Ambiguity was conceded by Mexico in the hearing, see *supra*.

<sup>127</sup> Trazegnies, 2005, at p. 10, discussing the application of good faith principle by way of the legitimate expectations rule suggests that the good faith principle requires "claridad y transparencia de la expresión y del comportamiento. Sin ella, los agentes jurídico-económicos no puedan calcular las consecuencias de sus actos porque el co-contratante de mala fe puede desajustar el acuerdo con cualquier pretexto". Trazegnies quotes later (at p. 14)

89. The “Oficio” or “Criterio” is not private legal advice – the claimant did not need any more legal advice having contracted several respected lawyers and law firms already. It comes, as respondent concedes<sup>128</sup>, with the presumption of being an official and authoritative act by the competent government agency. It comes with the full authority of government – on SEGOB letterhead, multiple official seals or stamps of the “Secretaria de Gobernacion” – the Mexican Interior Ministry. It is not a furtive note handed out secretly to Thunderbird to avoid the light of day, but it is formally copied to at least two senior Gobernacion officials; it presents itself as an official unilateral statement intended to have legal implications. It is signed, every page is initialled and it has reference to an official case identification code<sup>129</sup>. There is also a formal act of notarisisation of the document. The more formal a communication by an administrative agency to an individual in a specific case, the more likely it is to create a legitimate expectation; the threshold for informal or general communications is much higher.

90. Formal acts of government have to be treated with full respect<sup>130</sup>; it would not be respectful to treat a government’s formal declaration as if it were the un-informed utterings of an ignorant minor in need of protection against shady dealings. Thunderbird did not want or need a restatement of the letter of the law – it wanted, as was clear to the government, a statement if its “skill machines”, identified properly, could be operated in Mexico. It wanted an interpretation – and with the “predominant criterium”, it received one. We have to assume that SEGOB did mean what it said and was ready to provide “green light” to the investor. The presumption is that such a formal legal advice, sought by an investor, is valid, has an effective meaning, responds

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a formal determination by the Peruvian Telecommunications regulator upholding, in the regulatory context, a previous understanding of the regulator with a regulated company

<sup>128</sup> Response”, para 64, of October 2004,

<sup>129</sup> Alcantara, p. 926: Question: So this would be a document issued with the full authority under the applicable laws of Mexico; Answer: Yes, issued with full authority”.

<sup>130</sup> Mairal, p. 50, 51 emphasises that the more formal an official representation, the more it is effective in creating a legitimate expectation. The reason is that formality enhances the confidence while informal representations are less confidence inspiring.

properly to the request and in its operative conclusion gives to the investor a clear response. Respondent bears the burden of proving that the “oficio/criterio” was emitted in an improper procedure by officials acting manifestly outside their powers and that it did not convey the main message which was the reply to the main question of the investor: Can we operate our machines – the BESTCO and SCI machines which we (as the other operators) call “skill machines”, in Mexico?

91. We also have to assume that it was intended to say something substantial on the request for “green light” by Thunderbird – rather than just a re-copying of the text of the law. A view that reduces the conveyed meaning of the letter to something close to zero, lacking a true substantive response to the “solicitud”, does not do justice to accepted interpretation methodology for legal instruments which include a legally significant unilateral statement such as contained in the Oficio. Legal instruments formally emitted are in doubt to be interpreted for an “effet util”. If they serve as a formal and official reply to a request for clarification of the law by a foreign investor, then they have to be an effective response to the request. If it did so with so many reservations and ambiguity, then the government has to bear the risk for such ambiguity. There is a presumption – both in international and in comparative administrative law – of the legitimacy of official acts<sup>131</sup>. That is the risk that the government, as price for the due respect to official acts, has to bear.

92. That the “Oficio” gave green light was also the opinion of Thunderbird’s Legal Adviser Mr Ruiz de Velasco of Baker McKenzie. While he reiterated the reservations of the “Oficio” – which lawyer does not equally try to protect his back when giving legal opinions, the operative conclusions, and this is what counts, he confirmed that Thunderbird could go ahead and operate its video skill machines. He

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<sup>131</sup> Mairal, p. 81: “En efecto si la Administracion impugna el caracter de factum proprium, jugara un rol importante la presuncion de legitimidad del acto administrativo, en este case en favor del particular””.



may not have understood nor Mexican gambling law nor the functionalities of the machines; possibly, he did not appreciate the implication that the introduction of the criterium of “predominantly skill-involving” machines in the Oficio opened the interpretative door of the Mexican gambling law. But his opinion must be weighed primarily by its clear conclusion rather than by its lawyerly and self-protective reservations. While other sophisticated lawyers are competent to appreciate the self-protective legalese in legal opinions, in particular with hindsight ex-post, our impression from the hearing was not that this applied to Thunderbird. Mr Ruiz Velasco got in cross-examination increasingly confused about disclosure as it should have been, as it was done, about the functionality of the machines and their legal implication in Mexico, but that was because he had little if any understanding or interest in the technical and legal issues of the Mexican gambling law. Had he understood the implication of the “predominantly skill or chance” criterium introduced by the Oficio properly, then he would have been able to give a clearer legal opinion and represent this accordingly before the tribunal.

93. The “Oficio” was also within the competence of the government officials who signed it<sup>132</sup>. Interpretative and similar official assurances and representations must be “legitimate”, i.e. they must be issued by competent officials and not, at least from the due-diligence horizon of the recipient, be against the law<sup>133</sup>. SEGOB is the highest federal authority in Mexico for regulating the gambling business. Such authority involves a competence to determine, for the purpose of the administration of SEGOB, the boundaries of the law. That inevitably implies interpretation of the terms – even if such interpretation was not legally binding in the way courts act and subject to judicial action.

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<sup>132</sup> Alcantara p. 926 and cited supra; Mairal, p. 48, 49 on the requirement that officials making representations leading to legitimate expectations must act within their sphere of bureaucratic competence.

<sup>133</sup> So, for example, the (then) European Commission of Human Rights in the Pine Valley case, para. 84 (ECHR, Pine Valley Developments Ltd. and Others judgment of 29 November 1991, Series A No. 222)

Since virtually all games involve some elements of chance and skill, it is a normal and legitimate activity for the principal national regulatory authority to determine (and to convey to an investor) its own view of the precise line constituting that boundary, even more so as the underlying law, of the 1940s, was quite old and had not kept up with modern commercial and technological developments. International regulatory practices – on which Prof Rose testified for Mexico – had developed the “predominantly skill or chance” distinction; accordingly, it was perfectly appropriate for SEGOB to interpret the 1940s’ Mexican Gambling Law in the light of such practices, in particular as there was a political idea of liberalising the Gambling law around at the time. Liberalising it at the margin – rather than seeking a wholesale legislative change – is often if not mostly used to introduce policy changes in a way that is faster, more efficient and more politically palatable. Ex-Gobernacion Minister Labastida, Mexico’s chief expert Professor Rose and Thunderbird witness Watson all in effect concur that there was, in 2000, a window of opportunity for “stealth liberalisation” using the openness of the “skill” condition and SEGOB and Thunderbird exploited this window. The SEGOB officials therefore issued their “Oficio” well within their real and apparent competence and within the then emerging (but later reversed) official policy<sup>134</sup>.

94. Thunderbird’s view that the “Oficio” was giving formally (even if cautiously worded in bureaucratic language) green light to their operations was also reasonable. First, the machines and their mode of operation were well known to both parties. Second, Thunderbird had made clear to SEGOB that it considered the issuance of a comfort letter as significant to their operation, and also engaged on the path of cooperation with the government rather than the confrontational strategy applied by Mexican competitor Guardia. They might have been more cautious; they might have seen that the “Oficio” left many escape routes to SEGOB and was not an absolutely clear and un-

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<sup>134</sup> Mairal, p. 152 emphasises the ability of interpretative assurance to create for the thereon relying individual a legitimate expectation – except if the response given by the official is “clearly contrary to law”, p. 150-152

ambiguous assurance. But they were not unreasonable in drawing comfort from what appeared in the context of their communication the positive attitude of the Oficio towards Thunderbird's machines and the confirmation of this positive message in the operative paragraph of their legal adviser's subsequent legal opinion letter.

95. To sum up: The expectation was created, by the competent officials in their normal conduct of affairs, with Thunderbird and it was also reasonable by Thunderbird under the circumstances to draw confidence from the Oficio. We do therefore have a "legitimate expectation" protected by Art. 1105 of the NAFTA. Thunderbird evidently understood the "Oficio" to give green light, but my analysis also suggests that it could reasonably and in the context of the regulator-gambling business interaction understand the operative message and the "predominant" criterium to mean that green light was given, and for the machines it had named, envisaged for its operations and ultimately deployed for operations. Mexico's case in the main rests on the "deception of SEGOB" argument, but as I have determined earlier, it did not meet the incumbent burden of proof for deception.

#### Post-Oficio Acceptance of Thunderbird Operations by Outgoing Mexican Government

96. In spite of my different view attributing effectiveness to the "Oficio", I might have become swayed by the eloquent arguments of my colleagues dissecting the Oficio in a painstaking way that the "Oficio" was just not enough to create a legitimate expectation that Mexico's SEGOB was ready to use its powers to tolerate Thunderbird's operations. But the "comforting" messages coming from SEGOB to Thunderbird did neither start nor stop with the "Oficio" of August 15, 2000. As is recognised in "legitimate expectations" jurisprudence,<sup>135</sup>

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<sup>135</sup> R v IRC, ex p Unilever, 1996 STC 681, cited from Schonberg, Legitimate Expectations in Administrative Law, OUP 2001 121, 122; note the emphasis on "reasonable construction of a

conduct, as the “consistent and prolonged treatment of a person in a particular way, can create a reasonable expectation that the treatment will be continued until further notice”. Given the difficulty of enforcing Mexican anti-gambling laws throughout the country swiftly, I would not have been willing to qualify the about six months of toleration of Thunderbird’s operations alone, without preceding Oficio, by the then outgoing Mexican government as sufficient for creating a legitimate expectation under Art. 1105 of the NAFTA. But even if one considers the “Oficio” as not sufficiently strong and the post-Oficio toleration as not sufficiently prolonged, the combination of the two creates a much stronger case for a protected legitimate expectation<sup>136</sup>. This is also in line with the interpretation guideline of Art. 31 (2) of the Vienna Convention where subsequent conduct of the parties is taken as a significant indicator of their common intention. In comparative administrative law – in particular in legal systems of the Latin tradition – subsequent conduct by the administration is generally relied upon to interpret earlier, ambiguous, administrative acts and contracts<sup>137</sup>.

97.If SEGOB had been effectively deceived by dressing up a video-poker operation as an innocent video arcade game, as the majority suggests, then it had sufficient time to inspect the operations, realise that they were not what was submitted and for which SEGOB had given green light, but something else that was against Mexican law as then interpreted by SEGOB. Given the sensitivity of the issue and the long legal battles of SEGOB with Guardia starting in 1998, it would have been natural for SEGOB to check on the facilities soon after the “Oficio”

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party’s conduct” in Professor Bowett’s statement cited by Reisman/Arsanjani, op. cit. at p. 340

<sup>136</sup> That would also be the consequence of construing “legitimate expectation” in accordance with the common law equity doctrine of “laches” or, in civil law, acquiescence. The six-months by itself may not have been a very long period, but it is the full period from the grant of the “oficio” to the end of the PRI government. The fact that it took a new government with its own politics to rescind the acceptance embodied in the combination of Oficio and subsequent informed toleration suggests rather that the “Oficio” can be legitimately interpreted with the post-Oficio informed toleration by the outgoing PRI government.

<sup>137</sup> Mairal, 129: “La Suprema Corte de la provincia de Buenos Aires ha considerado a los hechos subsiguientes de las partes como “elementos decisivos” para la interpretacion de un contrato de obra publica”.. “Analogia regla cabe proponer respeto de los actos administrativos de objeto dudoso o ambiguo”.

of August 15, 2000. Lic. Alcantara testified to his ever present will to pursue vigorously and consistently any perpetrators<sup>138</sup>. Nothing would be more normal after a so carefully drafted *Oficio* than to inspect Thunderbird facilities to see that the “warnings” were observed and the machines were as what they were presented to SEGOB. But there was no action by SEGOB throughout 2000 and beyond – until a new government and thereafter a new Director of SEGOB – Guadelupe Vargas – took office. The first actions against Thunderbird, reflecting the change of interpretation and enforcement attitude, started in February 2001, i.e. only after a new government and a new SEGOB Director had taken office. I do therefore not share the tribunal’s view (para 165) that “approximately six months” is “insufficient to establish that prior to that date SEGOB had authorised (or was intentionally tolerating) Thunderbird’s operations. It was not just the mere passage of time from August 2000 to February 2001 that is relevant, but the fact that toleration and an absence of any action of monitoring, inspection, request for information or enforcement lasted throughout the whole period remaining for the outgoing PRI government. It only ended when a new, PAN-appointed SEGOB director, took office. As we have to read the “*Oficio*” in a way that is most likely to reflect the true intention and common understanding of the parties in the context of their interaction, it is only that period – of the same group of players motivated by the same type of approach and attitude to gambling regulation – that we have to look at. We do not have simply a period of six months’ toleration – short some might say for many government agencies to get their acts together, but the full remaining period of the tenure of the government which negotiated and later issued the “*Oficio*”. I note that in *Biloune v. Ghana*<sup>139</sup> the tribunal identified the about 12-months’ long toleration of a visible construction as a key factor for a finding of expropriation, i.e. a sanction that reaches much

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<sup>138</sup> P. 880: Question: “How soon will that action be taken? Answer: “Were it to depend on myself, believe me, it would be right away”. Later on the same question: “As soon as those actions and strategies allow”.

<sup>139</sup> 95 ILR 183 (1994) at pp. 207, 210

further than the Art. 1105 NAFTA breach at issue here<sup>140</sup>. But 12 months of toleration of a construction process indicates much less than the combination of a formal, though ambiguous, interpretative assurance combined with toleration not only of the prior process of establishing the gambling facilities, but also of their operation subsequent to the Oficio to the very end of the government's tenure. On the Biloune principles, Thunderbird had therefore a much better case for the lesser Art. 1105 NAFTA claim. Different from Biloune where a positive signal from the regulating agency was alleged, but contested, Thunderbird had a very formal assurance letter following its formal request plus a subsequent toleration of the very operations for which the Oficio had been requested.

98. In Thunderbird, the assurance letter was given in light of a well known interpretative dispute, where the facilities were not only established, but up and running and where the government had a specialised agency charged with monitoring and enforcing the regulation-intensive gambling law and where the government prided itself on rapid and energetic enforcement. The comparison with the Biloune case thus reinforces the view that SEGOB's conduct subsequent to the Oficio letter, throughout the outgoing PRI government, not only expressed toleration, but allows us to read the preceding Oficio in light of the subsequent toleration.

99. The combination of the "Oficio" with the continuous tolerating acceptance of Thunderbird's operation by SEGOB to the end of the term of the government – which had been responsible for issuing the Oficio – suggests that SEGOB knew exactly what it gave a green light for and was content with it. The conduct of both parties subsequent to the key "Oficio" – Thunderbird's continued investment and SEGOB's tolerance – confirms that the "Oficio" was meant to give green light to

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<sup>140</sup> In Biloune, the claimant also raised an assurance from government authorities for his construction without permit, but such an assurance was contested and in the tribunal's view not necessary for its determination of a "constructive expropriation".

the installation and operation of exactly the type of software-programmed slot machines Thunderbird operated and that SEGOB was perfectly aware and accepting of this fact – regardless of circuitous and convoluted way it formulated the Oficio.

100. In interpreting legal acts, what counts in the end is what the parties intended and what the recipient of a legally relevant communication did and could reasonably understand the main message to be. The fact that it took a new government and a new director – with his own sets of attitudes, affiliations and alliances<sup>141</sup> – to reverse the course that the Oficio of August 15, 2000 had most cautiously taken, suggests that the earlier Mexican government had indeed given green light to Thunderbird, had been fully conscious of it and accepted the consequences of Thunderbird now backing its expectation with substantial follow-up investment. The fact that it took a new government and a new SEGOB director to suddenly reverse the course – and the fact that “the first closure order was issued” against Thunderbird in early 2001 – and not against the confrontational Mexican competitor Guardia – is unlikely to be coincidental: Thunderbird was penalised for having collaborated with the (earlier) government and for having been part of the earlier government’s attempt to gradually relax the gambling prohibition.

101. If this is not enough to explain what SEGOB meant and the investor understood with the Oficio, then the “pro-active” duty of government to avoid contradiction and confusion of the investor – developed in the *MTD v Chile*, *Tecmed v. Mexico* and *Metalclad v Mexico* cases – would come into play. Given the close interaction between SEGOB and Thunderbird, one has to assume that SEGOB was aware that Thunderbird started to operate with its video-poker and related machines (identified as BESTCO and SCI machines) after the Oficio. If this was not covered by the Oficio – as the majority of the tribunal believes – then SEGOB had a duty to advise the investor

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<sup>141</sup> This has been the in my view credible – and never contested – interpretation by witness Montano, para 151.

accordingly and to ensure no legitimate expectation would arise. That they did not so, both confirms the meaning SEGOB and Thunderbird assigned to their Oficio, but also that SEGOB would have breached the duty of transparency and fair dealing with the investor by letting him run blindly into an open knife.

Disappointment of Legitimate Expectation with Discriminatory Elements in the Enforcement Process

102. The element of breach in the case of legitimate expectations under Art. 1105 of the NAFTA does not consist in the act of creating them, but in the disappointment of such expectations i.e. when a government changes course after the investor made its investment. We need therefore to examine not only how the expectations were created, but also how they were breached. Legitimate expectations – under Art. 1105 of the NAFTA or equivalent investment protection treaties - is never to be seen as an iron-clad guarantee – comparable to a long-term concession contract with a stabilisation guarantee – that policies will not change. Throughout the extensive jurisprudence surveyed, we find that if governments reverse their previously communicated and relied upon course, a balancing process takes place between the strength of legitimate expectations (stronger if an investment for the future has been committed) and the very legitimate goal of retaining “policy space” and governmental flexibility. Equality between individuals and absence of favouritism – i.e. non-discrimination – plays a role in the assessment of legitimate expectation<sup>142</sup>. That is even more relevant in investment treaties where the prohibition on discrimination in favour of domestic competitors is formally enshrined, as in Art. 1102 of the NAFTA.

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<sup>142</sup> Mairal, p. 104. That “discriminatory elements” can play a role in the examination of Art. 1105 of the NAFTA does not mean that a breach of Art. 1102 may automatically lead to a breach of other NAFTA obligations such as Art. 1105 or Art. 1110. That is also confirmed by the interpretation by the NAFTA Commission quoted in the award.



Courts have made reference to transitional measures<sup>143</sup> to smooth a reversal of policy. But this is not what occurred here. With the change of government and SEGOB director, enforcement started with priority and focus on the weakest player: the foreign investor<sup>144</sup>. As Licenciado Alcantara confirmed: The first closure order, under the new director, was issued against Thunderbird's Nuevo Laredo facility<sup>145</sup>. The new SEGOB director did not go first, as one would have expected, against Guardia who had never sought or obtained a comfort letter from government, but against the foreign investor who had engaged with the (previous) government and obtained an assurance, as disputed as such assurance later became. Enforcement attempts against Guardia followed, but they were ultimately not effective. It is hard to tell and the evidence is not conclusive if Guardia was simply more skilful with his "amparos" before Mexican courts or if SEGOB was pursuing Guardia with less intensity than Thunderbird, a much easier and politically less protected target. Lic Alcantara's, SEGOB's enforcement lawyer, cross-examination indicates that the direction of enforcement was not in his discretion but ordered from above by senior authorities ("Unidad de Gobierno")<sup>146</sup> in the "Secretaria de Gobernacion". Lic Alcantara – keen as he said he was to enforce vigorously - was excluded from such deliberations and acted simply as a lawyer executing enforcement directions given from above. His cross-examination indicated quite clearly that when he was given an enforcement job, he went about energetically, but the targets were

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<sup>143</sup> E.g. among many others: *Findlay v Secretary of State*, 1985, AC 318 discussed in De Smith, Woolf & Jowell, *Judicial Review of Administrative Action*, 428-430; Schonberg, 118-119.

<sup>144</sup> Mexico has not explained why the outgoing PRI government went on accepting Thunderbird's conduct and why then the incoming PAN government changed tack"; in this situation, the explanation offered by Ambassador Montano, p. 150, 151: "there was a difference in viewpoints on the part of the new officials" is relevant, including his reference to the possibility of collusion between Guardia – the competitor – and Guadalupe Vargas, the new Regulator even if he could not provide proof (who can?) but offered this as a plausible explanation not contested or better explained by respondent.

<sup>145</sup> p. 990

<sup>146</sup> From the records (confirmed by an internet review) the Unidad de Gobierno appears to be the (or one of the) central administrative departments of the Secretaria de Gobernacion; it is responsible for gambling regulation: [http://www.gobernacion.gob.mx/compilacion\\_juridica/webpub/Reg-Int-SEGOB-2005.pdf](http://www.gobernacion.gob.mx/compilacion_juridica/webpub/Reg-Int-SEGOB-2005.pdf).

given to him from above. Nothing has come to light or been produced by Mexico on who these officials were, how they went about their business and if they directed enforcement actions with equal energy against both Thunderbird and Guardia. This is another “black box” in Gobernacion overseeing SEGOB. But the results speak against such equality. Since the prima facie results indicate that Thunderbird was singled out without good reason (Guardia’s confrontation should in normal circumstances made him the first target), and since access to these people and their conduct controlling enforcement is under Mexico’s exclusive control, the prima facie presumption is that they favoured Guardia or at least had a particular reason to go after Thunderbird first rather than after Guardia<sup>147</sup>. That leads to another – rebuttable but not rebutted or explained and proved – presumption that there was an intention to discriminate against Thunderbird and quite plausibly to thereby favour the chief and most potent and visible Mexican competitor. Support comes here again from the method of the *Feldman v Mexico* tribunal<sup>148</sup> which inferred from a number of factors – including the willingness of the foreign investor to raise a NAFTA claim and the better-treatment of a well-connected Mexican investor – that there was a good case for an intention to single out Feldman because he was a foreign investor; with the unwillingness or inability of the government of Mexico to rebut that plausible conclusion based on available factual “dots” which the tribunal was able to connect with an explanatory “line”,<sup>149</sup> the tribunal rightly inferred from the available

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<sup>147</sup> It is well established that control over evidence and non-production of relevant evidence necessary for rebutting a presumption leads to a burden of proof on the evidence-controlling and not submitting party, e.g. *Kalkosch US-Mexican Claims Commission* case cited in D Sandifer, *Evidence before International Tribunals*, 1939; M Polkinghorne, *The Withholding of Documentary Evidence in International Arbitration*, 2004, at p. 13-16, forthcoming in *Fordham Law Review*. Most recently: *Methanex v. US*, p. 154, para 56: “the burden of proof.. shifted to Methanex, yet Methanex elected not to call the relevant partners of the unnamed law firm whose testimony might have clarified the issue. The Tribunal is unable to see why these partners could not have testified before it”. Similar at p. 155 (para 58), the tribunal again draws an inference from the fact that the relevant person “was not called by Methanex as a witness... was made aware of these proceedings and could have testified, Methanex provided no satisfactory explanation for his absence as a witness”.

<sup>148</sup> Paras 181, 182 in particular

<sup>149</sup> This is the language of the *Methanex v US* tribunal, *supra*

“dots” that they were connected by the “line” of discriminatory intention.

103. While I have come to an agreement with my respected colleagues that such conduct may not have amounted to a full breach of the national treatment duty of Art. 1102, I find more than enough “discriminatory elements” that have to be taken into account when judging the disappointment of legitimate expectation inherent in the rapid priority enforcement of closure against Thunderbird. “Discriminatory elements” may per se not amount to a breach of Art. 1102 of the NAFTA (and I concur that breach of one NAFTA Chapter XI duty does not necessarily indicate the breach of another one), but in particular in the context of fair and equitable treatment (Art. 1105 of the NAFTA) discriminatory elements have to play a role in the process of determining if problematic conduct has risen to the required threshold of intensity required under Art. 1105. I am comforted here by the similar (or identical) approach of the prestigious *Eureko v. Poland* (2005) tribunal; it has also linked “discriminatory conduct” with a finding of a breach of the fair and equitable standard<sup>150</sup>.

104. It is clear from the uncontested evidence and my assessment of the witnesses, in particular Lic Alcantara, that the reversal of government attitudes towards Thunderbird started right after the new PAN government and its new director of SEGOB, Guadalupe Vargas, took office and that it developed a special vigour in enforcing the law against Thunderbird. That is evidenced by the not contested fact that the first closure order was against Thunderbird. Under normal circumstances, one would expect that the first target of a more vigorous anti-gambling policy should have been Guardia who had pioneered the “skill” machine operation since 1999 and openly defied SEGOB, going as far to brag in public about his success of running

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<sup>150</sup> Para. 242: “that discriminatory conduct by the Polish Government is blunt violation of the expectations of the parties..”.

such operations “with or without the law”<sup>151</sup> – rather than Thunderbird who had chosen the approach of not confronting, but cooperating with the Regulator. Guardia is described in the most illustrative article as “friend of PAN politicians”. I therefore find the justification for a presumption of discriminatory enforcement energy and direction in the result. We do not know and hardly are able to know what happens exactly in the “black box” of government administration, in particular in sensitive matters and where domestic competitors are linked with government services against foreign competitors. That is why a distinct treatment by result raises the presumption of a discriminatory strategy and intention. SEGOB was, with respect to Thunderbird, successful before the Mexican courts. But such combination of exceptional enforcement energy and success did not occur against the competing operations of Mr Guardia. What happens within the Mexican courts is not separate from the measures SEGOB took nor does it provide immunity for SEGOB action: Mexico is before the NAFTA responsible for its courts as it is for the conduct of SEGOB<sup>152</sup>.

105. Without an extensive analysis of the national treatment obligation – Art. 1102 – I read the relevant jurisprudence – *Pope-Talbot v. Canada*, *Myers v Canada*, *Feldman v Mexico* and *Occidental v Ecuador* – as requiring the claimant to prove “likeness” and different treatment at least de-facto, with the burden of proof that such difference in treatment is either linked to legitimate policy objectives or

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<sup>151</sup> This is even more so as Guardia had publicly taunted SEGOB and had claimed political and religious (“Santa Rita”) protection to explain his success in running gambling operation – in dramatic contrast to Thunderbird which had taken the route of the “Oficio” assurance; Exhibit C-97, article from *Millenio*, August 18 of 2003 on Jose Maria Guardia, entitled: “Abriré mi casino con o sin ley” (I will open my casino with the law or without the law”. Guardia is described in this article as “Amigo de políticos PANISTAS” – i.e. as friend of “PAN” (the new government party) politicians.

<sup>152</sup> I concur with my colleagues that the allegations by Thunderbird do not rise, in their aggregate, to the serious and material due process breach that would qualify as a “denial of administrative justice”. But I remain troubled over the fact that it is not contested that the chief government lawyer, Alcantara, had an over 13 hours private discussion with one of the “Colegiado courts”, Witness Watson, 421, 422: “Mr Alcantara had arrived the day before the tribunal was to consider this matter, and had spent over 13 hours in locked, closed door session with the Colegiado of the Tribunal”. That may be acceptable practice in Mexico as I am advised, but it weakens the argument that discriminatory elements are not significant as the Mexican courts had cleared SEGOB’s conduct.

unrelated to the foreign nationality of the claimant going to defendant. I also read these persuasive precedents as suggesting that the best-placed major domestic competitor<sup>153</sup> has to be compared with the foreign investor. The fact that there may be other domestic competitors who are also not treated as favourably as the best domestic competitor does not detract from this approach. The reference to “most favourable treatment” in Art. 1102 (3) suggests that it is “the most favourable treatment” accorded to a domestic competitor, and not an “average treatment” or the “worst treatment afforded to a domestic competitor” that is the required benchmark. There is no defense of equally bad treatment for some, politically not favoured, domestic companies.

106. Treatment means the consolidated conduct by national authorities (including courts). I accept that discrimination requires a certain materiality and weight; it also requires that it can not be remedied rapidly and practically by an administrative or judicial appeal readily available<sup>154</sup>. It also does not involve a duty of “affirmative action” by the state to equalise all the informal handicaps which are inherent in the foreign origin of the investor nor does it require that bad luck and lack of litigation skill of the investor in judicial processes be automatically seen as a breach of national treatment. Nor do I see the Art. 1102 obligation to require a government to afford the same toleration to illegal operations just because it is foreign owned – such as supporting a foreign Mafia group just because a local police chief is in cahoots with a domestic Mafia group.

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<sup>153</sup> Note Loewen v. US, Final Award para. 14o: “What article 1102 (3) requires is a comparison between the standard of treatment accorded to a claimant and the most favourable treatment to a person in like situation to that claimants.”; OECD, MID-TERM REPORT ON THE 1976 DECLARATION AND DECISIONS Annex V (1982) AT P. 50; Unctad, National Treatment, 1999, p. 33; Myers v Canada, Partial Award, November 13, 2000, paras. 93, 112, 256; particularly in Pope & Talbot v. Canada, Interim Award, June 26, 2000, paras. 11, 24, 36, 38. The idea that one could use the example of badly treated domestic companies to justify discrimination between the best-treated domestic company and a foreign competitor is questionable; it could lead to a situation were some local companies are badly treated to avoid application of the NT standard. See: J. Kurtz, NATIONAL TREATMENT, FOREIGN INVESTMENT AND REGULATORY AUTONOMY, CONTRIBUTION TO HAGUE ACADEMY OF INTERNATIONAL LAW 2004 RESEARCH SEMINAR, FORTHCOMING IN 2006, P. 19/20.

<sup>154</sup> Paulsson, 2005, op. cit. supra

107. But we are not faced here with a criminal conduct, but rather an often legitimate gam(bl)ing service the legality of which depends on legal interpretations of the boundaries of the law; these boundaries are neither a thin line nor a bright line, but rather a fuzzy grey area. One can therefore identify government conduct (reinforced by court conduct) – by SEGOB in its enforcement intensity and focus – that leads to the result that the foreign investor who committed its investment after a reasonable comfort letter by the previous government suffers first, while the domestic investor who always played the card of legal confrontation continues to thrive. The most legitimate way to test the margins of a about 60 years old law bypassed by technology is surely to ask the government for an interpretation that takes into account emerging technologies and comparative regulatory practices. Why Thunderbird seems to have been penalised for this approach while the confrontational approach of the major domestic competitor is – 4 years later – still reaping rewards, has not been explained, neither by the government nor by the tribunal in its majority award. The reasons for this difference in result are hard to ascertain. It has to do with what happens within the “black box” of interface between government and domestic business people. But my conclusion is that we have at least a presumption of discriminatory and arbitrary elements in the SEGOB enforcement activity. That presumption has not been rebutted by a satisfactory explanation. Mexico has kept studiously silent on Guardia’s relationship with the government and the reason for his relative success with the courts. That such difference only emerges after a new government and a new SEGOB director have taken office reinforces the idea that SEGOB went after Thunderbird because it was seen to have reached a deal with the prior government.

108. The Mexican government could have cleared up such a presumption by producing the key players on its side: The Gobernacion Director General under whose authority the Oficio was executed; the SEGOB official who prepared and signed it; the SEGOB officials to

whom the “oficio” was copied to, Guadalupe Vargas who was the instrument of the reversal of policy with energetic targeting of Thunderbird. Nor did the respondent produce any member of the “Unidad de Gobierno” which, though left faceless and un-identified, ordered Lic Alcantara to focus on and go first after Thunderbird and which must bear responsibility for the relative ineffectiveness of enforcement against Guardia. Alcantara’s testimony on the first target of enforcement – Thunderbird – and on the location of the “command and control center” within Gobernacion indicates only one thing: That the unnamed powers in the “Unidad de Gobierno” had earmarked Thunderbird as the first and prioritised target. That the government did not produce any of these key players – both in the PRI and the subsequent PAN period - supports a not rebutted presumption that Thunderbird was singled out in enforcement. This is the same legal operation as was carried out by the Feldman v Mexico tribunal which found evidence, though never fully explained by Mexico, that the foreign investor was targeted by effective audit-based enforcement procedures, while the politically well connected and economically more powerful competitor was left alone<sup>155</sup>.

109. Accordingly, I find that a breach of the duty to respect investment-backed legitimate expectation under Art. 1105 of the NAFTA has taken place at the time when enforcement began against Thunderbird in 2001 without a similar enforcement effort displayed (on the evidence available and as determined by the operation of the presumption of discriminatory elements) against Guardia. The presumption that at least some discriminatory elements were present in the enforcement against Thunderbird strengthens the position of Thunderbird in the necessary balancing process between its investment-backed legitimate expectation and the equally legitimate acknowledgement of the need for governmental flexibility. Since it is in

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<sup>155</sup> The lack of enforcement resources was also considered not to excuse discrimination in *Gami v. Mexico*, para. 94; the issue here is not the relative weakness of enforcement in general, but the prioritising of the resources and energy that were available against the foreign – cooperative – rather than the domestic – confrontational – competitor.

the end the de-facto situation of different treatment that is compared – Guardia continues to operate from 2000 throughout 2004 at least – the presumption is that there is discrimination. Perhaps it is mere difference of relative luck and litigation skill (though that is not very probable), <sup>156</sup> perhaps Guardia was protected by higher government authorities and had a better way to persuade the courts. But that is not essential: With the evidence of a de-facto more favourable treatment of Guardia by the Mexican state (administration plus courts), Mexico has the burden of proof of explaining satisfactorily and justifying the available prima facie evidence of discrimination. I find the explanations not satisfactorily as there was no proof that enforcement was equally directed; Mexico did not present witnesses from its “Unidad de Gobierno”. Similarly, there was no satisfactory explanation why SEGOB singled out, after the change of government, Thunderbird rather than Guardia.

110. The acknowledgement of the legitimacy of government flexibility can not justify that Thunderbird was pursued with most vigour and priority when the dominant domestic competitor managed –

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<sup>156</sup> Note Ambassador Montano’s reference to Guardia’s very good informal relationship with government offices which squares with Prof Rose’s finding that a strong informal link is normally present when a local operator is tolerated and a foreign one closed down, see supra. It also squares with Lic Alcantara’s statement that he was “very keen “ to close down anybody contravening the law, but needed directions from higher authorities (“Unidad de Gobierno”) – from which nobody was presented by Mexico. These witness and expert statements are consistent with the references to Guardia’s close relationship with the Catholic Church (supporter of the ruling PAN party) and with PAN politicians in exhibit C 97 (Exhibit C-97’s journalistic information squares with references available by google search on Jose Maria Guardia (e.g. <http://www.revistavertigo.com/historico/27-9-2003/reportaje.html>; [http://raulrejo.tripod.com/SyPblogs02y03/2003\\_06\\_01\\_raulrejo\\_archive.html](http://raulrejo.tripod.com/SyPblogs02y03/2003_06_01_raulrejo_archive.html) ). These internet references to Mexican press reporting have not been entered into the arbitral record – except for the C-97 exhibit. Nevertheless, they provide publicly available information which needs to be used critically and cautiously – but in this case it merely confirms what the expert and witness statements from both sides already indicate and confirm. None of these statements and references have ever been contested by respondent. Accordingly, given the theoretical explanation (Rose), the reference (without proof) to close relationship of Guardia to influential politicians (Montano), the reference by Alcantara that the “shots were called from above” when it came to enforcement and the link made in Exhibit .. of Guardia to PAN politicians and to the PAN-supporting Catholic hierarchy, the prima facie evidence properly assessed leads to the presumption that Guardia was not effectively closed down because he was politically well connected and protected, and that possibly Thunderbird was closed down so rapidly in order to eliminate a competitor.



by whatever ways – to continue his operations throughout at least 2004 – though Thunderbird did and could rely on the positive signal from the then government in August 2001 followed by six months of toleration. SEGOB should have given Thunderbird a negotiated transition period to recoup its expenditures and relocate its operations and equipment within a reasonable period in 2001. The government of Mexico is not prevented, in case of a change of government, to change its interpretation of the law – from the view that the Gambling Law prohibited only machines which “predominantly involved chance” to one where there was some substantial involvement of chance in addition to skill; but such a change of interpretation can not override the legitimate expectation created by the earlier government, in particular if it was reasonable for the investor to have confidence in such expectation and if it was clear to the old and new government that the investor had carried out substantial investment because of the government-created expectation that the earlier, more liberal interpretation of the law would be respected. As Jan Paulsson has said:

“Surprising departures from settled patterns of reasoning or outcomes... must be viewed with the greatest scepticism if their effect is to disadvantage the foreigner”<sup>157</sup>.

Was Thunderbird’s legitimate expectation invalidated because of a presumption of corruption of SEGOB officials?

111. One issue has played an important, but not very visible role in the arbitration: The implications of the – uncontested – payment of a 300 000 \$ success fee to two Mexican lawyers – Aspe & Arroyo – for obtaining the August 15, 2000 “Oficio” from SEGOB. In principle, it is not exceptional that a success fee was paid for successful negotiations that produced a document that Thunderbird considered important for its investment process (including its relations with its financial backers). Both the Thunderbird CEO and Mexico’s expert Prof Rose

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<sup>157</sup> Op. cit, 2005, at p. 200

testified on the considerable economic value that a license, or a sub-license legal instrument has when it allows operation in a not generally open market. There was an insinuation – never maturing to a full-fledged assertion backed by substantiated facts and evidence – hinting the possibility of corruption. One can not exclude that this insinuation had some influence on the case. The role of the success fee and its implication for the existence or not of a “legitimate” expectation has therefore to be squarely addressed as it would undermine a fair hearing, if the issue were allowed to fester, but would not be made transparent and fully discussed. The tribunal notes (para 150), after an extensive discussion of the success fee arrangements, that “these facts do not have a bearing on the tribunal’s analysis below” and that it can “only interpret the 3 August 20000 Solicitud letter on its face value”. But the insinuation about the success fee arrangements hangs like a heavy dark cloud over the case. It is difficult to see how it can not have an effect on the analysis of in particular the “Oficio” which, as I have suggested earlier, can not be done purely “on its face value” as it is part and parcel and in the end the formal outcome of a prolonged interaction between both parties; an examination of this interaction only allows to place the “Oficio” properly in the context of the investor seeking a regulator’s clearance by a formal letter confirming a more liberal interpretation of the Gambling Law and the regulator’s accommodation of this request, albeit in a convoluted and ambiguous format “protecting its back”. Since I consider that attention must be paid to the context of the Oficio, that it can not be interpreted purely on its own as a free-floating document without history and purpose, I consider that the “success fee” story may have coloured the tribunal’s award. For this reason, the success fee story and its possible implications for the legal effect of the “Oficio” in creating a legitimate expectation has to be faced head on – rather than be developed in detail, then hang ominously over the legitimate expectation claim, but finally be dismissed as formally irrelevant and as such no longer a suitable object for a proper examination.

112. First, there is no doubt that the use of illicit practices such as direct or indirect bribery of government officials would be a reason to invalidate any legal effect of the "Oficio", as indeed the legitimacy of Thunderbird's claim as such. There is ample jurisprudence that a legitimate expectation protected by Art. 1105 of the NAFTA can not be created if deception, fraud or other illicit means were used to obtain the governmental assurance or other rights obtained from the government in this way<sup>158</sup>. There can be no international treaty protection for rights obtained by illicit means. In such cases, there may be an expectation, but not a "legitimate" one. It is generally very difficult to prove bribery as there is usually little if any paper trail. However, arbitral tribunals and courts, in particularly of more recent date and under the influence of the authoritative international conventions (mainly, but not exclusively the OECD anti-bribery convention) have been ready to use presumptions rather than full-fledged and hard to obtain full evidence. If a transaction creates enough suspicion so that – in the practice of the US Foreign Corrupt Practices Act – a "red flag" should show up on the face of the transaction, it is sufficient to require the party in control of such a transaction to prove that it was contrary to "red flag" indicators a proper one<sup>159</sup>. Note again the Methanex v. US award:

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<sup>158</sup> Schonberg, 126; Mairal p. 77; See MFM Underwriting, 1 WLR 1595 (1990); Matrix Securities, 1 WLR 334 (1994) with a reference to "placing all cards face up on the table" and disclose all relevant circumstances.

<sup>159</sup> See Abdulhay Sayed, Corruption in International Trade and Commercial Arbitration 2003; A. Crivellaro, Arbitration case law on bribery, Dossiers of the ICC Institute of World Business Law, 109; several ICC awards published in: YCA 1999, 7-79, p. 72; ICC case 5622, YCA 1994, 1994, p. 107; ICC Case No. 6497, YCA 1999, 7-79; Frontier AG v Thompson CSF, ICC Case NO 7664, in: Herve Gattegno, l'affaire Dumas, Paris 1998; referred to: Arbitration International, 1999, 329, 332; ICC Case 8891; ICC case NO. 8694/1996; Fadlallah, Les instrument de l'illicite, in: L'illicite dans le commerce international, 291-298 (published by CREDIMI, Dijon, Eds Kahn & Kessedjian, 1996); I note the most recent work in the field by Richard Kreindler, Strafrechtsrelevante und andere anstossige Vertraege als Gegenstand von Schiedsverfahren (Contracts with criminal law implications and other problematic contracts as object of arbitration), Frankfurt, 2005 – based on Dr Kreindler's earlier articles on the subject in English (available partly on TDM – [www.transnational-dispute-management.com](http://www.transnational-dispute-management.com))

“The tribunal is not averse to trying to “connect the dots” as a way of testing Methanex’s hypothesis”, and: “inference is an appropriate mode of decision in circumstances in which firmer evidence is not available” (Part III, B, para. 57)

113. But in this dispute, respondent has hinted, insinuated, focused in cross-examination on the role of the two lawyer-lobbyists Aspe and Arroyo, raised and queries the payment modalities of the success fee (a transfer made from Mexico to an account in the US), but it has never explicitly and properly asserted and tried to substantiate that the success fee had been an instrument of bribery or that at least it indicated – as a “red flag” – a suspicion of bribery of SEGOB officials. Neither Mexico nor Thunderbird have made the key players – Msrs Orozco Aceves (Director General de Gobierno); Martinez Ortiz; Antunano – the signatory of the “Oficio”, Guadalupe Vargas, the successor director of SEGOB, the members of the “Unidad de Gobierno” which decided on enforcement priorities nor lawyers Aspe & Arroyo, available. I have advocated throughout this procedure for pressure under the – limited – powers of the tribunal to make them appear, but in the end the insinuation remained what it was – an insinuation without substantiation and without being available for proper and full testing before the tribunal. The tribunal therefore should, in my view, have drawn inferences from this failure of Mexico to produce these key witnesses and officials – I follow here the as mostly very persuasive view of the late F.A. Mann, one of the past masters of international investment law<sup>160</sup>.

114. In this situation, as always when we are faced with a “black box” in which relevant events occur but which we do not see, tribunals have to work with a system of presumptions and tests of plausibility. It is

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<sup>160</sup> F.A. Mann, *Foreign Investment in the International Court of Justice: The ELSI case*, 86 *AJIL* (1992), 92, pp. 94 and 99 – criticising the ICJ chamber in the ELSI case for not drawing inferences from the failure of Italy to present as witnesses the key officials involved in the ELSI affair.

theoretically not impossible that the success fee and the work of the two lawyer-lobbyists Aspe & Arroyo had to do with illicit influencing of public officials. Similarly there is testimony by Mexico's expert Prof Rose on the great economic value and natural attractiveness that lies in collusion between a domestic gambling operator and the national gambling regulator to foreclose the operation of a foreign competitor:<sup>161</sup>

"If they have closed one down and don't close down a competitor who is very public, then there is the possibility, very strong possibility of bribes".

115. One can infer therefore, the possibility that the energetic closure action against Thunderbird after Mr Guadalupe Vargas took office (without a commensurate enforcement energy and result against Guardia) might involve an underlying Guardia/SEGOB alliance<sup>162</sup>. But both these theories are conjecture rather than proven fact. Having worked in investment negotiations in developing and transition countries for over 30 years, I have rarely encountered a deal that was not surrounded by corruption gossip. Relying on gossip – as plausible as it may appear in particular in conspiratorial explanation models – is never a professional way to proceed in such matters.

116. A legitimate interpretation of the events in 2000 is equally plausible<sup>163</sup>: The outgoing government did consider liberalisation of

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<sup>161</sup> P. 806

<sup>162</sup> This issue is raised: Montano, p. 152, 153; the witness had no proof – such proof is usually hidden in the black box, but Prof Rose's analysis provides a possible explanation. Respondent has never as far as I can read the record explicitly rejected the theory that there was an informal alliance between SEGOB director Guadalupe Vargas and Mexican competitor Guardia.

<sup>163</sup> One can find support for this approach in the *Methanex v. US* award (supra) where the tribunal, when faced with the accusation of political corruption of California governor Davis based on evidence of a 300 000+ \$ political contribution and a special meeting (the governor was flown at quite a distance for a private meeting with Archer Daniels senior executives (i.e. Methanex' US competitor) gave credence to the testimony of the (Archer Daniels employed or contracted) participants in this meeting about the "innocence" of the meeting, while finding that the regulatory process characterised by a normal course of legislation and transparency suggested the incriminated regulation was – or could easily – be justified as a normal outcome

gambling. Prof Rose, for Mexico, alluded to the window of opportunity that was open for a short while in 2000. The Mexican Congress had commissioned a study which, subsequently, in 2002 indicated the benefits of bringing the gambling industry back to Mexico. Senior politician and presidential hopeful Francisco Labastida had – as is uncontested – raised and supported the idea of “stealth liberalisation” through an interpretative assurance. Thunderbird’s uncontested narrative of government contacts indicates that SEGOB officials were appreciative of Thunderbird’s willingness to engage rather, as Guardia, confront the government. The sudden emergence of the “predominantly either skill – then yes, or predominantly chance, then no” - criterium in the “Oficio” of August 2000 attests that the criteria used for liberalising gambling regulation in other jurisdictions had come to the attention of SEGOB and found favour with its senior officials. That success fees or “lump sum payments” are paid for lobbyists (often lawyers) for achieving results – rather than just letting them maximise billable hours – is not unusual and not in industries where government licensing – by way of formal concessions or less formal interpretative comfort letters – is of great value. Dealing with governments, including, but not only, developing countries is always a difficult matter, particularly for foreign investors. It is likely to be rare to find a case where local lobbyists – “government relations experts” – do not have to be employed. They come with risks, but their involvement is in practice inevitable.

117. But what must ultimately decide this issue is that Mexico has the burden of proof – even if such burden can be discharged in an easier way by evidence of sufficient “red flag indicators”. Mexico is responsible for the very formal conduct of its officials; there is the presumption of the validity, legitimacy and effectiveness of the Oficio of August 2000. Insinuating corruption but not submitting it for proper

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of the California regulatory process to accommodate environmental and related citizens’ concerns. In other words, the Methanex tribunal built a high threshold of proof for corruption allegations and allowed any possible prima facie evidence to be rebutted by showing that there was a perfectly reasonable explanation for the incriminated regulatory outcome.

testing in legal combat is not an instrument that tribunals should pay any attention to, directly or indirectly, explicitly or implicitly. To quote the recent *Methanex v US* award in the context of examining the prospect of inferring conduct for which indicator “dots” might be available, but not the proof of the full story:

“therefore, to establish undue influence, Methanex would, at least, have to be in a position to allege if not also to demonstrate that a legal violation took place” (part III, Chapter B, para 22)

The Methanex tribunal was not impressed with the claim for improper behaviour on the part of the regulating state, though the assertions and facts in Methanex were stronger than the hints and innuendo in Thunderbird. As in Methanex, there was a reasonable explanation for the context and underlying policy of SEGOB under the earlier government to test and marginally expand the boundaries of the gambling law embodied in the *Oficio*. As a result, the Thunderbird allegations should deserve even less consideration than similar, but factually much more substantiated, allegations in the Methanex case.

118. Mexico, however, has not put forward any substantiated assertion or evidence; it has refrained from putting forward the main witnesses under its control, that is the SEGOB officials past and present. Thunderbird has equally refrained from putting forward Aspe & Arroyo, over which it presumably has less control than Mexico over its own officials. But the issue of bribery affecting the *Oficio* is something that Mexico has to prove, while Thunderbird only has to come forward with counter-evidence once Mexico has provided prima facie evidence of at least “red flag signals”. Insinuation without the readiness to come forward and have a substantiated allegation properly debated and tested before the tribunal is a poisonous way to conduct litigation. It has become more and more frequent in investment arbitration as both claimants and defendants raise such hints, without being ready to submit them to a full and fair trial. Tribunals should actively discourage

this tactic and ensure it plays no role, directly or indirectly, in their deliberation. For these reasons, I see in the light of the evidence available and the defense made by the respondent no reason to question the validity of the legitimate expectation created by the “Oficio” in combination with SEGOB’s subsequent conduct and sudden reversal once new powers took over. If Mexico had wished to question the legitimacy of the expectation created, it should have openly and directly, with substantiated assertions and proper evidence – mainly making its own officials in SEGOB (including the higher-level SEGOB officials which directed its enforcement efforts above Lic Alcantara and which issued the Oficio) available for testimony and cross-examination before the tribunal<sup>164</sup>.

### Compensation

119. Since the majority of the tribunal rejected all claims by Thunderbird, I do not need to get into the details of how compensation should have been calculated. But I can provide an outline. I concur largely with Mexico’s back-up argument that at most “reliance damages”, that is damages which were directly and reasonably caused by reliance of Thunderbird on the “Oficio”, later confirmed by SEGOB toleration, are owed. It is widely recognised that a “legitimate expectation” can only then lead to compensation if there was “detrimental reliance”, i.e. a link between the expectation and investment made – a principle which in American takings law has led to the notion of “investment-backed expectations”<sup>165</sup>. That detrimental reliance must also be a “reasonable” one (see *Waste Management II v. Mexico*, supra). For a normal business person

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<sup>164</sup> See here the Turkish-Greek Mixed Tribunal, *Megalidis v Turkey*, of 26 July 1928 which uses the method of inference in case of a respondent state which was unwilling to produce evidence under its control relying on the maxim “*omnia presumuntur contra spoliatorem*”. The tribunal inferred that the claimant’s factual assertions were correct; these could have been rebutted by Turkey if it had made the evidence under its control available.

<sup>165</sup> *Pennsylvania Coal v Mahon*, 260 US 393 (1972) – discussed in more detail in my article with Dr Abba Kolo:, *Environmental Regulation, Investment Protection and regulatory taking in international Law* 50 ICLQ 811-848 (2001)



engaged in foreign investment in Mexico, the “Oficio” and the subsequent conduct by SEGOB must have allowed the conclusion that the government was ready to accept the operation of the gaming machines envisaged – something which not only the Oficio, but also other factors (the high-level encouragement of Thunderbird, the discussion about liberalisation of an obsolete gambling law) supported.

120. The fact that the “Oficio” may have been only one of the various factors in its investment process is not an objection. Business decisions are usually made on the basis of several significant reasons and a single, causative relationship between one key factor – the Oficio – and the overall subsequent conduct by the investor is hard to establish. There is enough evidence that the interpretative assurance by SEGOB was an important factor for Thunderbird for opening the facilities which were already more or less ready and for adding new facilities. There was credible evidence by the CEO of Thunderbird, Jack Mitchell, by P. Watson, the business development consultant and by other credible references to the importance attached to this “comfort letter” by the financial backers. Plus, the payment of the success fee itself indicated that the comfort letter was for Thunderbird a matter of great significance. If the “Oficio” had not been very important for Thunderbird’s investment process as the majority award (para 164) suggests, why did then Thunderbird pay instantly the not insignificant amount of 300 000 \$ to those who helped to arrange it?<sup>166</sup>

121. Thunderbird’s position is that compensation were owed (estimated at over 100 M US \$) as if its operations had been well established, were likely to run at a high rate of profitability unencumbered by future competition or regulatory measures and should be compensated on the basis of projecting an initial measure of profitability, after disregarding initial start-up costs, into a long-term future. That,

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<sup>166</sup> Witness Mitchell, , 234, 235; 279, 280-285. The conditions of the success fee commitment letter spelled out that the fee was only payable if there was “no opposition or limitation to our operations”. Business logic and this in so far credible testimony dictate that Thunderbird did not commit and pay the 300 000 US \$ for nothing, but because it was important for increasing the legal certainty of its operations, at least in the eyes of its private investors.

however, is not a legally viable proposition: First, that would equate a “legitimate expectation” with a firm, long-term concession contract. But a legitimate expectation under Art. 1105 of the NAFTA is a much weaker legal position than a long-term concession contract. As all precedents show, governments retain flexibility to reverse a legitimate expectation in a reasonable way with transitional measures. A comfort letter may create a legally protected legitimate expectation even if it is not crystal-clear; but it is by far not the equal of a proper long-term concession contract. Even if we had a long-term, legally valid concession contract, one would have to take into account that the initial high profitability stemming from a successful start-up operation of a newcomer in a hitherto largely closed market is likely to give way as other competitors move in and thus, in the normal process of economic logic, depress the profitability. In cases of legitimate expectation (detrimental reliance), at most the government owes the investor the “negative interest”, i.e. the expenditure the investor has undertaken with confidence in the reliability of the government position communicated. But it does not give a claim to the “positive interest”, i.e. to be placed into a situation as if the government had committed in the form of a valid long-term concession contract.

122. The claimant can only reasonably be assumed to have relied on the “Oficio” from about August 2000 to February 2001 when the first dark clouds started to cover the sky over Thunderbird. By then, it had received a warning, could have easily appreciated the weakness of its legal and political decision in light of the ambiguities of the “Oficio” and the entry into power of a new government. By February 2001, it can no longer be assumed to have continued to invest in full confidence in SEGOB’s comfort letter. By October 2001, it was clear that there was a serious problem and the wise course of action would have been to stop operations and take the machines out of Mexico. The relevant expenditures incurred in direct detrimental reliance are therefore quite modest. They can also not include the 300 000 \$ success fee which was not an investment after and because of the “comfort letter”, but rather a payment to the lawyer-lobbyists for getting the comfort letter.

Finally, in line with Art. 39 of the ILC Articles on State Responsibility and the MTD v Chile tribunal (paras 240-243), the absence of a rigorous due diligence<sup>167</sup> in terms of ambiguous qualification of the machines in its “Solicitud”<sup>168</sup> and the unquestioned reliance on the “Oficio” in spite of its manifold obfuscations and ambiguities, should lead to a reduction of the compensation due under the concept of mitigation of damage and contributory negligence. While I do not have at this stage to calculate the hypothetical compensation in detail as the tribunal has rejected the claim, I would not have advocated a compensation award exceeding 500 000 \$.

123. To sum up: The award I have advocated would have provided a fair and equitable solution. Neither would it have produced exorbitant damages likely to undermine the acceptance of the investment arbitration regime nor would it have let Mexico – which played contradictory games with Thunderbird – come out of the arbitration without a good-governance signal: To be more careful with official assurances to investors<sup>169</sup> and to be more respectful of the expectation created with such assurances even in the context of a change of government, senior staff and policy direction<sup>169</sup>. This is not a zero-sum issue: If Mexico’s official declarations and assurances are given legal effect by way of application of the legitimate expectations concept under Art. 1105 of the NAFTA, Mexico can enhance the credibility and effectiveness of its policy tools to encourage foreign investment. To deny such effect is to reduce the effectiveness of instruments available to governments required to micro-manage an investment promotion policy in relation with specific investors. To Thunderbird and other entrepreneurial companies in a similar situation,

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<sup>167</sup> This was also the approach of MTD v Chile, paras. 242, 243; ; Mairal, 159-160

<sup>168</sup> Where sometimes reference is made to “involving skill” and sometimes to the “non-implication of chance”.

<sup>169</sup> The authoritative Encyclopaedia of Public International Law – on “good faith”, p. 601 by A. D’Amato – notes in this respect: “Nations must be more careful than ever before of what they say because they may be held to it. This expanded role for the concept of good faith indeed appears to be consistent with its roots in a natural law conception of international law. Nations ought to be able to rely upon the pronouncement of other nations, as well as to have their own declarations taken seriously and with the expectation of legal enforceability”. See also at p. 525 on the similar principle of “estoppel”.

the award would also have sent a due-diligence and good-governance signal as well: To be more careful with ambiguously drafted government assurances, with local lobbyists promising to control government conduct and to phase investment more prudently in alignment with the degree of legal assurance received – and not to make exorbitant damage claims with no legal foundation. Both parties should, in my view, have settled the matter much earlier, in the sense of a negotiated “velvet exit” of Thunderbird from Mexico and not in the style of an abrupt expulsion of the investor out of Mexico.

### Costs

124. The tribunal orders the claimant to pay  $\frac{3}{4}$  of the arbitration cost and to pay to Mexico  $\frac{3}{4}$  of the costs of Mexico’s own legal expenditures. It applies therefore the principle of “**costs follow the event**” to attorney costs. Such a practice is relatively frequent in civil-law litigation, less so in international commercial arbitration, but mostly with considerable limitations and judicial and tribunal competence to reduce such costs<sup>170</sup>. It is not at all practice in North American litigation and arbitration; some US courts have prohibited awards of attorney fees in arbitration<sup>171</sup>. “Fee shifting” is as a rule only allowed in case of misconduct – contempt of court, incompetent

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<sup>170</sup> Note the Himpurna tribunal’s consideration of the cost issue which suggests that also in civil law countries – such as Indonesia – cost of legal representation are in practice rarely awarded in significant amounts.

<sup>171</sup> Most recent and extensive analysis: J. Gotanda, Chapter 3 (Attorneys Fees & Costs) in: *Damages in Private International Law*, Preliminary Draft for 2006 Hague Academy Lecture, at page 19 and notes 85-89. See the UNIDROIT and American Law Institute draft principles and rules on transnational civil procedure (2002), at para 32:

32.3: “the prevailing party must ordinarily be reimbursed its reasonable costs and expenses from the losing party”

32.5:” the courts may reduce or preclude reimbursement against a losing party that had a reasonable factual and legal basis for its position.”- The Commentary says: “Under the American rule, each party bears its own costs and expenses, including its attorneys’ fees”. It seems that in Mexico itself, under its civil procedural code, the principle is as in civil countries – costs follow the event (Art. 7), but this is reportedly tempered by the fact that judges often (mostly?) apply their discretion under Art. 8 to allocate the costs of legal representation to each party. Communication received from a Mexican colleague.

or unacceptable litigation conduct, bad faith in arbitration or frivolous claims”<sup>172</sup>.

125. One of the US federal judges most respected for an understanding of economic analysis recently ruled that in international sales the loss claimed under Art. 74 CISG did not include attorney fees<sup>173</sup>. The Uncitral rules – Art. 40 – constitute a compromise between the “European” and the “American rule”<sup>174</sup> by establishing a slight (but not mandatory) preference for the “costs follow the event” rule for the arbitration cost, but leave it in the tribunal’s discretion to allocate the costs of legal representation (Art. 40 (1) and (2)). I can not follow the tribunal’s position (paras 213) that the Uncitral rules prefer that the losing investor pays to the prevailing government legal representation (“attorney”) costs: Section (1) of Art. 40 of the Uncitral rules prefers (without obligation) the “loser pays” principle for arbitration costs, but then, in section 2, different and distinct from section (1) leaves it fully open to the tribunal how to allocate legal representation (“attorney”) costs<sup>175</sup>. The distinction between Art. 40 (1) and Art. 40 (2) can not be simply explained as giving “larger discretion” (a term that is hard to appreciate – what is the difference between “discretion” and “larger discretion”?). It must mean something sensible. The only explanation is – in accordance with *Myers v Canada*<sup>176</sup> - that the limited preference for the “European Rule” for arbitration costs in Art. 40 (1) is omitted in favour of complete neutrality between the European and American rules with respect to “attorney costs” in Art. 40 (2). If it were otherwise, the distinction between arbitration costs (Art. 40 (1) and legal representation costs (Art. 40 (2) would not have been necessary. It is true that according to Art. 1135 the tribunal is empowered to award cost and that reference is made to applicable arbitration rules –

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<sup>172</sup> *Widell v Wolf*, 43 F3rd 1150 (7<sup>th</sup> Cir 1994); *Gotanda*, p. 20, notes 90-94.

<sup>173</sup> Judge Posner, *Zapata Hermanos v Hearthside Baking*, 313 F3rd 385 (7<sup>th</sup> Cir. 2002)

<sup>174</sup> I also understand that China and Japan do not follow the “costs follow the event” principle, see *Unidroit/ALI commentary*

<sup>175</sup> Art. 40 (1) : “the costs of arbitration shall in principle be borne by the unsuccessful party. However...” – Art. 40 (2), in contrast, says “with respect to the costs of legal representation... the arbitral tribunal... shall be free to determine which party shall bear such costs”.

<sup>176</sup> *Myers v Canada*, final award, paras 11, 12, 34.

including Art. 40 (2) UNCITRAL rules. But I suggest that a tribunal has to exercise its discretion under Art. 40 (2) of the UNCITRAL rules in conformity with well established standard practice; it is well established in administrative law that discretion is not unfettered and arbitrary, but needs to be exercised in line with established principles and practice. What is “appropriate and reasonable in the circumstances” (para 216) does not confer arbitrary discretion on the tribunal in its cost decision, but only discretion within the boundaries of established jurisprudence. That jurisprudence has developed the principle that legal representation costs can only be awarded in case of spurious claims or bad-faith litigation tactics.

126. The tribunal’s decision to order the losing investor-claimant to pay most of the costs of legal representation of the winning state respondent is a significant departure from established jurisprudence by all previous NAFTA tribunals and by most, if not virtually all other BIT-based ICSID cases. It is not required as a measure of damages; the distinction of the award of attorney costs for investor-claimants and not for respondent governments that can sometimes be observe, can be advocated on the basis of this concept: Only – successful – claimants can reasonably argue that attorney costs form part of their damages claim; respondent governments can only argue procedural law principles. It is not required by the Uncitral rules which are relied upon in investment arbitration to provide a standard set of procedural rules; reference to them was not intended to import the “European rule” to investment arbitration under the NAFTA nor does their specific language (Art. 40 (2) require application of the “European rule”. Since Art. 40 (2) of the Uncitral rules provides for arbitral discretion, such discretion must, I propose, be exercised in harmony with the well developed jurisprudence of, first, the NAFTA tribunals and, second, other ICSID-based BIT awards<sup>177</sup>. I am therefore bound to disagree with the tribunal’s departure from well established jurisprudence. Should an investment tribunal operating under a treaty decide to

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<sup>177</sup> Investment disputes resolved under European arbitration institutions rather follow the “European principle” of cost shifting.

diverge from well established jurisprudence, it should provide in detail and depth the why such deviation should be exceptionally justified. It is also my view that such deviation should be the subject of a proper hearing (orally or in writing) for both parties and based on extensive, in-depth reasoning to establish the compelling need for such an exceptional approach.

127. There are three recent and relevant surveys of the cost decisions: M. Buehler, in a survey that is focused on international commercial arbitration – not investment arbitration – concludes that in “mixed arbitration (meaning investor-state), too, the loser-pays rule seems to be the exception rather than the rule”. “In most cases, the tribunals simply ordered each party to bear half of the procedural costs and left the parties’ costs where they fell.” “Waste Management v. Mexico seems to be the only case where the private party was ordered to bear the procedural costs because it lost its case (nonetheless, legal costs were not allocated”<sup>178</sup>. – The survey of N. Rubins<sup>179</sup> focusing on investment arbitration notes that :

“awards of costs or legal fees against unsuccessful claimants in investment arbitration cases appear to be exceedingly rare” and that “investment arbitration tribunals have examined the issue on a case-by-case basis, more often than not dividing the arbitration costs equally between the parties, and, more frequently yet, ordering each party to bear its own legal fees”.

The most recent and exhaustive survey by Professor Gotanda finds that:

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<sup>178</sup> M. Buehler, Awarding Costs in international commercial arbitration: an Overview, in: 22 ASA Bulletin 2/2004 at p. 261

<sup>179</sup> The Allocation of Costs and Attorney's Fees in Investor-State Arbitration, ICSID Review - Foreign Investment Law Journal, Volume 18 Number 1, Spring 2003, p. 109

“One trend that has developed is the tribunals’ hesitation in awarding attorneys fees against a private party under the ICSID rules. Where there is case law awarding attorneys’ fees against a losing government party, there is a noticeable lack of cases where tribunals order a losing private party to bear the winning party’s cost of representation. Even where the private party’s claim or defense fails in its entirety tribunals have opted not to award attorneys’ fees and split the costs of the proceeding between the two parties”<sup>180</sup>.

A most recent survey on “ICSID Arbitration Awards and Cost”<sup>181</sup> finds, on a survey of 14 awards:

“The fourteen arbitration decisions reviewed indicate that, with few exceptions, the tribunals generally allocate one half of the arbitration costs to each party. In addition, the tribunals generally hold each party responsible for their own representation costs”.

And it concludes that only “reckless” or “bad faith” claims have led to claimant responsibility for respondent’s representation costs:<sup>182</sup>

“Unless there is a significant error, inconvenience of unreasonable action on the part of one party, it is most likely that each party will bear half of the arbitration costs and their own respective representation cost”.

128. Since this tribunal is departing from general practice, unanimously identified by all recent commentators, the issue requires closer

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<sup>180</sup> Gotanda, 2005, p. 41, notes 191-192 with reference to SPP v Egypt; Maritime Intl Nominees v Guinea; Benevenuti and Bonfant v Congo; Olguin v Paraguay;

<sup>181</sup> Wilson, Cain and & Gray, in TDM 2005 ([www.transnational-dispute-management.com](http://www.transnational-dispute-management.com)) at p. 15-18

<sup>182</sup> In the supplementary decision requested by claimant in Alex Genin v Estonia, claimant was ordered to pay also the respondent’s legal representation costs – a case that reinforces the view that standard practice is to award legal representation costs to losing claimant only in case of frivolous claims or bad-faith litigation.



analysis, both in terms of precedential cases (“how exceedingly rare is this tribunal’s approach”?) and in terms of the particular criteria that might, exceptionally and in specific cases, justify the U-turn as made by this tribunal. Before I do this, an observation is called for on the significance of precedent in international investment arbitration. The difference of the role of precedent in commercial arbitration from its role in international investment arbitration may explain why the tribunal made its unusual cost decision, without giving the parties the chance to comment on this departure, and without detailed reasoning to justify its departure. In commercial arbitration, there is no formal and very limited practical “persuasive” precedent. The reason is simply that most awards are still confidential; only a few are published or made public in sanitised form. The award is in the main an explanation to the parties of the reasoning of the tribunal, and there is no requirement or expectation of transparency, including its consequence of respect for established jurisprudence or the need to explain a significant deviation from well-established principles. Similarly, commercial arbitration as a rule applies specific rules of contracts; investment arbitration, on the other hand, applies treaty provisions that are general; in their investment protection core content, the investment treaties (with the equivalent of the multilateral treaties now well over 3500) express common principles and very similar, often identical language<sup>183</sup>. Every interpretation that is public is likely to exercise a general effect and will be taken up by counsel and tribunals in subsequent cases.

129. But that is different in investment arbitration: It is not two equal parties who agreed specifically to submit a dispute to confidential resolution, but it is the investor only which raises a matter usually involving public policy and administrative misconduct (as measured under a treaty’s obligations) against the host state. Investment arbitration is in substance a special form of international quasi-judicial review of governmental conduct using as a default the methods of

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<sup>183</sup> Philippe Kahn, Report of the French Section of the Hague Academy Research Seminar on international investment law, 2006, forthcoming;

commercial arbitration<sup>184</sup>. Following criticism for alleged “secrecy” (i.e. confidentiality in commercial arbitration language), awards are increasingly made public and debated – this is the now uniform practice in NAFTA Chapter XI arbitration and increasingly also so in ICSID cases, with all indicators pointing towards greater transparency. As a result of this primarily international and public-law character of investment arbitration, with transparency and public debate, the principles and practices of international law with respect to precedent become more relevant compared to the almost non-existent and at most illustrative character of precedent in commercial arbitration. That difference still needs to be appreciated<sup>185</sup>. In international and international economic law – to which investment arbitration properly belongs – there may not be a formal “stare decisis” rule as in common law countries, but precedent plays an important role. Tribunals and courts may disagree and are at full liberty to deviate from specific awards, but it is hard to maintain that they can and should not respect well-established jurisprudence. WTO, ICJ and in particular investment treaty jurisprudence shows the importance to tribunals of not “confronting” established case law by divergent opinion – except if it is possible to clearly distinguish and justify in-depth such divergence. The role of precedent has been recognised de facto in the reasoning style of tribunals, but can also be formally inferred from Art. 1131 (1) of the NAFTA – which calls for application of the “applicable rules of international law”; these include, according to Art. 38 of the statute of the International Court of Justice : “International custom, as evidence of general practice accepted as law” and “judicial decisions” as “subsidiary means for the determination of rules of law”.

130. In consequence, it appears to me that at the very least that, if a tribunal wishes in a significant question, to adopt a novel philosophy that diverges from well established principles is under an obligation to

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<sup>184</sup> Also Gaillard, *Jurisprudence du CIRDI*, 2004, at p. 7; further references see supra (including *SGS v Philippines* at para. 97).

<sup>185</sup> *Brower-Brueschke, the Iran-US Claims Tribunal*, 1998, 655; Gaillard, *op.cit. supra*; P. Norton, *op.cit. supra*

provide the parties with an opportunity of a full debate – such as calling for a “separate argument on the allocation of fees and expenses after rendering a decision on the merits”<sup>186</sup> – and to provide extensive reasoning which shows that the tribunal is both familiar with established jurisprudence and is prepared to justify its departure from such jurisprudence with in-depth reasoning. While the parties have both claimed all relevant costs, one should assume that they expected and assumed reasonably that the tribunal would follow general NAFTA and ICSID practice with respect to the attorney cost issue. If the tribunal wishes to diverge, it should give the parties the opportunity of a full hearing, at least in writing, to focus on this issue.

131. Arguably, in the context of NAFTA jurisprudence it is not proper at all for any tribunal – whatever their “depth of reasoning” and regardless of whether full hearing was afforded to the parties on the point of divergence – to diverge in a significant way, as this tribunal does here; for such purposes the NAFTA has set up the intergovernmental NAFTA Free Trade Commission (Art. 2001); in cases of similar significance this Commission has provided an authoritative guideline<sup>187</sup>.

132. A review of publicly accessible prior NAFTA awards indicates that there is no precedent for ordering a losing claimant to pay the legal expenses of government except in the case of spurious claims or bad-faith litigation. *Waste Management v. Mexico*<sup>188</sup> is often seen as an exception in so far as the claimant was ordered to pay the cost of the arbitration – but it was not ordered to pay the legal expenses of the respondent. In *Azinian v. Mexico*, in spite of finding fraudulent conduct

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<sup>186</sup> N. Rubins, *op. cit.* 120; *Pope-Talbot v Canada*, Award in respect of Damages, May 31, 2002, para 92; *Waste Management v Mexico*, Decision on Mexico’s preliminary objections concerning the previous proceedings, June 26, 2002, paras. 52-53 – reserving to “a later stage questions relating to the costs and expenses of the present phase of the proceedings”.

<sup>187</sup> Such as the Interpretation made on July 31, 2001; on its implications: *Pope-Talbot*, Award on Damages, 31 May 2002, at paras. 8-67;

<sup>188</sup> *Waste Management v. Mexico I*, Decision on Jurisdiction, ICSID Case No. ARB (AF/98/2) of June 2, 2000; rendered by a majority of the tribunal. The case dealt with non-compliance by Waste Management of procedural requirements for a NAFTA claim under Art. 1121 (2)(b).

with respect to the contracting out of a municipal concession contract, the tribunal split the costs of the arbitration, with each party bearing its own legal expenses. It argued among others that the “novelty of the issues” and professional conduct by counsel as reasons for its cost allocation in a case that might be seen as a “spurious” or “frivolous” claim by a company that did not measure up to a reasonable standard of integrity and competence<sup>189</sup>.

133. In order to seek justifications for the tribunal’s cost award, we need therefore to seek out the few cases where an award of legal expenses against the losing claimant was – at least to some extent – determined or mentioned: There has been up to now almost no ICSID case<sup>190</sup> where losing claimant had to pay respondent government’s cost. In some cases, the legal costs of the claimant had to be paid by the respondent government, taking into account relative success, efficient conduct and the principle of full compensation of investor damages suffered<sup>191</sup>. In the Myers case<sup>192</sup>, the government of Canada pointed out explicitly that it was NAFTA chapter XI practice not to award legal representation costs. The tribunal itself held that “

“Some arbitral tribunals are reluctant to order the losing party to pay the winner’s representation costs, unless the winner has prevailed over a manifestly spurious or unmeritorious position taken by the loser”. (para. 33)

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<sup>189</sup> Para 125: “The claim has failed in its entirety. The Respondent has been put to considerable inconvenience. In ordinary circumstances it is common in international arbitral proceedings that a losing claimant is ordered to bear the costs of the arbitration, as well as to contribute to the prevailing respondent’s reasonable costs of representation.” I suggest that while the tribunal did not as yet identify explicitly appreciate the differences between private-commercial arbitration and public-investment arbitration, it did so intuitively (and correctly).

<sup>190</sup> I discuss the Methanex v US award rendered after the main text of this opinion was prepared later.

<sup>191</sup> C Schreuer, The ICSID Convention, p. 1226, para 21, 22 with a discussion of special features of the MINE v Guinea case; the principle was also that each party had to bear, irrespective of losing or winning, its own legal expenses.

<sup>192</sup> 30 December 2002 Decision on costs, para. 48, available at [www.naftaclaims.com](http://www.naftaclaims.com); see also dissenting opinion by arbitrator B. Schwartz

134. Even in long-term concession contract cases resembling investment disputes, the practice is rather to let each party bear its legal costs, even if the losing respondent has to bear 100% of the tribunal costs<sup>193</sup>. In other recent cases (e.g. *Noble v Romania*), the “Arbitral Tribunal deems it fair and reasonable that the cost burden be shared equally between the parties, each bearing its own legal and other expenses and 50% of the arbitration costs” (para 236) though “all the claims ultimately failed” (para. 235).

135. Dr Benhamida, in a recent publication in TDM<sup>194</sup>, reviewed about 26 NAFTA and ICSID decisions rendered against the investor in favour of the state. In 19 of these cases, the tribunals decided that every party has to bear its own legal representation costs and to share the arbitration expenditures (tribunal, supporting institution). In all others where the tribunal awarded the winning respondent all or part of legal representation costs an element of either spurious claim or bad-faith litigation tactic was present. In *Soufraki v. UAE* (not a NAFTA case), the tribunal ordered the claimant to bear 2/3s of the arbitration cost – but each party to assume its litigation expenses. The only possibly relevant investment awards we have been able to identify<sup>195</sup> outside the context of the NAFTA and outside the context of arbitration rules mandating the “costs follow events rule” (e.g. Stockholm Chamber of

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<sup>193</sup> *Himpurna v Indonesia, Final Award v PT Perusahaan Listrik Negara, XXV YCA (2000)* at p. 106; the tribunal also took in mind that recovery of “significant” legal costs was foreign to the legal system of Indonesia

<sup>194</sup> W. Benhamida, in: TDM 2005 ([www.transnational-dispute-management.com](http://www.transnational-dispute-management.com))

<sup>195</sup> Since there are probably well over 100 cases, and none surveyed has the type of cost allocation this tribunal now determined, it has been very difficult to find any even remotely comparable case. I have, however, tried very hard with my research support team to review even remote cases not rendered under the NAFTA or within the ICSID system. The only case we have been able to identify is *Link-Trading Joint Stock Company v Moldova*, an (presumably unpublished) UNCITRAL award of April 18, 2002. In this – Uncitral rules and BIT-based case – the tribunal required the wholly unsuccessful claimant to pay 22000 US \$ towards the costs of the respondent government, a cost risk factor that constitutes less than 2% of this *Thunderbird v. Mexico* allocation of respondent government legal expenditures. Noah Rubins, at p. 126, has only identified one case, *Scimitar v Bangla Desh*, ICSID Award of April 5, 1994 where costs were awarded to respondent against losing claimant; but it seems such costs did not include legal representation costs of Bangla Desh and the litigation strategy of claimant was contradictory and in the end led to a de-facto withdrawal from the case.

Commerce) are the – unanimous - Generation Ukraine v. Ukraine award and the Uncitral-based (non-NAFTA, non-ICSID) Link Trading v. Moldova case.

136. In the Generation Ukraine case<sup>196</sup> the tribunal did award all costs Ukraine had paid into ICSID and added a contribution of 100 000 \$ to Ukraine's legal fees (In the Link Trading case the "contribution" was 22 200 \$). But one needs to read the award to get a flavour for the reasons. Not only was the claim rejected in its entirety and no possible reason for a justified claim was found to exist, but the tribunal was also extremely dissatisfied with the claimant's conduct before the tribunal. In other words: It considered the claim as spurious and a not justifiable waste of the resources and attention of respondent and tribunal, both in terms of jurisdiction, merits and conduct before the tribunal.

"The Claimant's written presentation of its case has also been convoluted, repetitive, and legally incoherent. It has obliged the Respondent and the Tribunal to examine a myriad of factual issues which have ultimately been revealed as irrelevant to any conceivable legal theory of jurisdiction, liability or recovery. Its characterisation of evidence has been unacceptably slanted, and has required the Respondent and the Tribunal to verify every allegation with suspicion". (para 24/2\_; - "The Claimant's position has also been notably inconsistent." (para 24.3) - Moreover, the Claimant's presentation of its damages claim has reposed on the flimsiest foundation. (para. 24.4) - The Claimant's presentation has lacked the intellectual rigour and discipline one would expect of a party seeking to establish a cause of action before an international tribunal. This lack of discipline has needlessly complicated the examination of the claim. (para 24.6) ". "The claimants submissions .. have been

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<sup>196</sup> ICSID Case No. ARB/00/9, Award of 16 September 2003.

seriously flawed due to the absence of a coherent analysis”  
(para. 20.26)

The “contribution” of 22200 US \$ to the respondent’s attorney costs in the Link Trading case (under Uncitral rules) could prima vista be seen as supporting, marginally, the cost decision in this award. There is, however, no review of precedent and only a very general reference to Art. 40 of the Uncitral rules in the award. But the tribunal also expressed, in its cost decision, dissatisfaction with the litigation conduct of claimant. It noted that the costs significantly exceeded what the tribunal estimated for the security deposit: “due principally to the unsolicited further submission of Claimant” (para. 96). This reference suggests that the 22200 US \$ contribution reflected an unnecessary increase of the arbitration cost due to unreasonable litigation conduct by claimant. The case, therefore, rather supports the principle that attorney costs of prevailing respondent can only be allocated to the unsuccessful claimant if there was in the tribunal’s judgment evidence of unreasonable, cost-enhancing, conduct. E contrario, the Link Trading award therefore follows the rule that Art. 40 (2) of the Uncitral rules has to be applied in investment disputes so that the losing claimant does not have to pay the respondent’s costs of legal representation. Since there is no such evidence or indication in the Thunderbird award of any professional cost-inflating or otherwise “bad faith” misconduct, the Link Trading case provides another example of a “jurisprudence constante”: Each party, in particular respondent, have to bear their own attorney costs.

137. The only NAFTA/ICSID case<sup>197</sup> where the parties’ legal costs were awarded to the prevailing government<sup>198</sup> is the Methanex v US case

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<sup>197</sup> In Nagel v Czech Republic, available at [www.transnational-dispute-management.com](http://www.transnational-dispute-management.com), the tribunal awarded to the prevailing respondent 80% of its legal representation costs. It considered the claim not tenable. But the case has been decided under the SCC rules which

that came out in August 2005<sup>199</sup>. The tribunal here recognizes, based on a survey of 1991 – i.e. before investment cases became widespread and at a date where modern NAFTA/ICSID jurisprudence on costs did not exist (as it does now):

“Certain tribunals are reluctant to order the unsuccessful party to pay the costs of the successful party’s legal representation unless the successful party has prevailed over a manifestly spurious position taken by the unsuccessful party.”

138. The Methanex award mentions that “other tribunals consider that the successful party should not normally be left out of pocket in respect of the legal costs reasonably incurred in enforcing or defending its legal rights” – but it does not mention such cases, in particular investment claims where the government has prevailed. It also does not discuss the contrast between arbitration and legal costs as is set up between section 1 and section 2 of Art. 40 of the Uncitral rules nor does it give any more detailed reasoning. But from the procedural history of the case, one can infer that the tribunal was not satisfied with the way claimant conducted its claim, in particular with respect to evidence<sup>200</sup>. Given this situation, the Methanex case should be seen as awarding attorney costs to prevailing respondent for the well-established reasons (even mentioned in the award) at para. 9), that is either frivolous claims or claims where the tribunals have developed a

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apply the “European” principle of costs follow the event and is thus not relevant for NAFTA or ICSID claims.

<sup>198</sup> The ICSID annulment committee in the CDC v Seychelles case awarded 83.345 £ to CDC (original claimant which prevailed in the annulment), but is based its award (para, 89, 90) on its consideration that the “Republic’s case before this Committee was fundamentally lacking in merit. While we refrain from going so far as to say that it was frivolous, we can state unequivocally... that the Republic’s case was, to any reasonable and impartial observer, most unlikely to succeed”.

<sup>199</sup> Cost decision at para. 9 – 12 of part V of the award,

<sup>200</sup> This relates in particular to in the end unjustified allegations of a “secret meeting” with the Governor of California and what appears to have been theft of documents for use in the arbitration, the issue of the “Vind” documents, final award at p. 154 or page 26, 27 of Part II – Chapter I). The implication of paragraph 54 of this chapter – at p.1 153 – is that the tribunal suggested that Methanex did not conduct the arbitration in good faith.



practice of penalizing unprofessional conduct by the party against which the cost determination is made. To quote:

“The tribunal decided that this documentation was procured by Methanex unlawfully ... in violation of a general duty of good faith imposed by Uncitral rules and, indeed, incumbent on all who participate in international arbitration”<sup>201</sup>.

139. From this survey, it is safe to infer that it is by now a standard principle of international investment law, in particular in the NAFTA context, but also in other ICSID cases, that in principle, each party bears its own legal costs and the costs of the arbitration are shared. Exceptions to this rule have occurred very rarely with respect to the arbitration expenditures and in favour of the winning claimant, but never – except for a limited “contribution” to the government’s legal expenses in the *Generation Ukraine* and *Link Trading v Moldova* case – in the case of a losing claimant. The only concept under which this so far well-established rule has not been observed or a different treatment suggested is for “manifestly spurious or unmeritorious”

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<sup>201</sup> P. 155 at para 58 of the final award. A comparison of the detailed cost submission by the US (approx 3 M US\$) with a cost submission statement of Methanex (“Methanex respectfully advises that the order of magnitude sought from the United States is US\$11 to US\$12 million”) suggests that there had been serious problems in the normal professional relationship between Methanex litigation group and the tribunal, as well as a serious imbalance in the cost submissions (i.e. a very detailed breakdown of about 3 M US\$ by the US and a general reference of “11-12 M US\$) by Methanex. That would suggest an additional reason for the tribunal exercising its powers under Art. 40 (2) of the Uncitral rules in allowing the US full recovery of its legal representation cost. The Methanex cost decision appears very much to include, or be fully based on, punitive elements – i.e. factors such as spurious claim and cost-increasing bad-faith litigation conduct. The Methanex award (p. 298 and para. 10 there) suggests as one way of justifying its cost decision: “In the present case, the Tribunal favours the approach taken by the Disputing Parties themselves, namely that as a general principle the successful party should be paid its reasonable legal costs by the unsuccessful party.” I would not necessarily agree with this reasoning: The parties are almost compelled by the psychological pressure of litigation to claim at the onset that both arbitration costs and legal representation costs should be awarded to them in case they prevail; to require a party, in particular a claimant, to make at the beginning of the litigation an extended argument why they should not pay legal representation costs in case they lose, is from that aspect of litigation psychology not a practical option. Parties, in particular the claimant, can only then be expected to focus on and develop such an argument in case the case on the merits has already been dismissed and the tribunal calls for a separate debate on the cost allocation.

positions taken by the loser, unprofessional conduct and significant breach of good-faith in arbitration<sup>202</sup>. There are a good reasons for this approach which has so far been intuitively, but not yet explicitly appreciated by tribunals in thrall to the attitudes prevalent in commercial arbitration: Investment arbitration is not a reciprocally agreed and structured method of dispute resolution. It is a unilateral right of investors – not mirrored by a reciprocal government right – to claim against alleged misconduct by governments under an investment treaty<sup>203</sup>. It is in substance comparable at most to national and international judicial review of administrative conduct – rather than to the reciprocal “contract” model of commercial arbitration. Governments can not sue investors because investors can not breach the treaty disciplines such as “expropriation”, discrimination or fair and equitable treatment. They focus exclusively on governmental action targeting foreign investors. Governments have made this asymmetric right available because it helps them to attract capital and improves their internal governance, and the perception of their governance quality internationally.

140. This principle of cost allocation in international judicial review of government conduct is also applied in GATT litigation. There has been a formal proposal to award litigation costs to winning developing countries because of the prohibitively high costs of WTO litigation; one can see this as a similar concept to the idea that investors – in particularly smaller companies – should not be penalized for complaining about host state breach of treaty investment protection obligations; the common idea is that for under-resourced claimants access to justice is illusory if the cost (and risk) of litigation is

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<sup>202</sup> SD Myers Final Award on Costs, para 33; Gotanda, 2005, p. 49 ff: citing delay tactics, reprehensive or unreasonable conduct as factors that have moved international commercial arbitral tribunals to award attorneys’ costs. This is also my explanation for the Methanex v US cost award.

<sup>203</sup> In French, the concept is therefore named “arbitrage transnational unilateral” – Walid Benhamida, Arbitrage Transnational Unilatéral-, Doctoral Thesis, University of Paris II, Forthcoming (as monograph).

prohibitive<sup>204</sup>. Costs of the winning respondent have also not been awarded in UN Compensation Commission cases; in the Iran-US Claims Tribunal cases, in a small number of cases where Iran prevailed, it was awarded very modest costs (a few thousand dollars)<sup>205</sup>. It is worth noting that the Iran-US Claims Tribunal relied, in order to reject award of attorney costs, inter alia, on the fact that in the US each party bears its own attorney fees. Its approach of avoiding generalization of a particular legal-culture approach to the cost issue makes sense to me.

141. The judicial practice most comparable to treaty-based investor-state arbitration is the judicial recourse available to individuals against states under the European Convention on Human Rights; again, states have to defray their own legal representation expenditures, even if they prevail.

142. Imposing the risk of government attorney costs on losing investors in effect undermines the very purpose of such treaties; it raises the litigation risk in factual situations which are as a rule ambiguous, confused and contradictory to a prohibitive level, in particularly for smaller companies for whom litigation risk is high and where a government enjoys significant superiority in terms of expertise, experience and resources available for defense against NAFTA arbitration. In this particular case, we have had a well integrated, highly competent, coordinated and seamlessly functioning government defense team consisting of over 7 or 8 Mexican and international

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<sup>204</sup> WTO Document TN/DS/W/19 of 9 October 2002, Negotiations on the Dispute Settlement Understanding, proposal on DSU by several developing countries at p. 2: The proposal is that in case of winning a WTO case the under-resourced developing country (only) should be awarded litigation costs from the respondent developed state. Note that para 210 of the award concedes that for an “investor with limited financial resources” “considerations of access to justice may play a role”.

<sup>205</sup> Gotanda, 2005, p. 47; *Sylvania v Iran*, 8 Iran-US CTR 298, 324 (1985): “so far, the tribunal has not awarded costs in all cases and even when it has, the amounts have generally been less than claimed. Chamber two has never awarded any costs, chamber one has awarded relatively small amounts of costs in only a few cases and Chamber Three has in general awarded costs to the successful party in an amount well below the one claimed, using a range between 5000 and 25000 \$ with costs of 70 000 \$ awarded in one case”. On the UNCC: communication from Jim Loftis of Vinson & Elkins, former senior counsel with the UNCC; (June 16, 2005).

lawyers, including from two expert law firms, hardened by many rounds of NAFTA Chapter XI litigation facing a small entrepreneurial company with (equally competent I should add) two outside single-practitioner lawyers. The tribunal's break-out from – for good reasons – established NAFTA and BIT/ICSID jurisprudence on cost allocation can only be seen as foreclosing access to this type of justice for smaller companies. But that is not the objective of the NAFTA treaty which, to promote trade, new employment opportunities (note the Preamble of the NAFTA), increase investment opportunities and eliminate barriers to trade in, and facilitate cross-border movement of goods and services (Art. 102) is not intended to provide access to investment arbitration only to major US and Canadian multinational companies. The approach to costs in this award suggests that investment arbitration is only for the very large companies, leaving out entrepreneurs with initiative, willingness to take (sometimes perhaps recklessly) risk and who may not have the same “international corporate style” appeal of the “men in dark suits”. But there is no indication that this was the intention of the negotiators of such treaties. The highly unusual cost award thus casts a “chill” over attempts by junior companies to rely on the NAFTA's investment protection regime and makes that recourse – very high-risk anyway<sup>206</sup> – doubly prohibitive because of the now added cost risk. In effect and in practice, it makes recourse to independent justice for smaller companies prohibitive.

143. The only reason possible to use the reversal of standard NAFTA and BIT cost jurisprudence is legitimate reliance on the principle of “manifestly spurious claims” and grave professional misconduct by claimant and its advocates<sup>207</sup>. But it is hard to find such evidence in

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<sup>206</sup> Barton Legum, *Lesson Learned from the NAFTA: The New Generation of U.S. Investment Treaty Arbitration Provisions*, 19 ICSID Rev. 344 (2004); this study notes that so far no NAFTA case against the US has ever succeeded and identifies in detail the substantial litigation risks; the investor litigation risk assessment by this study would have to be compounded were this tribunal's approach to costs to be followed.

<sup>207</sup> The “unprofessional conduct” criterium shows up in the *Generation Ukraine v. Ukraine* case, but also for an isolated incident in the *Pope-Talbot v Canada* case, award of 26

the Thunderbird – Mexico case. The tribunal itself has been explicitly positive about the professional conduct of the arbitration by claimant (para 213). If the claim had been “manifestly spurious”, the tribunal could have accepted Mexico’s request for bifurcation and in a preliminary decision rejected jurisdiction and admissibility. The implication of ICJ jurisprudence on the requirement that claims be founded prima facie in law and in fact, suggests that manifestly spurious claims should be rejected in a preliminary phase<sup>208</sup>. There is also the practice of the Iran-US claims tribunal to dismiss a claim that is manifestly without merit<sup>209</sup>. But this tribunal rejected the Mexican request for a preliminary phase focusing on jurisdiction and admissibility issues only. This conduct of the tribunal hardly suggests that the claim was manifestly spurious. The fact that it had to rely on a painstaking ex-post analysis of a convoluted and ambivalent Mexican “comfort letter “ (“oficio”), arrived at after years of in-depth argument involving dozens of fine-comb-handling lawyers and evidence from both sides, does not help to establish a “manifestly spurious claim”.

144. Similarly, I do not share the tribunal’s statement that, in order to distinguish itself from the Azinian award (NAFTA protection was sought for a fraudulently obtained concession contract with no indication of governmental misconduct), that NAFTA jurisprudence was no longer “novel”. It may be useful to cite here the approach of the Vivendi v. Argentina annulment committee commenting on and endorsing the

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November 2002; it is clear that a serious breach of good faith in litigation contributed, and probably determined, the cost decision in the Methanex case, see infra.

<sup>208</sup> Oil Platforms, Iran v US, Preliminary Objections, 12 December 1996, paras 16-2; also Art. 28 (6) of the 2004 US model BIT, available at: [www.transnational-dispute-management.com](http://www.transnational-dispute-management.com) :

“When it decides a respondent’s objection under paragraph 4 or 5, the tribunal may, if warranted, award to the prevailing disputing party reasonable costs and attorneys’ fees incurred in submitting or opposing the objection. In determining whether such an award is warranted, the tribunal shall consider whether either the claimant’s claim or the respondent’s objection was frivolous, and shall provide the disputing parties a reasonable opportunity to comment”

<sup>209</sup> Parvis Karim Panahi v US , 28 Iran-US CTR 225, 228 (1992): Cyprus Petroleum v Iran, 11 Iran-US CTR 70, 71 (1986) – I rely here on a comment by V. Heiskanen, for TDM ([www.transnational-dispute-management.com](http://www.transnational-dispute-management.com)) 2005 on “Frivolous claims”.

cost decision of the original Vivendi tribunal (para 117, 118) which made each party bear its own expenditures:

“It observed that the dispute raised “a set of novel and complex issues not previously addressed in international arbitral precedent..... Moreover, Argentina was entitled to take the position it took, which itself raised a difficult and novel question of public importance concerning ICSID and the operation of investment protection agreements on the model of the BIT.”

In the light of the importance of the arguments advanced by the parties in connection with this case, the Committee considers it appropriate that each party bear its own expenses incurred...”

145. The issues at stake here – allocation of the risk of ambiguity of a governmental assurance, the scope of disclosure to government before obtaining a comfort letter – raise hitherto in BIT jurisprudence unsettled questions of how to apply the principle of “legitimate expectation” under Art. 1105 of the NAFTA. While there have been recently several awards on the question, no easily applicable doctrine of legitimate expectation under Art. 1105 of the NAFTA has so far evolved. It appears to me far from settled that one can dismiss easily a national treatment claim in a situation where the foreign investor – having pursued a cooperative approach – is closed down immediately and effectively, with no luck at all with domestic courts, while government enforcement is never successful with a politically well-connected domestic competitor. Also, the evidence of the government counsel huddling for over 13 hours discreetly with a senior judge in the case does at least raise questions of due process under international, if not national, standards. The tribunal may not have felt such procedural flaws in their aggregate reached the threshold of a breach of Art. 1105, but that is not to say that claimant made a frivolous claim in raising the issue of administrative denial of justice. I doubt that a reasonable, objective observer would have come at the outset to the conclusion that Thunderbird’s claim was frivolous and manifestly unjustified.

146. Under these circumstances, I must conclude that there is no evidence, so far and on the record of the case, of a “manifestly spurious” claim. One could have thought to define “winning” by a relation of the investor’s claim (about 100+ M US \$) to the outcome – zero in the award, about 500K US \$ in my reckoning). But that would be a practice of civil law litigation not applicable here. This was a North-American investor, incorporated in Canada but largely run from the US and with a US approach. It (and its counsel) followed what seems to be the standard US practice of making arguably “excessive” monetary claims. But international tribunals have to be careful with cultural prejudices; NAFTA litigation is not meant to penalize claimant and its counsel for what is normal in their own jurisdiction, but which might be seen in other jurisdictions not as acceptable. A measure of cultural tolerance is required in transnational dispute resolution.

147. Another reason one could think of would be that the claim related to gambling, an industry that is seen in many religious quarters as not very salubrious and provoking a moral opprobrium. But gambling, while usually heavily regulated, of the type at issue here (slot machines) is an entertainment activity that is widely practiced around the world<sup>210</sup> and can not be per se condemned as not worthy of investment treaty protection. The next reason I can think of as providing a justification for this decision deviating significantly from standard investment arbitration practice is the suspicion raised by the payment of the success fee – i.e. that possibly the two lawyers who arranged for the comfort letter may have shared that fee with Mexican officials. If it were so, I would have no hesitation whatsoever to penalize the claimant for daring to use an investment treaty to protect the fruits of unethical behaviour. As I have argued earlier, I would not require full proof, but rather enough corroborating indicators leading to a reversal of the burden of proof on claimant. But Mexico has not

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<sup>210</sup> Mexico’s expert Professor Rose attests the pervasive liberalisation and legalisation of such operations: p. 776: “This explosion of legal gambling hasn’t been just in the US. It’s everywhere in the world”.

raised this suspicion openly, with substantiated argument and evidence and with a credible effort to bring its own officials who were involved in the comfort letter to the tribunal. In that situation, I consider that we have to disregard insinuations of bribery if they are not properly raised, substantiated and open to a fair hearing. Otherwise, and with this award, a signal is sent out to respondent governments to insinuate corruption as a standard defense technique; it is persuasive and effective, without having to stand up to the proper scrutiny of a full and proper litigation debate. The negative proof of non-corruption, is rarely possible. There is no foreign investment where a close interaction, mostly with use of local consultants, with the government can be avoided. The whiff of corruption can therefore be made to appear in virtually any foreign investment project.



To conclude: While I have sympathized with my colleagues' view not to find a breach of the principle of "legitimate expectation" under Art. 1105 of the NAFTA , I find no reason to reverse a well established NAFTA and ICSID jurisprudence consisting in letting each party, winning or losing, bear its own legal expenses and share the costs of arbitration short of clear evidence of either gross professional misconduct on the part of a party in arbitration or a manifestly spurious claim.

Thomas Wälde

St Andrews, December 2005

Annex: Decision on Costs in Arbitration rendered against the investor  
(investor-state) arbitration<sup>211</sup>

Case	Decision on cost
<p><b>1. <i>Noble Ventures, Inc. v. Romania</i>,</b> ICSID Case No. ARB/01/11 (US/Romania BIT)- Final Award, 12 October 2005, § 230 <i>et seq.</i></p>	<p>The Tribunal dismissed the claims. The tribunal decided that each party shall bear the expenses incurred by it in connection with the arbitration and that the arbitration costs, including the fees of the members of the Tribunal, shall be borne by the parties in equal shares.</p> <p>The tribunal said that “233. Provisions regarding the Tribunal’s decision in the matter of costs are to be found in Art. 61(2) of the ICSID Convention and Arts. 28 and 47 (j) of the ICSID Arbitration Rules. Noting that none of these provisions mentions specific criteria for the decision on costs, the Tribunal takes into account the following particular considerations:</p> <p>234. On one hand, it is a principle common to both national laws and international law that a party injured by a breach must be compensated for its losses and damages, which include arbitration costs. On the other hand, the “loser pays” principle is not common to all national laws or international law, and in particular is stated in neither the ICSID Convention nor the ICSID Arbitration Rules.</p> <p>235. On the issue of costs the Tribunal has taken into consideration all the circumstances of this case. In particular, it notes that, although all the claims ultimately failed, the Claimant succeeded on certain issues, notably the fundamental legal issue of the umbrella clause contained in</p>

<sup>211</sup> Excerpted from the forthcoming comment by W. Benhamida in TDM (2005) at [www.transnational-dispute-management.com](http://www.transnational-dispute-management.com). I acknowledge gratefully Dr Benhamida’s consent.

	<p>Article II(2)(c) of the BIT as a basis for liability under the BIT in this case and the factual issue with regard to the diligence exercised by SOF after the execution of the SPA, albeit without causal significance. The Tribunal also has in mind that the basic flaws in the SPA are to be attributed to both SOF and the Claimant.</p> <p>236. Therefore, using the discretion that it has under the ICSID Convention and the ICSID Arbitration Rules, the Arbitral Tribunal deems it fair and reasonable that the cost burden be shared equally between the parties, each bearing its own legal and other expenses and 50 % of the arbitration costs”</p>
<p><b>2. Methanex Corporation v. United States of America</b> UNCITRAL (NAFTA)- <u>Final Award</u>, 3 August 2005, Part V.</p>	<p>The Tribunal dismissed the claims. The tribunal applied UNCITRAL Rules. The Tribunal observed that it has a broad discretion in relation to its award in respect of costs under Articles 38 and 40 of the UNCITRAL Rules.</p> <p>The Tribunal determines that there is no compelling reason not to apply the general approach required by the first sentence of Article 40(1) of the UNCITRAL Rules. Although over the last five years, Methanex has prevailed on certain arguments and other issues against the USA, Methanex is the unsuccessful party both as to jurisdiction and the merits of its Claim. There is no case here for any apportionment under Article 40(1) of the Rules or other departure from this general principle. Accordingly, the Tribunal decides that Methanex as the unsuccessful party shall bear the costs of the arbitration.</p> <p>With regard to disputing party legal costs, the Tribunal observed that the practices of international tribunals vary widely. Certain tribunals are reluctant to order the unsuccessful party to pay the costs of the successful party’s legal representation unless the successful party has prevailed over a manifestly spurious position taken by the unsuccessful party. Other arbitral tribunals consider that the successful party should not normally be left out of pocket in respect of the legal costs</p>

	<p>reasonably incurred in enforcing or defending its legal rights.</p> <p>In the present case, the Tribunal favours the approach taken by the Disputing Parties themselves, namely that as a general principle the successful party should be paid its reasonable legal costs by the unsuccessful party.</p> <p>In this case, the USA has emerged as the successful party, as regards both jurisdiction and the merits. The Tribunal has borne in mind that, at the time of the Partial Award, it could have been argued that the USA had lost several important arguments on the admissibility issues; but over time the Partial Award does not affect the end-result of the dispute overall, as decided by this Final Award.</p> <p>Likewise, the issues on which the USA did not prevail in this Award were of minor significance. The Tribunal does not consider any apportionment appropriate under Article 40(2) of the UNCITRAL Rules.</p> <p>Accordingly, the Tribunal decides that Methanex shall pay to the USA the amount of its legal costs reasonably incurred in these arbitration proceedings.<sup>212</sup></p>
<p><b>3. Empresas Lucchetti, S.A. and Lucchetti Peru, S.A. v. Peru</b>, ICSID Case No. ARB/03/4 (Peru/Chile BIT), Decision on Jurisdiction, 7 February 2005. p. 25 <i>et seq.</i></p>	<p>The Tribunal holds that it has no jurisdiction to hear the merits of the present claim. The Tribunal decides that each Party shall pay one half of the arbitration costs and bear its own legal costs</p>

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<sup>212</sup> The tribunal considered there was significant bad-faith litigation – for a discussion: see separate opinion

<p><b>4. Consortium</b>  <b>Groupement L.E.S.I.-</b>  <b>DIPENTA v. Algeria,</b>  ICSID Case No.  ARB/03/08  (Algeria/Italy BIT) -  <u>Decision on</u>  <u>Jurisdiction, 10 January</u>  <u>2005 (French), § 43 et</u>  <u>seq.</u></p>	<p>Le Tribunal arbitral n'est pas compétent pour connaître du litige entre le Consortium L.E.S.I. – Dipenta et la République algérienne démocratique et populaire. Chaque Partie supporte la moitié des frais de l'arbitrage et supporte ses propres frais de représentation</p>
<p><b>5. Gami</b>  <b>Investments, Inc. v.</b>  <b>Mexico,</b> UNCITRAL  (NAFTA), Final Award,  15 November 2004, §  134 <i>et seq.</i></p>	<p>The tribunal declared that it has jurisdiction over the claims but it dismissed them in their entirety. The tribunal nevertheless finds equitable that each side bears its costs.</p> <p>The Tribunal said that "There are two reasons for not giving Mexico any recovery in this respect. The first is that Mexico raised an unsuccessful jurisdictional objection which became a major feature of the proceedings. The costs associated with that special hearing were significant. The second is that GAMI grievance must be considered as serious. It raised disquieting questions with respect to regulatory act and omission. The Tribunal said that UNCITRAL rules accorded the arbitrators broad discretion with allocation</p>

	<p>of cost. It concluded that each party bears its own expenditures. The amount paid to the Tribunal is divided equally".</p>
<p><b>6. Loewen Group, Inc. and Raymond L. Loewen v. United States (II)</b>, ICSID Case No. ARB(AF)/98/3 (NAFTA). -Decision on Respondent's Request for a Supplementary, 6 September 2004, § 23 <i>et seq.</i></p>	<p>The Tribunal rejected the Respondent's Request. The Tribunal ordered that each party shall bear its own cost and shall bear equally the expenses of the Tribunal and the secretariat.</p>
<p><b>7. Joy Mining Machinery Limited v. Egypt</b>, ICSID Case No. ARB/03/11 (United Kingdom/Egypt BIT) - Decision on Jurisdiction, 30 July 2004, p. 25 <i>et seq.</i></p>	<p>The tribunal decided that the Tribunal lacks competence to consider the claims made by the Company. Each Party shall pay one half of the arbitration costs. Each Party shall bear its own legal costs.</p>
<p><b>8. Soufraki v. United Arab Emirates, ICSID Case No. ARB/02/7 (Italy/United Arab Emirates BIT).</b>- Decision on Jurisdiction, 7 July 2004, § 85 <i>et seq.</i></p>	<p>The Tribunal decided that the dispute falls outside its jurisdiction under Article 25(1) and (2)(a) of the ICSID Convention and Article 1(3) of the BIT. Taking into account the circumstances of the case and the Respondent's success with its jurisdictional objection, the Tribunal concludes that it is appropriate that the costs of the proceeding, including the fees and expenses</p>

	of the Tribunal and the ICSID Secretariat, be borne two-thirds by Claimant and one-third by Respondent, but that each party bears its own legal costs and expenses in connection with the proceeding.
<p><b>9. Waste Management, Inc. v. United Mexican States (II)</b>, ICSID Case No. ARB(AF)/00/3 (NAFTA) -Final Award, 30 April 2004, § 179 <i>et seq.</i></p>	<p>The Tribunal decided that (a) the claim is admissible under Chapter 11 of NAFTA; (b) That the conduct of the Respondent which is the subject of the claim did not involve any breach of Article 1105 or 1110 of NAFTA; (c) That Waste Management's claim is accordingly dismissed in its entirety; (d) That each Party shall bear its own costs and half of the costs and expenses of these proceedings.</p>
<p><b>10. Consortium R.F.C.C. v. Kingdom of Morocco</b>, ICSID Case No. ARB/00/6 (Italy/Morocco BIT)-Final Award, 22 December 2003 (French), § 112 <i>et seq.</i></p>	<p>Le Tribunal rejette les demandes du Consortium RFCC; met les frais d'arbitrage à parts égales à la charge du Consortium RFCC et du Royaume du Maroc; dit que chaque partie supportera ses propres frais et honoraires de conseils et de représentation engagés dans la présente procédure.</p>
<p><b>11. Generation Ukraine, Inc. v. Ukraine</b>, ICSID Case No. ARB/00/9 (United States/Ukraine BIT)-Final Award, 16 September 2003, § 24.1 <i>et seq.</i></p>	<p>The claim fails in its entirety. The tribunal considered whether there are any reasons to attenuate the general rule that an unsuccessful litigant in international arbitration should bear the reasonable costs of its opponent.</p> <p>Counsel for the Claimant has suggested that "there's more documentation in this particular ICSID reference than has ever been in any previous ICSID reference." The Tribunal is not certain that such an affirmation is verifiable; it is certainly true that the written evidence and submissions in this case have been voluminous. But the Claimant's written presentation of its case has also</p>

been convoluted, repetitive, and legally incoherent. It has obliged the Respondent and the Tribunal to examine a myriad of factual issues which have ultimately been revealed as irrelevant to any conceivable legal theory of jurisdiction, liability or recovery. Its characterisation of evidence has been unacceptably slanted, and has required the Respondent and the Tribunal to verify every allegation with suspicion.

The Claimant's position has also been notably inconsistent. Moreover, the Claimant's presentation of its damages claim has reposed on the flimsiest foundation. The Claimant's presentation has lacked the intellectual rigour and discipline one would expect of a party seeking to establish a cause of action before a international tribunal. This lack of discipline has needlessly complicated the examination of the claim. Even at the stage of final oral submissions in March 2003, counsel for the Claimant relied on two ICSID awards without mentioning that they had been partially annulled. While the Tribunal was fortunately aware of that limitation on the pertinence of those awards, this was due to the happenstance of the arbitrators' personal knowledge. The Tribunal assumes in counsel's favour that he was unaware of the annulments; that is bad enough, and does no credit to the Claimant.

The Respondent has claimed costs of USD 739,309.80, representing "contract payments of lawyers [sic] and experts services and expenses for business trips". The Tribunal is unsatisfied with these uncorroborated costs submissions, and considers them vastly overstated.

It awards all costs the Respondent has paid into ICSID, or USD 265,000 as well as a contribution of USD 100,000 to the Respondent's legal fees.



<p><b>12. <i>Loewen v. United States (I)</i></b>, ICSID Case No. ARB (AF)/98/3 (NAFTA) - Final Award, 26 June 2003, §240 <i>et seq.</i></p>	<p>In regard to the question of costs the Tribunal is of the view that the dispute raised difficult and novel questions of far-reaching importance for each party, and the Tribunal therefore ordered that each party shall bear its own costs, and shall bear equally the expenses of the Tribunal and the Secretariat.</p>
<p><b>13. <i>Yaung Chi Oo Trading PTE Ltd. v. Government of the Union of Myanmar</i></b> ASEAN Investment Agreement, I.D. Case No. ARB/01/1 -Final Award, 31 March, 2003, § 87 <i>et seq.</i></p>	<p>The Tribunal unanimously holds that it lacks jurisdiction in the case. As to the question of costs, the Tribunal notes that neither party sought costs at the end of the oral proceedings. For its own part, the Tribunal concludes that no order should be made in relation to the costs of the parties or the fees and expenses of the Tribunal. Each party has succeeded in part in terms of the issues which were argued before the Tribunal, even if in the result the Claimant fails on grounds essentially unrelated to the merits of its underlying claim. The tribunal concluded that each party shall bear its own costs, and shall bear equally the fees, costs and expenses of the Tribunal and the Secretariat.</p>
<p><b>14. <i>ADF Group Inc. v. United States</i></b>, ICSID Case No. ARB (AF)/00/1 (NAFTA). - Final Award, 9 January 2003, § 200.</p>	<p>In its Counter-Memorial, the Respondent asked the Tribunal for an order requiring the Investor to bear the costs of this proceeding, including the fees and expenses of the Members of the Tribunal, the expenses and charges of the Secretariat and the expenses incurred by the United States by reason of this proceeding. Having regard to the circumstances of this case, including the nature and complexity of the questions raised by the disputing parties, the Tribunal believes that the costs of this proceeding should be shared on a fifty-fifty basis by the disputing parties, including the fees and expenses of the Members of the Tribunal and the expenses and charges of the Secretariat. Each party shall bear its own expenses incurred in connection with this proceeding.</p>

<p><b>15. <i>Mondev International Ltd. v United States of America</i></b>, ICSID Case No. ARB(AF)/99/2 (NAFTA)- Final Award, 11 October 2002, § 158 <i>et seq.</i></p>	<p>The Tribunal dismisses Mondev's claims in their entirety. As to the question of costs and expenses, the United States sought orders that Mondev pay the Tribunal's costs and the legal expenses of the United States on the basis that its claim was unmeritorious and should never have been brought.</p> <p>The Tribunal said that " NAFTA tribunals have not yet established a uniform practice in respect of the award of costs and expenses. In the present case the Tribunal does not think it appropriate to make any order for costs or expenses, for several reasons. First, the United States has succeeded on the merits, but it has by no means succeeded on all of the many arguments it has advanced, including a number of arguments on which significant time and costs were expended.</p> <p>Secondly, in these early days of NAFTA arbitration the scope and meaning of the various provisions of Chapter 11 is a matter both of uncertainty and of legitimate public interest.</p> <p>Thirdly, the Tribunal has some sympathy for Mondev's situation, even if the bulk of its claims related to pre-1994 events. It is implicit in the jury's verdict that there was a campaign by Boston (both the City and BRA) to avoid contractual commitments freely entered into. In the end, the City and BRA succeeded, but only on rather technical grounds. An appreciation of these matters can fairly be taken into account in exercising the Tribunal's discretion in terms of costs and expenses.</p> <p>The Tribunal concluded that each party shall bear its own costs, and shall bear equally the expenses of the Tribunal and the Secretariat.</p>
<p><b>16. <i>W. Nagel v. Czech Republic</i></b>, SCC Case 49/2002</p>	<p>The Arbitral Tribunal has reached the conclusion that Mr Nagel's claims are to be dismissed in their entirety. This should normally have as a consequence that Mr Nagel</p>

<p>(UK/Czech Republic BIT), Decision on Jurisdiction 9 September 2002, p. 166 <i>et seq.</i> (SAR version).</p>	<p>should bear his own costs and also be ordered to pay the Czech Republic's costs and be ultimately responsible for the costs and expenses of the Arbitral Tribunal and the administrative fee of the SCC Institute.</p> <p>However, the Arbitral Tribunal considers that some costs and expenses must be considered to relate to specific objections raised by the Czech Republic which were rejected by the Arbitral Tribunal. The Arbitral Tribunal considers it justified to take these circumstances into account when making an order about costs and expenses. Thus, while Mr Nagel should be responsible for his own costs in their entirety, he should be obliged to reimburse only 80 % of Czech Republic's costs.</p> <p>Mr. Nagel has contested the reasonableness of Czech the Republic's cost claims. He has argued that the number of more than 3,267 hours indicated by the Republic as having been devoted to the case by lawyers and other timekeepers is excessive since there have been (a) no preliminary hearings or appearances of any kind, (b) no disclosures of documents, (c) only three days of evidentiary hearings in which the Republic cross-examined only one witness and produced the testimony of only four witnesses, and (d) only three written submissions from each side, none of unusual length. Mr. Nagel also argued that the claim of USD 118,041 for experts was excessive and unreasonable and pointed out that the testimony of one of the experts (...) had relevance, if at all, only to damages and that his costs should therefore be disallowed at this stage of the proceedings.</p> <p>The Arbitral Tribunal first notes that there is a very considerable difference between the amounts claimed by the two parties as compensation for costs.</p>
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	<p>In view of the outcome of the arbitration, the Arbitral Tribunal finds that the parties should be ultimately responsible, [Mr Nagel for 90 % and the Czech Republic for 10 % of these costs and expenses</p> <p>In relation to the arbitrators and the Arbitration Institute, the parties shall be responsible, jointly and severally, for the payment of the amounts due to the arbitrators and the Arbitration Institute. As between the parties, Mr Nagel shall be responsible for 90 % and the Czech Republic for 10 % of the amounts due in this arbitration to the arbitrators and the Arbitration Institute.</p>
<p><b>17. <i>Link-Trading Joint Stock Company v. Moldova</i>, UNCITRAL (US/Moldova BIT) – Final Award, 18 April 2002, § 83 <i>et seq.</i></b></p>	<p>The tribunal said that according to article 38 of UNCITRAL rules, the cost of arbitration including fees for legal representation and assistance shall in principle be borne by the unsuccessful party, although the tribunal may apportion such costs among the parties if it determines that this would be reasonable under the circumstances of the case.</p> <p>The Tribunal holds that the Claimant has failed to prove its claim of violation of the BIT by the respondent and the reasonable costs of arbitration shall be awarded to respondent.</p> <p>The respondent made a submission as to its cost (counsel fees and experts) for a total USD 144, 422, 80. The tribunal considered that it would be reasonable to award the respondent an amount of USD 22,200.</p> <p>As for the cost of arbitrators and secretariat, The tribunal said that these expenditures shall be beard by the claimant.</p>

<p><b>18. <i>Genin, Eastern Credit Limited, Inc. and A.S. Baltoil v Estonia (II)</i></b>, ICSID Case No. ARB/99/2. (United States/Estonia BIT)- Decision on Request for Supplementary Decisions and Rectification, 4 April 2002, § 19 <i>et seq.</i></p>	<p>Claimants' Request for Supplemental Decisions and Rectification is denied. The Tribunal said that "19. The Claimants had their "day in court". In fact, they had their week before the Tribunal. Not content with the result, they initiated further proceedings, as was their right, making the Request which the Tribunal hereby denies.</p> <p>20. In the present instance, the Tribunal has no hesitation in ordering that the costs associated with Claimants' Request shall follow the result. Specifically, and in accordance with Article 61 of the ICSID Convention and Arbitration Rule 47(1)(g), the Tribunal orders that the costs of the present proceeding - that is, the expenses incurred by the parties as well as the fees and expenses of the members of the Tribunal associated with the Request - shall be paid in full by Claimants.</p> <p>21. In this regard, the Tribunal assesses the expenses incurred by the Respondent in connection with the present proceeding in the amount of US\$26,485.43, in accordance with the Respondent's Statement on Costs submitted on March 11, 2002, and assesses the fees and expenses of the members of the Tribunal associated with the Request in the amount of US\$14,769.15, in accordance with the Secretariat's communication of March 14, 2002.</p> <p>Accordingly, the Tribunal orders Claimants to reimburse Respondent the total amount of US\$41,254.58 within 15 days of the date on which the present decision is dispatched to the parties"</p>
<p><b>19. <i>Mihaly International Corporation v Sri Lanka, Award</i></b>, ICSID Case No. ARB/00/2 (United States/Sri</p>	<p>The costs of the proceedings including the fees and expenses of the Arbitrators and the Secretariat shall be shared by the Parties in equal portion; and that (b) Each Party shall bear its own costs and expenses in respect of legal fees for counsels and their respective costs for the preparation of the written and the oral proceedings</p>

<p>Lanka BIT)- Decision on Jurisdiction, 15 March 2002, § 63.</p>	
<p><b>20. <i>Lauder v. Czech Republic</i></b>, UNCITRAL. (United States/Czech Republic BIT)- Final Award, 3 September 2001, § 315 <i>et seq.</i></p>	<p>According to Article 40 of the UNCITRAL Rules, the costs of arbitration shall in principle be borne by the unsuccessful party. However, the Arbitral Tribunal may apportion such costs between the Parties if it determines that apportionment is reasonable, taking into account the circumstances of the case. The same applies according to Article 40(2) with respect to the costs of legal representation and assistance. The Arbitral Tribunal can take into account the circumstances of the case and is free to determine which Party shall bear such costs or may apportioned such costs between the Parties if it determines that apportionment is reasonable.</p> <p>318. Among the circumstances the Tribunal has taken into account is its finding that the Respondent, at the very beginning of the investment by the Claimant in the Czech Republic, breached its obligations not to subject the investment to discriminatory and arbitrary measures when it reneged on its original approval of a capital investment in the licence holder and insisted on the creation of a joint venture. Furthermore, various steps were taken by the Media Council, especially, but not only, the 15 March 1999 letter to CET 21. Although the Arbitral Tribunal came to the conclusion that such acts did not constitute a violation of the Treaty obligations of the Respondent, the Claimant bona fide could nevertheless feel that he had to commence these arbitration proceedings. Furthermore, the behaviour of</p>

	<p>the Respondent regarding the discovery of documents, which the Claimant could rightly feel might shed more light on the acts of the Respondent, needs to be mentioned in this context.</p> <p>319. Taking all these circumstances of the case into account, the Arbitral Tribunal comes to the decision that each Party shall pay one half of the fees and expenses of the Arbitral Tribunal and the hearing cost and bear its own costs for legal representation and assistance and the costs of its witnesses.</p>
<p><b>21. <i>Olguín v Paraguay</i></b>, ICSID Case No. ARB/98/5. (Peru/Paraguay BIT), Final Award, 26 July 2001, § 85 <i>et seq.</i></p>	<p>Although this Tribunal is rejecting all of Mr. Olguín’s claims, it does not feel that it is fair to make him pay the costs for these proceedings.</p> <p>In the first place, the Respondent’s questioning of this Tribunal’s jurisdiction was flatly rejected, on the grounds expressed earlier. In the second place, as already stated various times in this Award, while the oversight exercised by the Paraguayan State through its bodies did not rise to a level of negligence that created liability to pay the losses suffered by the Claimant, it is also true that it cannot be considered to have been exemplary.</p> <p>Moreover, the conduct of the Republic of Paraguay needlessly prolonged these proceedings by repeatedly failing to meet the deadlines set by the Tribunal, in particular, the obligations imposed by the ICSID Administrative and Financial Regulations. For the above reasons, this Tribunal feels that it is fair that the parties each contribute part of the expenses arising from these proceedings, dividing the procedural costs in equal shares, and each assuming the costs for their legal representation.</p>
<p><b>22. <i>Genin, Eastern</i></b></p>	<p>The Tribunal dismissed the claims. Two factors, in particular, have shaped the Tribunal’s determination of the allocation of the costs of the arbitration. Both</p>

<p><b><i>Credit Limited, Inc. and A.S. Baltoil v Estonia (I)</i></b>, ICSID Case No. ARB/99/2, (United States/Estonia BIT)- Final Award, 25 June 2001, § 379 <i>et seq.</i></p>	<p>of those factors relate to the conduct of the parties as demonstrated by the written and oral evidence adduced by them.</p> <p>380. First, the Tribunal cannot but decry Mr. Genin's failure to cooperate with the Estonian banking authorities during the period in which the salient facts underlying the dispute took place. His concealment, right up until his cross-examination by Respondent's counsel during the hearing, of his ownership of the companies in question was an element of both substantive and procedural significance, with effect on the conduct of the arbitration. Claimants themselves concede, in their Post-Hearing Memorial, that Mr. Genin's conduct could be considered to have affected the case and that it is thus appropriate for the Tribunal to take this conduct into account when considering the allocation of costs. The Tribunal cannot but concur with both parts of that statement.</p> <p>381. On the other hand, as mentioned above, the awkward manner by which the Bank of Estonia revoked EIB's license, and in particular the lack of prior notice of its intention to revoke EIB's license and of any means for EIB or its shareholders to challenge that decision prior to its being formalized, cannot escape censure.</p> <p>382. Either of these factors, alone, might have impelled an award of costs against the offending party.</p> <p>383. Accordingly, and taking into consideration the circumstances of the case, the Tribunal determines that each party shall bear all of the expenses incurred by it in connection with the arbitration. The costs of the arbitration, including the fees and expenses of the</p>
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	<p>members of the Tribunal and the charges for the use of the facilities of the ICSID, shall be borne by the parties in equal shares.</p> <p>The tribunal concluded that All of Claimants' claims are dismissed; (6) Respondent's counterclaim is dismissed; and (7) Each party shall bear all of its own costs and expenses incurred in connection with the proceedings, and the costs of the arbitration shall be borne by Claimants and Respondent, respectively, in equal shares.</p>
<p><b>23. Gruslin v Malaysia</b>, ICSID Case No. ARB/99/3, (Belgo-Luxembourg/Malaysia BIT)- Decision on Jurisdiction, 27 November 2000, § 27.4 <i>et seq.</i></p>	<p>The tribunal rejects the claimant's submission that the respondent should be ordered to pay any of the claimant's cost of his unsuccessful claim now dismissed for want of jurisdiction.</p> <p>The Tribunal invoked some considerations that militate against the claimant being award to pay the respondent's cost. Among these considerations the inequality if the position of the parties: the tribunal remarked that the claimant conducted the proceedings in person and with particular tenacity and was not assisted as the state was by counsellors. Second consideration: the fact that the respondent did not raise the approved project argument until the second round of pleadings. The tribunal concluded that each party shall bear all of its own costs and expenses incurred in connection with the proceedings, and the costs of the arbitration shall be borne by Claimants and Respondent, respectively, in equal shares.</p>

<p><b>24.</b>                    <b>Waste Management, Inc. v. Mexico (I),</b> ICSID Case No. ARB(AF)/98/2, (NAFTA)- Decision on Jurisdiction, 2 June 2000, p. 240, <i>ICSID FILJ</i> version.</p>	<p>The majority said that the tribunal has no jurisdiction to hear the case because the claimant's breach of one of the requisites laid down by NAFTA Article 1121(2)(b) (waive their right to initiate or continue before any administrative tribunal or court under the law of any NAFTA Party, or other dispute settlement procedures, any proceedings.</p> <p>The majority orders the Claimant to pay the costs of the present arbitration proceedings, and each of the disputing parties to defray the respective costs occasioned by its own defence.</p> <p>The arbitral award has been adopted by a majority of the Arbitral Tribunal.</p>
<p><b>25.</b>                    <b>Azinian, Davitian, &amp; Baca v. Mexico,</b> ICSID Case No. ARB (AF)/97/2, (NAFTA)- Final Award, 1 November 1999, § 125 <i>et seq.</i></p>	<p>The claim has failed in its entirety. The Respondent has been put to considerable inconvenience. In ordinary circumstances it is common in international arbitral proceedings that a losing claimant is ordered to bear the costs of the arbitration, as well as to contribute to the prevailing respondent's reasonable costs of representation. This practice serves the dual function of reparation and dissuasion.</p> <p>The Tribunal said that "126. In this case, however, four factors militate against an award of costs. First, this is a new and novel mechanism for the resolution of international investment disputes. Although the Claimants have failed to make their case under NAFTA, the Arbitral Tribunal accepts, by way of limitation, that the legal constraints on such causes of action were unfamiliar.</p> <p>Secondly, the Claimants presented their case in an efficient and professional manner. Thirdly, the Arbitral Tribunal considers that by raising issues of defective performance (as opposed to voidness ab initio) without</p>

	<p>regard to the notice provisions of the Concession Contract, the Naucalpan Ayuntamiento may be said to some extent to have invited litigation. Fourthly, it appears that the persons most accountable for the Claimants' wrongful behaviour would be the least likely to be affected by an award of costs; Mr. Goldenstein is beyond this Arbitral Tribunal's jurisdiction, while Ms. Baca – who might as a practical matter be the most solvent of the Claimants – had no active role at any stage.</p> <p>127. Accordingly the Arbitral Tribunal makes no award of costs, with the result that each side bears its own expenditures, and the amounts paid to ICSID are allocated equally"</p>
<p><b>26. <i>Tradex Hellas S.A. v. Albania</i></b>, ICSID Case No. ARB/94/2 (Jurisdiction based on foreign investment law not BIT) – Final Award, 29 April 1999, § 206 <i>et seq.</i></p>	<p>For its decision regarding the costs of the proceeding, the Tribunal first takes into account that Tradex prevailed in the procedure concluded by the Decision on Jurisdiction of 24 December 1996, and that now, Albania prevailed on the merits. Furthermore, though, taking the dispute as a whole, Tradex failed in its claim, it may be taken into account that, by no means, this claim can be considered as frivolous in view of the many difficult aspects of fact and law involved and dealt with in this Award.</p> <p>herefore, the Tribunal concludes that, in view of all the circumstances of this dispute, each Party should bear its own expenses and the costs of its own legal representation, and that the costs of the arbitration, covered by equal advance deposits by both Parties, should be borne by the Parties equally in shares of 50 %.</p>



**WORLD TRADE  
ORGANIZATION**

**WT/DS50/AB/R**  
19 December 1997

(97-5539)

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**Appellate Body**

**INDIA - PATENT PROTECTION FOR PHARMACEUTICAL  
AND AGRICULTURAL CHEMICAL PRODUCTS**

**AB-1997-5**

*Report of the Appellate Body*

WORLD TRADE ORGANIZATION  
APPELLATE BODY

**India - Patent Protection for  
Pharmaceutical and Agricultural Chemical  
Products**

India, *Appellant*

United States, *Appellee*

European Communities, *Third Participant*

AB-1997-5

Present:

Lacarte-Muró, Presiding Member

Bacchus, Member

Beeby, Member

**I. Introduction**

1. India appeals from certain issues of law and legal interpretations in the Panel Report, *India - Patent Protection for Pharmaceutical and Agricultural Chemical Products*<sup>1</sup> (the "Panel Report"). The Panel was established to consider a complaint by the United States against India concerning the absence in India of either patent protection for pharmaceutical and agricultural chemical products under Article 27 of the *Agreement on Trade-Related Aspects of Intellectual Property* (the "*TRIPS Agreement*"), or of a means for the filing of patent applications for pharmaceutical and agricultural chemical products pursuant to Article 70.8 of the *TRIPS Agreement* and of legal authority for the granting of exclusive marketing rights for such products pursuant to Article 70.9 of the *TRIPS Agreement*. The relevant factual aspects of India's "legal regime"<sup>2</sup> for patent protection for pharmaceutical and agricultural chemical products are described at paragraphs 2.1 to 2.12 of the Panel Report.

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<sup>1</sup>WT/DS50/R, 5 September 1997.

<sup>2</sup>WT/DS50/4, 8 November 1996.

2. The Panel Report was circulated to the Members of the World Trade Organization (the "WTO") on 5 September 1997. The Panel reached the following conclusions:

On the basis of the findings set out above, the Panel concludes that India has not complied with its obligations under Article 70.8(a) and, in the alternative, paragraphs 1 and 2 of Article 63 of the TRIPS Agreement, because it has failed to establish a mechanism that adequately preserves novelty and priority in respect of applications for product patents in respect of pharmaceutical and agricultural chemical inventions during the transitional period to which it is entitled under Article 65 of the Agreement, and to publish and notify adequately information about such a mechanism; and that India has not complied with its obligations under Article 70.9 of the TRIPS Agreement, because it has failed to establish a system for the grant of exclusive marketing rights.<sup>3</sup>

The Panel made the following recommendation:

The Panel recommends that the Dispute Settlement Body request India to bring its transitional regime for patent protection of pharmaceutical and agricultural chemical products into conformity with its obligations under the TRIPS Agreement ...<sup>4</sup>

3. On 15 October 1997, India notified the Dispute Settlement Body<sup>5</sup> (the "DSB") of its intention to appeal certain issues of law covered in the Panel Report and legal interpretations developed by the Panel, pursuant to paragraph 4 of Article 16 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (the "DSU"), and filed a Notice of Appeal with the Appellate Body, pursuant to Rule 20 of the *Working Procedures for Appellate Review* (the "*Working Procedures*"). On 27 October 1997, India filed an appellant's submission.<sup>6</sup> On 10 November 1997, the United States filed an appellee's submission pursuant to Rule 22 of the *Working Procedures*. That same day, the European Communities filed a third participant's submission pursuant to Rule 24 of the *Working Procedures*. The oral hearing provided for in Rule 27 of the *Working Procedures* was held on 14 November 1997. At the oral hearing, the participants and third participant presented their arguments and answered questions from the Division of the Appellate Body hearing the appeal.

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<sup>3</sup>Panel Report, para. 8.1.

<sup>4</sup>Panel Report, para. 8.2.

<sup>5</sup>WT/DS50/6, 16 October 1997.

<sup>6</sup>Pursuant to Rule 21(1) of the *Working Procedures*.

## II. Arguments of the Participants

### A. Appellant - India

4. India appeals certain aspects of the legal findings and conclusions of the Panel relating to Articles 70.8, 70.9 and 63 of the *TRIPS Agreement*. India asserts that it has established, through "administrative instructions"<sup>7</sup>, "a means" by which applications for patents for pharmaceutical and agricultural chemical products (often referred to as "mailbox applications") can be filed and filing dates assigned to them. India contends that, as of 15 October 1997, 1924 such applications had been received, of which 531 were by United States' applicants. Upon receipt, the particulars of these applications, including serial number, date, name of applicant, and the title of the invention were published in the Official Gazette of India. None of these applications had been taken up for examination, and none had been rejected. On 2 August 1996, the Government had stated in Parliament: "The Patent Offices have received 893 patent applications in the field of drug or medicine from Indian or foreign companies/institutions until 15 July 1996. The applications for patents will be taken up for examination after 1 January 2005, as per the World Trade Organization (WTO) Agreement which came into force on 1 January 1995".<sup>8</sup>

5. India argues that the function of Article 70.8(a) of the *TRIPS Agreement* is to ensure that the Member concerned receives patent applications as from 1 January 1995 and maintains a record of them on the basis of which patent protection can be granted as from 2005. India asserts that the Panel ruled that Article 70.8(a) comprises two obligations: first, to establish a mailbox to receive patent applications for pharmaceutical and agricultural chemical products and to allot filing and priority dates to them; and second, to create legal certainty that the patent applications and the patents based on them will not be rejected or invalidated in the future. India maintains that the second obligation is a creation of the Panel.

6. India asserts that the Panel justified the creation of this second obligation by invoking the concept of predictability of competitive relationships that was developed by panels in the context of Articles III and XI of the GATT 1947. India contends that this concept cannot be unquestioningly imported into the *TRIPS Agreement*. Furthermore, the Panel used this concept to advance the date on which India must give substantive rights to inventors of pharmaceutical and agricultural chemical products. Thus,

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<sup>7</sup>India's appellant's submission, p. 10.

<sup>8</sup>See Panel Report, Annex 2.



India concludes, the Panel incorporated into the procedural requirements of Article 70.8(a) the substantive obligations set out in paragraphs (b) and (c) of Article 70.8 and turned an obligation to be carried out in the future into a current obligation.

7. India asserts that the means of filing provided by India ensures that patents can be granted when they are due. According to India, there is absolute certainty that India can, when patents are due in accordance with paragraphs (b) and (c) of Article 70.8, decide to grant such patents on the basis of the applications currently submitted and determine the novelty and priority of the inventions in accordance with the date of these applications. India insists that there is no logical link between the theoretical refusal of a mailbox application under current law and the grant of a patent in accordance with paragraphs (b) and (c) of Article 70.8 in the future.

8. According to India, the Panel interpreted into the *TRIPS Agreement* the requirement that a Member must eliminate any reasonable doubts that it has met the requirements set out in that Agreement. To India, the Panel's interpretation of Article 70.8(a) entails a violation of established principles governing the burden of proof.

9. India argues that the effect of the Panel's shift in the burden of proof from the complainant to the defendant was exacerbated by the standard of proof which the Panel applied to the evidence submitted by India to demonstrate that the United States' assertion was based on an incorrect interpretation of Indian law. In India's view, the Panel did not assess the Indian law as a fact to be established by the United States, but as a law to be interpreted by the Panel. According to India, the Panel's initiative contrasts with the cautious approach of previous panels to issues of municipal law.<sup>9</sup> The Panel should have followed GATT practice and given India, as the author of the mailbox system, the benefit of the doubt as to the status of that system under its domestic law. The Panel also should have sought guidance on the manner in which the Indian authorities interpreted that law. India contends that the assertion by a Member that a mailbox system exists, and that it has been set up in accordance with its domestic law, may be displaced only by compelling evidence that the mailbox is illegal in domestic law: it is essentially for the Member itself to determine the methodology by which it sets out the mailbox system in terms of its municipal laws.

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<sup>9</sup>India cites Panel Report, *Canada - Measures Affecting the Sale of Gold Coins*, L/5863, 17 September 1985, unadopted, paras. 58 and 59; and Panel Report, *United States - Measures Affecting the Importation, Internal Sale and Use of Tobacco*, adopted 4 October 1994, DS44/R, para. 75.

10. India argues that the text of Article 70.9 establishes the obligation to provide exclusive marketing rights to a pharmaceutical or agricultural chemical product for which a patent application has been made only after the events specified in the provision have occurred. India maintains that there is nothing in the text of Article 70.9 that creates an obligation to make a system for the grant of exclusive marketing rights system generally available in the domestic law before the events listed in Article 70.9 have occurred.

11. In India's view, the Panel did not examine the context of Article 70.9 fully. There are many provisions in the *TRIPS Agreement* -- including Articles 22.2, 25.1, 39.2, 42-48 and 51 -- which explicitly oblige Members to change their domestic law to authorize their domestic authorities to take certain actions before the need to take such actions actually arises. India also notes that a comparison of the terms of Article 70.9 with those of Article 27, according to which "patents shall be available" for inventions, is revealing. According to India, the Panel examines Article 70.9 only in the context of Article 27, and dismisses the relevance of the distinction between "shall be available" and "shall be granted" in the wording of these related provisions because "an exclusive marketing right cannot be 'granted' in a specific case unless it is 'available' in the first place".<sup>10</sup>

12. India maintains that Article 70.9 is part of the transitional arrangements of the *TRIPS Agreement* whose very function is to enable developing countries to postpone legislative changes. Patent protection for pharmaceutical and agricultural chemical products is the most sensitive TRIPS issue in many developing countries. To India, the Panel's interpretation of Article 70.9 has the consequence that the transitional arrangements would allow developing countries to postpone legislative changes in all fields of technology except in the most sensitive ones.

13. In India's view, the Panel did not base its interpretation on the terms of Article 70.9, nor did it take into account the context and the transitional object and purpose of this provision; instead, the Panel justified its expansive approach with the need to establish predictable conditions of competition. India contends that this notion turns an obligation to take actions in the future into an obligation to take action immediately. India notes that there are numerous transitional provisions in the *Marrakesh Agreement Establishing the World Trade Organization* (the "*WTO Agreement*")<sup>11</sup> that require action at some point in the future, either when a date has arrived or an event has occurred. These are all obligations that are, just like those under Article 70.8 and 70.9 of the *TRIPS Agreement*, contingent

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<sup>10</sup>Panel Report, para. 7.56 and note 112.

<sup>11</sup>Done at Marrakesh, Morocco, 15 April 1994.

upon a date or event. While it would be desirable if all Members were immediately to enable their executive authorities to take the required actions even before the dates or events requiring those actions have occurred, India asserts that these provisions cannot reasonably be interpreted to imply the obligation to provide for such conditions in the domestic law in advance of that date or event.

14. India asserts that, under Articles 3, 7 and 11 of the DSU, panels are to make findings and recommendations only on matters submitted to them by the parties to the dispute. India therefore contends that the Panel exceeded its authority under the DSU by ruling on the subsidiary claim by the United States relating to Article 63 after accepting its principal claim under Article 70.8. If the Appellate Body were to conclude that the Panel was entitled to present findings on the United States' Article 63 claim, India asks whether the Panel was entitled to recommend simultaneously that India bring its mailbox system into conformity with Article 70.8(a) and Article 63 of the *TRIPS Agreement*. If the Panel was so entitled, India further asks the Appellate Body to what the recommendation relating to Article 63 refers.

B. *Appellee - United States*

15. The United States endorses the legal findings and conclusions of the Panel relating to Articles 70.8, 70.9 and 63 of the *TRIPS Agreement*. The United States asserts that the Panel correctly analyzed the text and context of Article 70.8, and focused on the failure of the system described by India to achieve the object and purpose of this provision. The United States contends that the concept of the importance of creating the predictability needed to plan future trade was developed in the context of Articles III and XI of the GATT 1947, as the Panel observed. However, it does not follow that the objectives of ensuring minimum standards of treatment and regulating competitive relationships are mutually exclusive. Protecting legitimate expectations of WTO Members regarding conditions of competition is as central to trade relating to intellectual property as it is to trade in goods that do not relate to intellectual property.

16. According to the United States, under Article 70.8, reasonable assurances of treatment must be provided for mailbox applications. The United States deems that the Panel correctly interpreted Article 70.8 to require a mailbox system under which patent applications have a secure legal status. This interpretation respects the relationship between paragraphs (a), (b) and (c) of Article 70.8, and the purpose of the mailbox system. The United States insists that the administrative system described by India does not provide a sound legal basis for filing mailbox applications. According to the United States, the Panel correctly placed the burden of proof on the United States, consistent with the Appellate

Body Report in *United States - Measure Affecting Woven Wool Shirts and Blouses from India* ("*United States - Shirts and Blouses*").<sup>12</sup> The United States argues that nothing in the Panel's analysis had the effect of shifting the burden of proof from the United States to India, and that the Panel applied the correct standard of proof. In the view of the United States, the Panel did not require India to prove that its administrative instructions to patent offices were immune from challenge, but rather found that India had not rebutted the evidence presented by the United States regarding the likelihood that mailbox applications and patents ultimately based on them would be invalidated by such a challenge.

17. The United States asserts that the Panel appropriately considered India's factual arguments regarding the operation of the Act to Amend and Consolidate the Law Relating to Patents (the "Patents Act"), and that India's arguments represent an attempt to turn a factual question into a legal issue. While the United States acknowledges the propriety of seeking guidance from Members regarding their domestic laws, it argues that giving a Member the benefit of the doubt regarding matters of interpretation of its domestic law is not equivalent to unquestioning acceptance of the Member's position. In the view of the United States, India's argument is inconsistent with the requirement in Article 11 of the DSU that a panel make "an objective assessment" of the facts of the case. On this point, the United States recalls that the panel in *United States - Restrictions on Imports of Cotton and Man-Made Fibre Underwear* stated, "a policy of total deference to the findings of the national authorities could not ensure an "objective assessment" as foreseen by Article 11".<sup>13</sup>

18. The United States contends that the Panel correctly found that India has failed to comply with Article 70.9. According to the United States, the text of Article 70.9 indicates that the obligation to establish exclusive marketing rights became effective upon the entry into force of the *WTO Agreement*. The ordinary meaning of the term "granted" is to "give (rights, property, etc.) formally; transfer legally".<sup>14</sup> The definition implies that availability and authority are necessary, but not sufficient, conditions for "granting" something. The United States asserts that the Panel correctly stated: "an exclusive marketing right cannot be "granted" in a specific case unless it is "available" in the first place".<sup>15</sup> Moreover, the terms used in other Articles of the *TRIPS Agreement* reflect the context of

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<sup>12</sup>Adopted 23 May 1997, WT/DS33/AB/R.

<sup>13</sup>Adopted 25 February 1997, WT/DS24/R, para. 7.10.

<sup>14</sup>The United States cites H.W. Fowler and F.G. Fowler (eds.), *The Concise Oxford English Dictionary* (1990), p. 514.

<sup>15</sup>Panel Report, para. 7.56, note 112.

each Article, and do not support the conclusion that there is no obligation under Article 70.9 to provide a system for granting exclusive marketing rights before a particular case arises.

19. The United States maintains that the context, object and purpose of Article 70.9 indicate that it imposes a current, not future, obligation. In the view of the United States, the Panel correctly found that the average period of time required to satisfy the conditions set forth in Article 70.9 is not relevant to the analysis. The United States further argues that India's argument is factually incorrect: the Panel found that at least one United States' company had satisfied the steps required for the grant of exclusive marketing rights, but had not applied for them in India because it could not obtain information regarding the appropriate procedure for doing so. In addition, the United States presented evidence regarding the likelihood that various products designed to treat serious medical conditions would be ready for introduction to the Indian market in advance of the timeframe described by India.

20. The United States argues that the consequence of India's view of Article 70.9 is that a national of another WTO Member would have to apply for exclusive marketing rights that did not exist under Indian law, and only at that time would India be obligated to enact legislation providing such rights. There would be at least a temporary violation of a Member's rights because that Member's national would have to wait for India to enact legislation making these rights available. According to the United States, such a result is inconsistent with the principle of fostering predictable conditions of competition and does not protect the legitimate expectations of Members under Article 70.9.

21. In the view of the United States, the Panel's finding on Article 70.9 does not imply that all future obligations under the *WTO Agreement* should be implemented immediately in Members' domestic law. Requiring a system for granting exclusive marketing rights protects the core balance of the *TRIPS Agreement* with respect to pharmaceutical and agricultural chemical product patents. Under the *TRIPS Agreement*, the *quid pro quo* for taking advantage of the extended transition period for granting product patents for pharmaceutical and agricultural chemical inventions was the grant of exclusive marketing rights.

22. The United States asks the Appellate Body to affirm the Panel's decision to make findings on the Article 63 issue submitted to it by the United States. In the view of the United States, the Panel correctly addressed both the issue of India's failure to comply with Article 70.8 and its failure to comply with Article 63. The United States asserts that Articles 3, 7, and 11 of the DSU establish that the Panel acted within its authority in addressing the United States' claim: the United States submitted this issue to the Panel in both written and oral submissions and India had an abundant opportunity to

respond; and the United States' characterization of its Article 63 claim is not determinative of the Panel's authority to address it.

C. *Third Participant - European Communities*

23. The European Communities endorses the Panel's findings concerning the failure by India to take the action necessary to implement its obligations under Article 70.8 of the *TRIPS Agreement* and agrees with the Panel's interpretation of Article 70.9 of the *TRIPS Agreement*. The European Communities supports the Panel's finding that India failed to take the action necessary to implement its obligations under Article 70.8 of the *TRIPS Agreement*. In the view of the European Communities, India's arguments about the Panel's interpretation of municipal law are unfounded: there is nothing in the ruling of the Panel which suggests that it did anything other than treat domestic law as a question of fact to be proved by the party asserting a breach of Article 70.8. The European Communities asserts that the Panel's findings show that the Panel treated the question of municipal law as a matter of evidence. Moreover, India's submission that the Panel's interpretation on this point be treated as a question of fact would result in it being excluded from the remit of the Appellate Body.

24. The European Communities maintains that the Panel's approach in interpreting Article 70.8(a) was consistent with the provisions of Article 31 of the *Vienna Convention on the Law of Treaties* ("the *Vienna Convention*").<sup>16</sup> Accordingly, in analyzing the meaning to be given to the term "means" in paragraph (a) of Article 70.8, the Panel considered that term in its context and in the light of the object and purpose of Article 70.8. The European Communities asserts that the setting up of such a mailbox mechanism is clearly not an end in itself. The objective of the mechanism cannot simply be to permit the filing of applications: such a mechanism would serve no useful purpose. The objective is rather to ensure that the novelty and priority of such applications is preserved and made available as from the date of application of the Agreement for developing countries.

25. With respect to India's claims that the Panel effectively relieved the United States of the burden of proof of adducing evidence that a breach of Article 70.8 had occurred, the European Communities asserts that the Panel's reasoning is correct. According to the European Communities, it is clear, from paragraph 7.37 of the Panel's findings, that India was not able to discharge the burden of proof upon it to demonstrate that its system for mailbox applications was not tainted with a degree of legal insecurity.

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<sup>16</sup>Done at Vienna, 23 May 1969, 1155 U.N.T.S. 331; 8 International Legal Materials 679.

In the view of the European Communities, this question relates to the Panel's appreciation of the evidence before it and is therefore not a question of law. In consequence, it falls outside the scope of the remit of the Appellate Body.

26. The European Communities supports the Panel's interpretation of Article 70.9 of the *TRIPS Agreement*. The European Communities maintains that Article 70.9 provides for the granting of a residual right (the exclusive marketing right) to applicants as long as the products are not patentable during the transitional period available to developing country Members. For that purpose, applicants must be able to identify the authority to whom they have to address a request for the granting of an exclusive marketing right. They must also be given the opportunity to know what their rights are with regard to other potential applicants who might request exclusive marketing rights for the same product. In the view of the European Communities, India's proposed reading of Article 70.9 disregards this aspect of the law on intellectual property rights that concerns the relationship between different actual or potential applicants. It is not possible to regulate this relationship by legislative or administrative action only after the relevant events have occurred, since such subsequent action would not be capable of determining the relationship between several actual or potential applicants. The European Communities insists that the protection of the exclusivity of the exclusive marketing right is a necessary component of the mechanism that is required under Article 70.9.

27. The European Communities contends that India's attempt to deny the need for a mechanism for the grant of exclusive marketing rights cannot be considered as a good faith interpretation of Article 70.9. According to the European Communities, India's reference to the sensitivity of the question of exclusive rights for the marketing of pharmaceuticals and agricultural chemical products in developing countries is not relevant. The European Communities contends that the basic rule of international treaty law is "*pacta sunt servanda*", that is, that treaties must be observed. Moreover, treaty provisions must be read in context and treaty interpretation must be carried out in good faith. In the view of the European Communities, the *TRIPS Agreement* contains many provisions concerning the rights of applicants and right holders with regard to third parties; the context of the *TRIPS Agreement* requires developing country Members that invoke the transitional period to allow, in advance, the grant of exclusive marketing rights under Article 70.9 and to provide the relevant mechanism for the grant of such exclusive marketing rights in order to define the position of applicants and right holders with regard to other persons. According to the European Communities, India's argument that this reading of Article 70.9 is not consistent with the general understanding of the kind of action that is required by Members during transitional periods, provided for in a number of other multilateral trade agreements, is misleading:

it neglects that Article 70.9 deals with an obligation arising during the transitional period, not after its expiry.

### **III. Issues Raised In This Appeal**

28. The appellant, India, raises the following issues in this appeal:

- (a) What is the proper interpretation to be given to the requirement in Article 70.8(a) of the *TRIPS Agreement* that a Member shall provide "a means" by which applications for patents for inventions relating to pharmaceutical or agricultural chemical products can be filed?
- (b) Did the Panel err in its treatment of Indian municipal law, or in its application of the burden of proof, in examining whether India had complied with its obligations under Article 70.8(a) of the *TRIPS Agreement*?
- (c) Does Article 70.9 of the *TRIPS Agreement* require that there must be a "mechanism" in place to provide for the grant of exclusive marketing rights effective as from the date of entry into force of the *WTO Agreement*?
- (d) Did the Panel, after having accepted the principal claim of the United States under Article 70.8 of the *TRIPS Agreement*, err by making conclusions on the alternative claim by the United States under Article 63 of the *TRIPS Agreement*?

### **IV. The *TRIPS Agreement***

29. The *TRIPS Agreement* is one of the new agreements negotiated and concluded in the Uruguay Round of multilateral trade negotiations. The *TRIPS Agreement* brings intellectual property within the world trading system for the first time by imposing certain obligations on Members in the area of trade-related intellectual property rights. As one of the covered agreements under the DSU, the *TRIPS Agreement* is subject to the dispute settlement rules and procedures of that Understanding. The dispute that gives rise to this case represents the first time the *TRIPS Agreement* has been submitted to the scrutiny of the WTO dispute settlement system.



30. Among the many provisions of the *TRIPS Agreement* are certain specific obligations relating to patent protection for pharmaceutical and agricultural chemical products. With respect to patentable subject matter, Article 27.1 of the *TRIPS Agreement* provides generally:

Subject to the provisions of paragraphs 2 and 3, patents shall be available for any inventions, whether products or processes, in all fields of technology, provided that they are new, involve an inventive step and are capable of industrial application. Subject to paragraph 4 of Article 65, paragraph 8 of Article 70 and paragraph 3 of this Article, patents shall be available and patent rights enjoyable without discrimination as to the place of invention, the field of technology and whether products are imported or locally produced. (footnote deleted)

31. However, Article 65 of the *TRIPS Agreement* provides, in pertinent part:

1. Subject to the provisions of paragraphs 2, 3 and 4, no Member shall be obliged to apply the provisions of this Agreement before the expiry of a general period of one year following the date of entry into force of the WTO Agreement.

2. A developing country Member is entitled to delay for a further period of four years the date of application, as defined in paragraph 1, of the provisions of this Agreement other than Articles 3, 4 and 5.

...

4. To the extent that a developing country Member is obliged by this Agreement to extend product patent protection to areas of technology not so protectable in its territory on the general date of application of this Agreement for that Member, as defined in paragraph 2, it may delay the application of the provisions on product patents of Section 5 of Part II to such areas of technology for an additional period of five years.

5. A Member availing itself of a transitional period under paragraphs 1, 2, 3 or 4 shall ensure that any changes in its laws, regulations and practice made during that period do not result in a lesser degree of consistency with the provisions of this Agreement.

32. With respect to patent protection for pharmaceutical and agricultural chemical products, certain specific obligations are found in Articles 70.8 and 70.9 of the *TRIPS Agreement*. The interpretation of these specific obligations is the subject of this dispute. Our task is to address the legal issues arising from this dispute that are raised in this appeal.

## V. Interpretation of the *TRIPS Agreement*

33. As one of the fundamental issues in this appeal, India has questioned the Panel's enunciation and application of a general interpretative principle which, the Panel stated, "must be taken into account" in interpreting the provisions of the *TRIPS Agreement*. The Panel found that:

... when interpreting the text of the TRIPS Agreement, the legitimate expectations of WTO Members concerning the TRIPS Agreement must be taken into account, as well as standards of interpretation developed in past panel reports in the GATT framework, in particular those laying down the principle of the protection of conditions of competition flowing from multilateral trade agreements.<sup>17</sup>

India argues that the Panel's invocation of this principle caused the Panel to misinterpret both Article 70.8 and Article 70.9 and led the Panel to err in determining whether India had complied with those obligations.<sup>18</sup>

34. The Panel stated that:

The protection of legitimate expectations of Members regarding the conditions of competition is a well-established GATT principle, which derives in part from Article XXIII, the basic dispute settlement provisions of GATT (and the WTO).<sup>19</sup>

The Panel also referred to certain GATT 1947 panel reports<sup>20</sup> as authority for this principle. The Panel noted that whereas the "disciplines formed under GATT 1947 (so-called GATT *acquis*) were primarily directed at the treatment of the goods of other countries", "the concept of the protection of legitimate expectations" in relation to the *TRIPS Agreement* applies to "the competitive relationship between a Member's own nationals and those of other Members (rather than between domestically produced goods and the goods of other Members, as in the goods area)".<sup>21</sup>

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<sup>17</sup>Panel Report, para. 7.22.

<sup>18</sup>India's appellant's submission, pp. 5-8 and 21.

<sup>19</sup>Panel Report, para. 7.20

<sup>20</sup>In particular: Panel Report, *Italian Discrimination Against Imported Agricultural Machinery*, adopted 23 October 1958, BISD 7S/60, paras. 12-13; Panel Report, *United States - Taxes on Petroleum and Certain Imported Substances*, adopted 17 June 1987, BISD 34S/136, para. 5.22; and Panel Report, *United States - Section 337 of the Tariff Act of 1930*, adopted 7 November 1989, BISD 36S/345, para. 5.13.

<sup>21</sup>Panel Report, para. 7.21.

35. In *Japan - Taxes on Alcoholic Beverages*, on the status of adopted panel reports, we acknowledged:

Article XVI:1 of the *WTO Agreement* and paragraph 1(b)(iv) of the language of Annex 1A incorporating the GATT 1994 into the *WTO Agreement* bring the legal history and experience under the GATT 1947 into the new realm of the WTO in a way that ensures continuity and consistency in a smooth transition from the GATT 1947 system. This affirms the importance to the Members of the WTO of the experience acquired by the CONTRACTING PARTIES to the GATT 1947 -- and acknowledges the continuing relevance of that experience to the new trading system served by the WTO. Adopted panel reports are an important part of the GATT *acquis*.<sup>22</sup>

36. Although the Panel states that it is merely applying a "well-established GATT principle", the Panel's reasoning does not accurately reflect GATT/WTO practice. In developing its interpretative principle, the Panel merges, and thereby confuses, two different concepts from previous GATT practice. One is the concept of protecting the expectations of contracting parties as to the competitive relationship between their products and the products of other contracting parties. This is a concept that was developed in the context of *violation* complaints involving Articles III and XI, brought under Article XXIII:1(a), of the GATT 1947. The other is the concept of the protection of the reasonable expectations of contracting parties relating to market access concessions. This is a concept that was developed in the context of *non-violation* complaints brought under Article XXIII:1(b) of the GATT.

37. Article 64.1 of the *TRIPS Agreement* incorporates by reference Article XXIII of the GATT 1994 as the general dispute settlement provision governing the *TRIPS Agreement*.<sup>23</sup> Thus, we have no quarrel in principle with the notion that past GATT practice with respect to Article XXIII is pertinent to interpretation of the *TRIPS Agreement*. However, such interpretation must show proper appreciation of the different bases for action under Article XXIII.

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<sup>22</sup>Adopted 1 November 1996, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, p. 14.

<sup>23</sup>Article 64.1 of the *TRIPS Agreement* reads:

The provisions of Articles XXII and XXIII of GATT 1994 as elaborated and applied by the Dispute Settlement Understanding shall apply to consultations and the settlement of disputes under this Agreement except as otherwise specifically provided herein.

38. Article XXIII:1 of the GATT 1994 sets out the various causes of action on which a Member may base a complaint. A Member may have recourse to dispute settlement under Article XXIII when it considers that:

... any benefit accruing to it directly or indirectly under this Agreement is being nullified or impaired or that the attainment of any objective of the Agreement is being impeded as the result of

- (a) the failure of another contracting party to carry out its obligations under this Agreement, or
- (b) the application by another contracting party of any measure, whether or not it conflicts with the provisions of this Agreement, or
- (c) the existence of any other situation.<sup>24</sup>

39. Article XXIII:1(a) involves so-called "violation" complaints. These are disputes that arise from an alleged failure by a Member to carry out its obligations. During nearly fifty years of experience, Article XXIII:1(a) has formed the basis of almost all disputes under the GATT 1947 and the *WTO Agreement*. In contrast, Article XXIII:1(b) involves so-called "non-violation" complaints. These are disputes that do not require an allegation of a violation of an obligation. The basis of a cause of action under Article XXIII:1(b) is not necessarily a violation of the rules, but rather the nullification or impairment of a benefit accruing to a Member under a covered agreement. In the history of the GATT/WTO, there have been only a handful of "non-violation" cases arising under Article XXIII:1(b).<sup>25</sup> Article XXIII:1(c), covering what are commonly called "situation" complaints, has never been the foundation for a recommendation or ruling of the GATT CONTRACTING PARTIES or the Dispute Settlement Body, although it has formed the basis for parties' arguments before panels in a small number of cases.<sup>26</sup>

40. In the context of violation complaints made under Article XXIII:1(a), it is true that panels examining claims under Articles III and XI of the GATT have frequently stated that the purpose of

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<sup>24</sup>Article XXIII:1 of the GATT 1994.

<sup>25</sup>Previous panels have found "non-violation" nullification or impairment in only four of 14 cases where it was alleged: Working Party Report, *Australia - Subsidy on Ammonium Sulphate*, adopted 3 April 1950, BISD II/188; Panel Report, *Germany - Imports of Sardines*, adopted 31 October 1952, BISD IS/53; Panel Report, *Germany - Import Duties on Starch and Potato Flour*, noted 16 February 1955, BISD 3S/77; and Panel Report, *European Communities - Payments and Subsidies Paid to Processors and Producers of Oilseeds and Related Animal-Feed Proteins*, adopted 25 January 1990, BISD 37S/86.

<sup>26</sup>See, generally, F. Roessler, "The Concept of Nullification and Impairment in the Legal System of the World Trade Organization" in E.-U. Petersmann (ed.), *International Trade Law and the GATT/WTO Dispute Settlement System* (Kluwer, 1997), pp. 123-142; and E.-U. Petersmann, *The GATT/WTO Dispute Settlement System: International Law, International Organizations and Dispute Settlement* (Kluwer, 1997), pp. 170-176.

these articles is to protect the expectations of Members concerning the competitive relationship between imported and domestic products, as opposed to expectations concerning trade volumes. However, this statement is often made *after* a panel has found a violation of, for example, Article III or Article XI that establishes a *prima facie* case of nullification or impairment.<sup>27</sup> At that point in its reasoning, the panel is examining whether the defending party has been able to rebut the charge of nullification or impairment. It is in this context that panels have referred to the expectations of Members concerning the conditions of competition.

41. The doctrine of protecting the "reasonable expectations" of contracting parties developed in the context of "non-violation" complaints brought under Article XXIII:1(b) of the GATT 1947. Some of the rules and procedures concerning "non-violation" cases have been codified in Article 26.1 of the DSU. "Non-violation" complaints are rooted in the GATT's origins as an agreement intended to protect the reciprocal tariff concessions negotiated among the contracting parties under Article II.<sup>28</sup> In the absence of substantive legal rules in many areas relating to international trade, the "non-violation" provision of Article XXIII:1(b) was aimed at preventing contracting parties from using non-tariff barriers or other policy measures to negate the benefits of negotiated tariff concessions. Under Article XXIII:1(b) of the GATT 1994, a Member can bring a "non-violation" complaint when the negotiated balance of concessions between Members is upset by the application of a measure, whether or not this measure is inconsistent with the provisions of the covered agreement. The ultimate goal is not the withdrawal of the measure concerned, but rather achieving a mutually satisfactory adjustment, usually by means of compensation.<sup>29</sup>

42. Article 64.2 of the *TRIPS Agreement* states:

Subparagraphs 1(b) and 1(c) of Article XXIII of GATT 1994 shall not apply to the settlement of disputes under this Agreement for a period of five years from the date of entry into force of the WTO Agreement.

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<sup>27</sup>See, for example: Working Party Report, *Brazilian Internal Taxes*, adopted 30 June 1949, BISD II/181, para. 16; Panel Report, *United States - Taxes on Petroleum and Certain Imported Substances*, adopted 17 June 1987, BISD 34S/136, para. 5.1.9; Panel Report, *Canada - Administration of the Foreign Investment Review Act*, adopted 7 February 1984, BISD 30S/140, para. 6.6; Panel Report, *Japanese Measures on Imports of Leather*, adopted 15/16 May 1984, BISD 31S/94, para. 55; Panel Report, *Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, adopted 10 November 1987, BISD 34S/83, para. 5.11; Panel Report, *European Economic Community - Restrictions on Imports of Apples*, adopted 22 June 1989, BISD 36S/135, para. 5.25; and Panel Report, *United States - Measures Affecting the Importation, Internal Sale and Use of Tobacco*, adopted 4 October 1994, DS44/R, para. 99.

<sup>28</sup>See, in general, E.-U. Petersmann, "Violation Complaints and Non-violation Complaints in International Law" (1991) *German Yearbook of International Law* 175.

<sup>29</sup>This is codified in Article 26.1(b) of the DSU.

The meaning of this provision is clear: the *only* cause of action permitted under the *TRIPS Agreement* during the first five years after the entry into force of the *WTO Agreement* is a "violation" complaint under Article XXIII:1(a) of the GATT 1994. This case involves allegations of violation of obligations under the *TRIPS Agreement*. However, the Panel's invocation of the "legitimate expectations" of Members relating to conditions of competition melds the legally-distinct bases for "violation" and "non-violation" complaints under Article XXIII of the GATT 1994 into one uniform cause of action. This is not consistent with either Article XXIII of the GATT 1994 or Article 64 of the *TRIPS Agreement*. Whether or not "non-violation" complaints should be available for disputes under the *TRIPS Agreement* is a matter that remains to be determined by the Council for Trade-Related Aspects of Intellectual Property (the "Council for TRIPS") pursuant to Article 64.3 of the *TRIPS Agreement*. It is *not* a matter to be resolved through interpretation by panels or by the Appellate Body.

43. In addition to relying on the GATT *acquis*, the Panel relies also on the customary rules of interpretation of public international law as a basis for the interpretative principle it offers for the *TRIPS Agreement*. Specifically, the Panel relies on Article 31 of the *Vienna Convention*, which provides in part:

1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.

44. With this customary rule of interpretation in mind, the Panel stated that:

In our view, good faith interpretation requires the protection of legitimate expectations derived from the protection of intellectual property rights provided for in the Agreement.<sup>30</sup>

45. The Panel misapplies Article 31 of the *Vienna Convention*. The Panel misunderstands the concept of legitimate expectations in the context of the customary rules of interpretation of public international law. The legitimate expectations of the parties to a treaty are reflected in the language of the treaty itself. The duty of a treaty interpreter is to examine the words of the treaty to determine the intentions of the parties. This should be done in accordance with the principles of treaty interpretation set out in Article 31 of the *Vienna Convention*. But these principles of interpretation neither require nor condone

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<sup>30</sup>Panel Report, para. 7.18.

the imputation into a treaty of words that are not there or the importation into a treaty of concepts that were not intended.

46. In *United States - Standards for Reformulated and Conventional Gasoline*<sup>31</sup>, we set out the proper approach to be applied in interpreting the *WTO Agreement* in accordance with the rules in Article 31 of the *Vienna Convention*. These rules must be respected and applied in interpreting the *TRIPS Agreement* or any other covered agreement. The Panel in this case has created its own interpretative principle, which is consistent with neither the customary rules of interpretation of public international law nor established GATT/WTO practice. Both panels and the Appellate Body must be guided by the rules of treaty interpretation set out in the *Vienna Convention*, and must not add to or diminish rights and obligations provided in the *WTO Agreement*.

47. This conclusion is dictated by two separate and very specific provisions of the DSU. Article 3.2 of the DSU provides that the dispute settlement system of the WTO:

... serves to preserve the rights and obligations of the Members under the covered agreements, and to clarify the existing provisions of those agreements in accordance with customary rules of interpretation of public international law. Recommendations and rulings of the DSB cannot add to or diminish the rights and obligations provided in the covered agreements.

Furthermore, Article 19.2 of the DSU provides:

In accordance with paragraph 2 of Article 3, in their findings and recommendations, the panel and Appellate Body cannot add to or diminish the rights and obligations provided in the covered agreements.

These provisions speak for themselves. Unquestionably, both panels and the Appellate Body are bound by them.

48. For these reasons, we do not agree with the Panel that the legitimate expectations of Members *and* private rights holders concerning conditions of competition must always be taken into account in interpreting the *TRIPS Agreement*.

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<sup>31</sup>Adopted 20 May 1996, WT/DS2/AB/R, pp. 16-17.

**VI. Article 70.8**

49. Article 70.8 states:

Where a Member does not make available as of the date of entry into force of the WTO Agreement patent protection for pharmaceutical and agricultural chemical products commensurate with its obligations under Article 27, that Member shall:

- (a) notwithstanding the provisions of Part VI, provide as from the date of entry into force of the WTO Agreement a means by which applications for patents for such inventions can be filed;
- (b) apply to these applications, as of the date of application of this Agreement, the criteria for patentability as laid down in this Agreement as if those criteria were being applied on the date of filing in that Member or, where priority is available and claimed, the priority date of the application; and
- (c) provide patent protection in accordance with this Agreement as from the grant of the patent and for the remainder of the patent term, counted from the filing date in accordance with Article 33 of this Agreement, for those of these applications that meet the criteria for protection referred to in subparagraph (b).

50. With respect to Article 70.8(a), the Panel found that:

... Article 70.8(a) requires the Members in question to establish a means that not only appropriately allows for the entitlement to file mailbox applications and the allocation of filing and priority dates to them, but also provides a sound legal basis to preserve novelty and priority as of those dates, so as to eliminate any reasonable doubts regarding whether mailbox applications and eventual patents based on them could be rejected or invalidated because, at the filing or priority date, the matter for which protection was sought was unpatentable in the country in question.<sup>32</sup>

51. In India's view, the obligations in Article 70.8(a) are met by a developing country Member where it establishes a mailbox for receiving, dating and storing patent applications for pharmaceutical and agricultural chemical products in a manner that properly allots filing and priority dates to those

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<sup>32</sup>Panel Report, para. 7.31.



applications in accordance with paragraphs (b) and (c) of Article 70.8.<sup>33</sup> India asserts that the Panel established an additional obligation "to create legal certainty that the patent applications and the eventual patents based on them will not be rejected or invalidated in the future".<sup>34</sup> This, India argues, is a legal error by the Panel.

52. The introductory clause to Article 70.8 provides that it applies "[w]here a Member does not make available as of the date of entry into force of the WTO Agreement patent protection for pharmaceutical and agricultural chemical products commensurate with its obligations under Article 27 ..." of the *TRIPS Agreement*. Article 27 requires that patents be made available "for any inventions, whether products or processes, in all fields of technology", subject to certain exceptions. However, pursuant to paragraphs 1, 2 and 4 of Article 65, a developing country Member may delay providing product patent protection in areas of technology not protectable in its territory on the general date of application of the *TRIPS Agreement* for that Member until 1 January 2005. Article 70.8 relates specifically and exclusively to situations where a Member does not provide, as of 1 January 1995, patent protection for pharmaceutical and agricultural chemical products.

53. By its terms, Article 70.8(a) applies "notwithstanding the provisions of Part VI" of the *TRIPS Agreement*. Part VI of the *TRIPS Agreement*, consisting of Articles 65, 66 and 67, allows for certain "transitional arrangements" in the application of certain provisions of the *TRIPS Agreement*. These "transitional arrangements", which allow a Member to delay the application of some of the obligations in the *TRIPS Agreement* for certain specified periods<sup>35</sup>, do not apply to Article 70.8. Thus, although there are "transitional arrangements" which allow developing country Members, in particular, more time to implement certain of their obligations under the *TRIPS Agreement*, no such "transitional arrangements" exist for the obligations in Article 70.8.

54. Article 70.8(a) imposes an obligation on Members to provide "a means" by which mailbox applications can be filed "from the date of entry into force of the WTO Agreement". Thus, this obligation has been in force since 1 January 1995. The issue before us in this appeal is not whether

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<sup>33</sup>India's appellant's submission, pp. 4-5.

<sup>34</sup>India's appellant's submission, p. 5.

<sup>35</sup>Pursuant to Article 65.1, all Members were entitled to delay the application of most of the provisions of the *TRIPS Agreement* for one year after the date of entry into force of the *WTO Agreement*. Pursuant to Article 65.2, developing country Members are generally entitled to a delay of a further four years. Where a developing country Member is obliged to extend patent protection to areas of technology to which it did not extend such protection on the general date of application of the *TRIPS Agreement* for that Member, Article 65.4 states that that developing country Member may delay the application of the provisions on product patents to such areas of technology for an additional period of five years.

this obligation exists or whether this obligation is now in force. Clearly, it exists, and, equally clearly, it is in force now. The issue before us in this appeal is: what precisely is the "means" for filing mailbox applications that is contemplated and required by Article 70.8(a)? To answer this question, we must interpret the terms of Article 70.8(a).

55. We agree with the Panel that "[t]he analysis of the ordinary meaning of these terms alone does not lead to a definitive interpretation as to what sort of 'means' is required by this subparagraph".<sup>36</sup> Therefore, in accordance with the general rules of treaty interpretation set out in Article 31 of the *Vienna Convention*, to discern the meaning of the terms in Article 70.8(a), we must also read this provision in its context, and in light of the object and purpose of the *TRIPS Agreement*.

56. Paragraphs (b) and (c) of Article 70.8 constitute part of the context for interpreting Article 70.8(a). Paragraphs (b) and (c) of Article 70.8 require that the "means" provided by a Member under Article 70.8(a) must allow the filing of applications for patents for pharmaceutical and agricultural chemical products from 1 January 1995 and preserve the dates of filing and priority of those applications, so that the criteria for patentability may be applied as of those dates, and so that the patent protection eventually granted is dated back to the filing date. In this respect, we agree with the Panel that,

... in order to prevent the loss of the novelty of an invention ... filing and priority dates need to have a sound legal basis if the provisions of Article 70.8 are to fulfil their purpose. Moreover, if available, a filing must entitle the applicant to claim priority on the basis of an earlier filing in respect of the claimed invention over applications with subsequent filing or priority dates. Without legally sound filing and priority dates, the mechanism to be established on the basis of Article 70.8 will be rendered inoperational.<sup>37</sup>

57. On this, the Panel is clearly correct. The Panel's interpretation here is consistent also with the object and purpose of the *TRIPS Agreement*. The Agreement takes into account, *inter alia*, "the need to promote effective and adequate protection of intellectual property rights".<sup>38</sup> We believe the Panel was correct in finding that the "means" that the Member concerned is obliged to provide under Article 70.8(a) must allow for "the entitlement to file mailbox applications and the allocation of filing

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<sup>36</sup>Panel Report, para. 7.25.

<sup>37</sup>Panel Report, para. 7.28.

<sup>38</sup>Preamble to the *TRIPS Agreement*.

and priority dates to them".<sup>39</sup> Furthermore, the Panel was correct in finding that the "means" established under Article 70.8(a) must also provide "a sound legal basis to preserve novelty and priority as of those dates".<sup>40</sup> These findings flow inescapably from the necessary operation of paragraphs (b) and (c) of Article 70.8.

58. However, we do *not* agree with the Panel that Article 70.8(a) requires a Member to establish a means "so as to eliminate any reasonable doubts regarding whether mailbox applications and eventual patents based on them could be rejected or invalidated because, at the filing or priority date, the matter for which protection was sought was unpatentable in the country in question".<sup>41</sup> India is *entitled*, by the "transitional arrangements" in paragraphs 1, 2 and 4 of Article 65, to delay application of Article 27 for patents for pharmaceutical and agricultural chemical products until 1 January 2005. In our view, India is obliged, by Article 70.8(a), to provide a legal mechanism for the filing of mailbox applications that provides a sound legal basis to preserve both the novelty of the inventions and the priority of the applications as of the relevant filing and priority dates. No more.

59. But what constitutes such a sound legal basis in Indian law? To answer this question, we must recall first an important general rule in the *TRIPS Agreement*. Article 1.1 of the *TRIPS Agreement* states, in pertinent part:

... Members shall be free to determine the appropriate method of implementing the provisions of this Agreement within their own legal system and practice.

Members, therefore, are free to determine how best to meet their obligations under the *TRIPS Agreement* within the context of their own legal systems. And, as a Member, India is "free to determine the appropriate method of implementing" its obligations under the *TRIPS Agreement* within the context of its own legal system.

60. India insists that it has done that. India contends that it has established, through "administrative instructions"<sup>42</sup>, a "means" consistent with Article 70.8(a) of the *TRIPS Agreement*. According to India,

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<sup>39</sup>Panel Report, para. 7.31.

<sup>40</sup>Panel Report, para. 7.31.

<sup>41</sup>*Ibid.*

<sup>42</sup>This is India's term for its measure. India's appellant's submission, p. 10.

these "administrative instructions" establish a mechanism that provides a sound legal basis to preserve the novelty of the inventions and the priority of the applications as of the relevant filing and priority dates consistent with Article 70.8(a) of the *TRIPS Agreement*. According to India, pursuant to these "administrative instructions", the Patent Office has been directed to store applications for patents for pharmaceutical and agricultural chemical products separately for future action pursuant to Article 70.8, and the Controller General of Patents Designs and Trademarks ("the Controller") has been instructed not to refer them to an examiner until 1 January 2005. According to India, these "administrative instructions" are legally valid in Indian law<sup>43</sup>, as they are reflected in the Minister's Statement to Parliament of 2 August 1996.<sup>44</sup> And, according to India:

There is ... *absolute certainty* that India can, when patents are due in accordance with subparagraphs (b) and (c) of Article 70.8, decide to grant such patents on the basis of the applications currently submitted and determine the novelty and priority of the inventions in accordance with the date of these applications.<sup>45</sup> (emphasis added)

61. India has not provided any text of these "administrative instructions" either to the Panel or to us.

62. Whatever their substance or their import, these "administrative instructions" were not the initial "means" chosen by the Government of India to meet India's obligations under Article 70.8(a) of the *TRIPS Agreement*. The Government of India's initial preference for establishing a "means" for filing mailbox applications under Article 70.8(a) was the Patents (Amendment) Ordinance (the "Ordinance"), promulgated by the President of India on 31 December 1994 pursuant to Article 123 of India's Constitution. Article 123 enables the President to promulgate an ordinance when Parliament is not in session, and when the President is satisfied "that circumstances exist which render it necessary for him to take immediate action". India notified the Ordinance to the Council for TRIPS, pursuant to Article 63.2 of the *TRIPS Agreement*, on 6 March 1995.<sup>46</sup> In accordance with the terms of Article 123 of India's Constitution, the Ordinance expired on 26 March 1995, six weeks after the reassembly of Parliament. This was followed by an unsuccessful effort to enact the Patents (Amendment) Bill 1995

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<sup>43</sup>Response by India to questioning at the oral hearing.

<sup>44</sup>Panel Report, Annex 2.

<sup>45</sup>India's appellant's submission, p. 8.

<sup>46</sup>IP/N/1/IND/1, 8 March 1995.

to implement the contents of the Ordinance on a permanent basis.<sup>47</sup> This Bill was introduced in the Lok Sabha (Lower House) in March 1995. After being passed by the Lok Sabha, it was referred to a Select Committee of the Rajya Sabha (Upper House) for examination and report. However, the Bill was subsequently not enacted due to the dissolution of Parliament on 10 May 1996. From these actions, it is apparent that the Government of India initially considered the enactment of amending legislation to be necessary in order to implement its obligations under Article 70.8(a). However, India maintains that the "administrative instructions" issued in April 1995 effectively continued the mailbox system established by the Ordinance, thus obviating the need for a formal amendment to the Patents Act or for a new notification to the Council for TRIPS.<sup>48</sup>

63. With respect to India's "administrative instructions", the Panel found that "the current administrative practice creates a certain degree of legal insecurity in that it requires Indian officials to ignore certain mandatory provisions of the Patents Act"<sup>49</sup>; and that "even if Patent Office officials do not examine and reject mailbox applications, a competitor might seek a judicial order to do so in order to obtain rejection of a patent claim".<sup>50</sup>

64. India asserts that the Panel erred in its treatment of India's municipal law because municipal law is a fact that must be established before an international tribunal by the party relying on it. In India's view, the Panel did not assess the Indian law as a fact to be established by the United States, but rather as a law to be interpreted by the Panel. India argues that the Panel should have given India the benefit of the doubt as to the status of its mailbox system under Indian domestic law. India claims, furthermore, that the Panel should have sought guidance from India on matters relating to the interpretation of Indian law.<sup>51</sup>

65. In public international law, an international tribunal may treat municipal law in several ways.<sup>52</sup> Municipal law may serve as evidence of facts and may provide evidence of state practice. However, municipal law may also constitute evidence of compliance or non-compliance with international

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<sup>47</sup>We note that an Expert Group advised the Indian Government that a formal legal basis was required to make the mailbox system valid under Indian law. See Panel Report, para. 7.36.

<sup>48</sup>Response of India to questioning at the oral hearing.

<sup>49</sup>Panel Report, para. 7.35.

<sup>50</sup>Panel Report, para. 7.37.

<sup>51</sup>India's appellant's submission, pp. 13 and 15.

<sup>52</sup>See, for example, I. Brownlie, *Principles of Public International Law*, 4th ed. (Clarendon Press, 1990), pp. 40-42.

obligations. For example, in *Certain German Interests in Polish Upper Silesia*, the Permanent Court of International Justice observed:

It might be asked whether a difficulty does not arise from the fact that the Court would have to deal with the Polish law of July 14th, 1920. This, however, does not appear to be the case. From the standpoint of International Law and of the Court which is its organ, municipal laws are merely facts which express the will and constitute the activities of States, in the same manner as do legal decisions and administrative measures. *The Court is certainly not called upon to interpret the Polish law as such; but there is nothing to prevent the Court's giving judgment on the question whether or not, in applying that law, Poland is acting in conformity with its obligations towards Germany under the Geneva Convention.*<sup>53</sup> (emphasis added)

66. In this case, the Panel was simply performing its task in determining whether India's "administrative instructions" for receiving mailbox applications were in conformity with India's obligations under Article 70.8(a) of the *TRIPS Agreement*. It is clear that an examination of the relevant aspects of Indian municipal law and, in particular, the relevant provisions of the Patents Act as they relate to the "administrative instructions", is essential to determining whether India has complied with its obligations under Article 70.8(a). There was simply no way for the Panel to make this determination without engaging in an examination of Indian law. But, as in the case cited above before the Permanent Court of International Justice, in this case, the Panel was not interpreting Indian law "as such"; rather, the Panel was examining Indian law solely for the purpose of determining whether India had met its obligations under the *TRIPS Agreement*. To say that the Panel should have done otherwise would be to say that only India can assess whether Indian law is consistent with India's obligations under the *WTO Agreement*. This, clearly, cannot be so.

67. Previous GATT/WTO panels also have conducted a detailed examination of the domestic law of a Member in assessing the conformity of that domestic law with the relevant GATT/WTO obligations. For example, in *United States - Section 337 of the Tariff Act of 1930*<sup>54</sup>, the panel conducted a detailed examination of the relevant United States' legislation and practice, including the remedies available under Section 337 as well as the differences between patent-based Section 337 proceedings and federal district court proceedings, in order to determine whether Section 337 was inconsistent with Article III:4 of the GATT 1947. This seems to us to be a comparable case.

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<sup>53</sup>[1926], PCIJ Rep., Series A, No. 7, p. 19.

<sup>54</sup>Adopted 7 November 1989, BISD 36S/345.

68. And, just as it was necessary for the Panel in this case to seek a detailed understanding of the operation of the Patents Act as it relates to the "administrative instructions" in order to assess whether India had complied with Article 70.8(a), so, too, is it necessary for us in this appeal to review the Panel's examination of the same Indian domestic law.

69. To do so, we must look at the specific provisions of the Patents Act. Section 5(a) of the Patents Act provides that substances "intended for use, or capable of being used, as food or as medicine or drug" are not patentable. "When the complete specification has been led in respect of an application for a patent", section 12(1) *requires* the Controller to refer that application and that specification to an examiner. Moreover, section 15(2) of the Patents Act states that the Controller "shall refuse" an application in respect of a substance that is not patentable. We agree with the Panel that these provisions of the Patents Act are mandatory.<sup>55</sup> And, like the Panel, we are not persuaded that India's "administrative instructions" would prevail over the contradictory mandatory provisions of the Patents Act.<sup>56</sup> We note also that, in issuing these "administrative instructions", the Government of India did not avail itself of the provisions of section 159 of the Patents Act, which allows the Central Government "to make rules for carrying out the provisions of [the] Act" or section 160 of the Patents Act, which requires that such rules be laid before each House of the Indian Parliament. We are told by India that such rulemaking was not required for the "administrative instructions" at issue here. But this, too, seems to be inconsistent with the mandatory provisions of the Patents Act.

70. We are not persuaded by India's explanation of these seeming contradictions. Accordingly, we are not persuaded that India's "administrative instructions" would survive a legal challenge under the Patents Act. And, consequently, we are not persuaded that India's "administrative instructions" provide a sound legal basis to preserve novelty of inventions and priority of applications as of the relevant filing and priority dates.

71. For these reasons, we agree with the Panel's conclusion that India's "administrative instructions" for receiving mailbox applications are inconsistent with Article 70.8(a) of the *TRIPS Agreement*.

72. India raises the additional argument that the Panel erred in its application of the burden of proof in assessing Indian municipal law. In particular, India alleges that the Panel, after having required

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<sup>55</sup>Panel Report, para. 7.35.

<sup>56</sup>Panel Report, para. 7.37.

the United States merely to raise "reasonable doubts" suggesting a violation of Article 70.8, placed the burden on India to dispel such doubts.<sup>57</sup>

73. The Panel states:

As the Appellate Body report on *Shirts and Blouses* points out, "a party claiming a violation of a provision of the WTO Agreement by another Member must assert and prove its claim". In this case, it is the United States that claims a violation by India of Article 70.8 of the TRIPS Agreement. Therefore, it is up to the United States to put forward evidence and legal arguments sufficient to demonstrate that action by India is inconsistent with the obligations assumed by India under Article 70.8. In our view, the United States has successfully put forward such evidence and arguments. Then, ... the onus shifts to India to bring forward evidence and arguments to disprove the claim. We are not convinced that India has been able to do so (footnotes deleted).<sup>58</sup>

74. This statement of the Panel is a legally correct characterization of the approach to burden of proof that we set out in *United States - Shirts and Blouses*.<sup>59</sup> However, it is not sufficient for a panel to enunciate the correct approach to burden of proof; a panel must also apply the burden of proof correctly. A careful reading of paragraphs 7.35 and 7.37 of the Panel Report reveals that the Panel has done so in this case. These paragraphs show that the United States put forward evidence and arguments that India's "administrative instructions" pertaining to mailbox applications were legally insufficient to prevail over the application of certain mandatory provisions of the Patents Act. India put forward rebuttal evidence and arguments. India misinterprets what the Panel said about "reasonable doubts". The Panel did not require the United States merely to raise "reasonable doubts" before the burden shifted to India. Rather, after properly requiring the United States to establish a *prima facie* case and after hearing India's rebuttal evidence and arguments, the Panel concluded that *it* had "reasonable doubts" that the "administrative instructions" would prevail over the mandatory provisions of the Patents Act if a challenge were brought in an Indian court.

75. For these reasons, we conclude that the Panel applied the burden of proof correctly in assessing the compliance of India's domestic law with Article 70.8(a) of the *TRIPS Agreement*.

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<sup>57</sup>India's appellant's submission, p. 12.

<sup>58</sup>Panel Report, para. 7.40.

<sup>59</sup>Adopted 23 May 1997, WT/DS33/AB/R, p. 16.



**VII. Article 70.9**

76. Article 70.9 of the *TRIPS Agreement* reads:

Where a product is the subject of a patent application in a Member in accordance with paragraph 8(a), exclusive marketing rights shall be granted, notwithstanding the provisions of Part VI, for a period of five years after obtaining marketing approval in that Member or until a product patent is granted or rejected in that Member, whichever period is shorter, provided that, subsequent to the entry into force of the WTO Agreement, a patent application has been filed and a patent granted for that product in another Member and marketing approval obtained in such other Member.

77. With respect to Article 70.9, the Panel found:

Based on customary rules of treaty interpretation, we have reached the conclusion that under Article 70.9 there must be a mechanism ready for the grant of exclusive marketing rights at any time subsequent to the date of entry into force of the WTO Agreement.<sup>60</sup>

78. India argues that Article 70.9 establishes an obligation to grant exclusive marketing rights for a product that is the subject of a patent application under Article 70.8(a) after all the other conditions specified in Article 70.9 have been fulfilled.<sup>61</sup> India asserts that there are many provisions in the *TRIPS Agreement* that, unlike Article 70.9, explicitly oblige Members to change their domestic laws to authorize their domestic authorities to take certain action before the need to take such action actually arises.<sup>62</sup> India maintains that the Panel's interpretation of Article 70.9 has the consequence that the transitional arrangements in Article 65 allow developing country Members to postpone legislative changes in all fields of technology except the most "sensitive" ones, pharmaceutical and agricultural chemical products. India claims that the Panel turned an obligation to take action in the future into an obligation to take action immediately.<sup>63</sup>

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<sup>60</sup>Panel Report, para. 7.60.

<sup>61</sup>India's appellant's submission, p. 19.

<sup>62</sup>*Ibid.*; for example, India asserts that according to Articles 42-48 of the *TRIPS Agreement*, the judicial authorities of Members "shall have the authority" to grant certain rights. Article 51 obliges Members to "adopt procedures" to enable right holders to prevent the release of counterfeited or pirated products from customs. Article 39.2 requires Members to give natural and legal persons "the possibility of preventing" the disclosure of information. According to Article 25.1 "Members shall provide for the protection" of certain industrial designs and Article 22.2 obliges Members to "provide the legal means for interested parties to prevent" certain misuses of geographical indications. India further asserts that a comparison of the terms of Article 70.9 with those of Article 27 according to which "patents shall be available" for inventions is revealing.

<sup>63</sup>India's appellant's submission, p. 21.

79. India's arguments must be examined in the light of Article XVI:4 of the *WTO Agreement*, which requires that:

Each Member shall ensure the conformity of its laws, regulations and administrative procedures with its obligations as provided in the annexed Agreements.

80. Moreover, India acknowledged before the Panel and in this appeal that, under Indian law, it is necessary to enact legislation in order to grant exclusive marketing rights in compliance with the provisions of Article 70.9. This was already implied in the Ordinance, which contained detailed provisions for the grant of exclusive marketing rights in India effective 1 January 1995. However, with the expiry of the Ordinance on 26 March 1995, no legal basis remained, and with the failure to enact the Patents (Amendment) Bill 1995 due to the dissolution of Parliament on 10 May 1996, no legal basis currently exists, for the grant of exclusive marketing rights in India. India notified the Council for TRIPS of the promulgation of the Ordinance pursuant to Article 63.2 of the *TRIPS Agreement*<sup>64</sup>, but has failed as yet to notify the Council for TRIPS that the Ordinance has expired.

81. Given India's admissions that legislation is necessary in order to grant exclusive marketing rights in compliance with Article 70.9 and that it does not currently have such legislation, the issue for us to consider in this appeal is whether a failure to have in place a mechanism ready for the grant of exclusive marketing rights, effective *as from the date of entry into force* of the *WTO Agreement*, constitutes a violation of India's obligations under Article 70.9 of the *TRIPS Agreement*.

82. By its terms, Article 70.9 applies only in situations where a product patent application is filed under Article 70.8(a). Like Article 70.8(a), Article 70.9 applies "notwithstanding the provisions of Part VI". Article 70.9 specifically refers to Article 70.8(a), and they operate in tandem to provide a package of rights and obligations that apply *during* the transitional periods contemplated in Article 65. It is obvious, therefore, that both Article 70.8(a) *and* Article 70.9 are intended to apply as from the date of entry into force of the *WTO Agreement*.

83. India has an obligation to implement the provisions of Article 70.9 of the *TRIPS Agreement* effective as from the date of entry into force of the *WTO Agreement*, that is, 1 January 1995. India concedes that legislation is needed to implement this obligation. India has not enacted such legislation.

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<sup>64</sup>IP/N/1/IND/1, 8 March 1995.

To give meaning and effect to the rights and obligations under Article 70.9 of the *TRIPS Agreement*, such legislation should have been in effect since 1 January 1995.

84. For these reasons, we agree with the Panel that India should have had a mechanism in place to provide for the grant of exclusive marketing rights effective as from the date of entry into force of the *WTO Agreement*, and, therefore, we agree with the Panel that India is in violation of Article 70.9 of the *TRIPS Agreement*.

### VIII. Article 63

85. India argues that, under Articles 3, 7 and 11 of the DSU, a panel may make findings only on issues that have been submitted to it by the parties to the dispute. With this in mind, India contends that the Panel exceeded its authority under the DSU by ruling on the subsidiary claim by the United States under Article 63 of the *TRIPS Agreement* after having first accepted the principal claim by the United States of a violation of Article 70.8 of the *TRIPS Agreement*.<sup>65</sup>

86. The facts are these. The Panel's terms of reference<sup>66</sup> refer to the request by the United States for the establishment of a panel.<sup>67</sup> The United States did not include a claim under Article 63 in its request for the establishment of a panel in this case.<sup>68</sup> The United States did not mention Article 63 in its first written submission to the Panel. The United States did not raise Article 63 as an alternative claim for the first time until its oral statement at the first substantive meeting of the parties with the Panel.

87. In *United States - Shirts and Blouses*, we said that "[a] panel need only address those claims which must be addressed in order to resolve the matter in issue in the dispute".<sup>69</sup> This means that a panel has the discretion to determine the claims it must address in order to resolve the dispute between the parties -- provided that those claims are within that panel's terms of reference. We have stressed, on more than one occasion, the fundamental importance of a panel's terms of reference.

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<sup>65</sup>India's appellant's submission, p. 24.

<sup>66</sup>WT/DS50/5, 5 February 1997.

<sup>67</sup>WT/DS50/4, 8 November 1996.

<sup>68</sup>*Ibid.*

<sup>69</sup>Adopted 23 May 1997, WT/DS33/AB/R, p. 19. A footnote to this statement reads: "The 'matter in issue' is the 'matter referred to the DSB' pursuant to Article 7 of the *DSU*".

In *European Communities - Regime for the Importation, Sale and Distribution of Bananas* ("*European Communities - Bananas*"), we found that "[i]t is the panel's terms of reference, governed by Article 7 of the DSU, which set out the claims of the complaining parties relating to the matter referred to the DSB".<sup>70</sup> In *Brazil - Measures Affecting Desiccated Coconut* ("*Brazil - Desiccated Coconut*"), we stated:

A panel's terms of reference are important for two reasons. First, terms of reference fulfil an important due process objective -- they give the parties and third parties sufficient information concerning the claims at issue in the dispute in order to allow them an opportunity to respond to the complainant's case. Second, they establish the jurisdiction of the panel by defining the precise claims at issue in the dispute.<sup>71</sup>

88. We stated also in *Brazil - Desiccated Coconut* that all claims must be included in the request for establishment of a panel in order to come within the panel's terms of reference, based on the practice of panels under the GATT 1947 and the Tokyo Round Codes.<sup>72</sup> That past practice required that a claim had to be included in the documents referred to, or contained in, the terms of reference in order to form part of the "matter" referred to a panel for consideration. Following both this past practice and the provisions of the DSU, in *European Communities - Bananas*, we observed that there is a significant difference between the *claims* identified in the request for the establishment of a panel, which establish the panel's terms of reference under Article 7 of the DSU, and the *arguments* supporting those claims, which are set out and progressively clarified in the first written submissions, the rebuttal submissions, and the first and second panel meetings with the parties as a case proceeds. There we said:

Article 6.2 of the DSU requires that the *claims*, but not the *arguments*, must all be specified sufficiently in the request for the establishment of a panel in order to allow the defending party and any third parties to know the legal basis of the complaint. If a *claim* is not specified in the request for the establishment of a panel, then a faulty request cannot be subsequently "cured" by a complaining party's argumentation in its first written submission to the panel or in any other submission or statement made later in the panel proceeding.<sup>73</sup>

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<sup>70</sup>Adopted 25 September 1997, WT/DS27/AB/R, para. 145.

<sup>71</sup>Adopted 20 March 1997, WT/DS22/AB/R, p. 22.

<sup>72</sup>*Ibid.*

<sup>73</sup>Adopted 25 September 1997, WT/DS27/AB/R, para. 143.

89. Thus, a claim *must* be included in the request for establishment of a panel in order to come within a panel's terms of reference in a given case. In this case, after describing the obligations of Articles 27, 70.8 and 70.9 of the *TRIPS Agreement*, the request for establishment of a panel by the United States reads, in pertinent part:

... India's legal regime appears to be inconsistent with the obligations of the TRIPS Agreement, including but not necessarily limited to Articles 27, 65 and 70 ....

Accordingly, the United States respectfully requests the establishment of a panel to examine this matter in light of the TRIPS Agreement, and to find that India's legal regime fails to conform to the obligations of Articles 27, 65 and 70 of the TRIPS Agreement, and nullifies or impairs benefits accruing directly or indirectly to the United States under the TRIPS Agreement.<sup>74</sup>

90. With respect to Article 63, the convenient phrase, "including but not necessarily limited to", is simply not adequate to "identify the specific measures at issue and provide a brief summary of the legal basis of the complaint sufficient to present the problem clearly" as required by Article 6.2 of the DSU. If this phrase incorporates Article 63, what article of the *TRIPS Agreement* does it not incorporate? Therefore, this phrase is not sufficient to bring a claim relating to Article 63 within the terms of reference of the Panel.

91. In *European Communities - Bananas*, we accepted the view of the panel in that case that it was "sufficient for the Complaining Parties to list the provisions of the specific agreements alleged to have been violated without setting out detailed arguments as to which specific aspects of the measures at issue relate to which specific provisions of those agreements", and we also agreed with the panel that the request in that case was sufficiently specific to comply with the "minimum standards" established by Article 6.2 of the DSU.<sup>75</sup> In this case, in contrast, there is a failure to identify a specific provision of an agreement that is alleged to have been violated. This falls below the "minimum standards" that we were willing to accept in *European Communities - Bananas*.

92. We note also the Panel's statement that it "ruled, at the outset of the first substantive meeting held on 15 April 1997, that all legal claims would be considered if they were made prior to the end

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<sup>74</sup>WT/DS50/4, 8 November 1996.

<sup>75</sup>Adopted 25 September 1997, WT/DS27/AB/R, para. 141; Panel Reports, adopted 25 September 1997, WT/DS27/R/ECU, WT/DS27/R/GTM, WT/DS27/R/HND, WT/DS27/R/MEX, WT/DS27/R/USA, para. 7.29.

of that meeting; and this ruling was accepted by both parties".<sup>76</sup> We do not find this statement at all persuasive in advancing the argument made by the United States on this issue. Nor do we find this statement consistent with the letter and the spirit of the DSU. Although panels enjoy some discretion in establishing their own working procedures, this discretion does not extend to modifying the substantive provisions of the DSU. To be sure, Article 12.1 of the DSU says: "Panels shall follow the Working Procedures in Appendix 3 unless the panel decides otherwise after consulting the parties to the dispute". Yet that is *all* that it says. Nothing in the DSU gives a panel the authority either to disregard or to modify other explicit provisions of the DSU. The jurisdiction of a panel is established by that panel's terms of reference, which are governed by Article 7 of the DSU. A panel may consider only those claims that it has the authority to consider under its terms of reference. A panel cannot assume jurisdiction that it does not have. In this case, Article 63 was not within the Panel's jurisdiction, as defined by its terms of reference. Therefore, the Panel had no authority to consider the alternative claim by the United States under Article 63.

93. The United States argues that, in the consultations between the parties to this dispute in this case, India had not disclosed the existence of any "administrative instructions" for the filing of mailbox applications for pharmaceutical and agricultural chemical products. Therefore, the United States asserts that it had no way of knowing that India would rely on this argument before the Panel. The United States maintains that, for this reason, it had not included a claim under Article 63 in its request for the establishment of a panel.<sup>77</sup> All that said, there is, nevertheless, no basis in the DSU for a complaining party to make an additional claim, outside of the scope of a panel's terms of reference, at the first substantive meeting of the panel with the parties. A panel is bound by its terms of reference.

94. All parties engaged in dispute settlement under the DSU must be fully forthcoming from the very beginning both as to the claims involved in a dispute and as to the facts relating to those claims. Claims must be stated clearly. Facts must be disclosed freely. This must be so in consultations as well as in the more formal setting of panel proceedings. In fact, the demands of due process that are implicit in the DSU make this especially necessary during consultations. For the claims that are made and the facts that are established during consultations do much to shape the substance and the scope of subsequent panel proceedings. If, in the aftermath of consultations, any party believes that all the pertinent facts relating to a claim are, for any reason, not before the panel, then that party should ask the panel in that case to engage in additional fact-finding. But this additional fact-finding cannot alter

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<sup>76</sup>Panel Report, para. 7.9.

<sup>77</sup>Response by the United States to questioning at the oral hearing.

the claims that are before the panel -- because it cannot alter the panel's terms of reference. And, in the absence of the inclusion of a claim in the terms of reference, a panel must neither be expected nor permitted to modify rules in the DSU.

95. It is worth noting that, with respect to fact-finding, the dictates of due process could better be served if panels had standard working procedures that provided for appropriate factual discovery at an early stage in panel proceedings.

96. For these reasons, we find that the Panel erred in its findings and conclusions relating to the alternative claim by the United States under Article 63 of the *TRIPS Agreement*. In the light of this finding, it is not necessary for us to consider whether the Panel erred also in recommending simultaneously that India bring itself into compliance with its obligations under both Articles 70.8(a) and 63 of the *TRIPS Agreement*.

## **IX. Findings and Conclusions**

97. For the reasons set out in this Report, the Appellate Body:

- (a) upholds the Panel's conclusion that India has not complied with its obligations under Article 70.8(a) to establish "a means" that adequately preserves novelty and priority in respect of applications for product patents in respect of pharmaceutical and agricultural chemical inventions during the transitional periods provided for in Article 65 of the *TRIPS Agreement*;
- (b) upholds the Panel's conclusion that India has not complied with its obligations under Article 70.9 of the *TRIPS Agreement*; and
- (c) reverses the Panel's alternative findings that India has not complied with paragraphs 1 and 2 of Article 63 of the *TRIPS Agreement*.

98. The Appellate Body *recommends* that the Dispute Settlement Body request India to bring its legal regime for patent protection of pharmaceutical and agricultural chemical products into conformity with India's obligations under Articles 70.8 and 70.9 of the *TRIPS Agreement*.

Signed in the original at Geneva this 4th day of December 1997 by:

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Julio Lacarte-Muró  
Presiding Member

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James Bacchus  
Member

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Christopher Beeby  
Member



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## A. Introduction

### 1. Notion

1 The term 'source of law' may mean different things. It may refer to either historical, ethical, social, or other bases for a legal rule, or it may refer to legal rules as such (Abi Saab 31). The notion will be used here in the latter sense.

2 Speaking of 'sources of international law' presupposes that there exist legal, ie binding, rules in international law. This view is not uncontested and, apart from that, those who take that view advance different reasons why international law consists of binding rules.

### 2. Binding Nature of International Law

3 Generally speaking, those who argue that international law is binding rest their claim on one of two arguments: they either refer to the consent expressed by those subjects of international law being bound (Oppenheim 332), or they ascertain that the norm in question reflects accepted meta-legal principles such as justice, equity, and fairness (Equity in International Law).

4 This contribution takes the position that, ultimately, no individual source of international law (treaty law, customary international law, general principles, etc) is founded on one of these two justifications alone. Neither can, for example, international treaties provide for a long-term sustainable order among States, notwithstanding the consent of the States involved, if they do not also mirror the principles of justice, equity, and fairness. Nor is it possible to establish an international order on justice, equity, and fairness alone, however defined, if the subjects of international law do not consent thereto. The delicate balance between these two foundations of international law has to be achieved for each source of international law at the moment of its establishment and it has to be upheld over time. A variety of mechanisms are available in international law to gain consent, uphold consent, or to ensure that a norm under consideration meets the principles of fairness, equity, and justice. Reservations to international treaties; objections to the establishment of a rule of customary international law; the review of existing international treaties; the drafting of subsequent ones; the modification of treaty as well as customary law through subsequent practice; the establishment of peremptory norms of international law (*ius cogens*); and the development of non-binding rules such as resolutions and declarations of international organizations and international conferences having an impact on the progressive development of international law should be seen from this point of view. It is decisive to take into account that the sources of international law constitute a unity, and together form the corpus of international law. Whereas some sources may predominantly be based upon consent (eg international treaties), others may be more open to meta-legal and general considerations derived from ethics, reasonableness, and logic (principles of international law) (see also Ethos, Ethics and Morality in International Relations; Reasonableness in International Law). Therefore, the corpus of international law comprising all sources is based upon consent as well as meta-legal rules and general considerations. In that respect, the individual sources of international law complement each other as far as their substance but also, and more prominently, as far as their foundation is concerned.

5 Those who deny the binding nature of international law (amongst others Posner and Goldsmith; Bolton) argue that international law serves more as a set of guidelines than legal rules. They advance several reasons, from the lack of a central law-making power and the lack of efficient enforcement mechanisms, to the assumption that States act—and should act—only in the furtherance of self-interest, thus denying the existence of community interest[s]. This approach is neither new nor innovative. It can be traced back to Hans Morgenthau and Carl Schmitt. Although some of their criticism of international law is well-founded, they fail to explain why subjects of international law conclude international treaties and why they try to justify any alleged deviation

from a commitment entered into. They also fail to appreciate that the States—even the most powerful ones—are in favour of establishing a world order which has a stabilizing effect on world affairs. And finally, they cannot rebut the argument of Louis Henkin that ‘almost all nations observe all principles of international law and almost all of their obligations almost all of the times’ (at 47).

**6** This contribution is based on the premise that international law is constituted by legally binding norms, stemming from different sources. The term ‘sources’ refers to two different, albeit interrelated, issues, namely, the process and procedure through which binding rules of international law and the rules of international law as such are generated. The process character of international law is being emphasized not with the aim to question the legally binding nature of international law but to indicate that international law is in permanent flux, even though it is meant to have and does have a stabilizing effect on international relations.

## **B. Identification of Sources of International Law**

**7** Unlike national laws where the sources of law are usually specified in a norm superior to laws and regulations, usually a constitution, no such norm exists in international law (Shaw 66). Some consider this a deficiency of international law (Posner and Goldsmith). This criticism has its foundation in an emphasis of national law as the only model for a legal order; a view that disregards the fact that the legal rules governing the relationship between subjects of international law may have to follow different principles.

**8** However, statutes of international courts and tribunals specify the sources of international law they may use. Notably, an international court or tribunal may not have the competence to invoke international law *in toto* but rather a part thereof. For example, according to Art. 293 UN Convention on the Law of the Sea, international courts and tribunals having jurisdiction under Part XV Section 2 of the Convention shall apply the Convention and other rules of international law not incompatible with the Convention. In other words, the international courts and tribunals concerned are not free to apply international law in its totality, at least theoretically.

**9** According to Art. 38 (1) ICJ Statute, the sources to be applied by the International Court of Justice (ICJ), whose function it is to decide in accordance with international law such legal disputes as are submitted to it, are:

- a) international treaties, whether general or particular, establishing rules recognized by the contesting States Parties to a dispute before the ICJ;
- b) customary international law as evidence of a general practice accepted as law;
- c) the general principles of law recognized by civilized nations; and
- d) subject to the provisions of Art. 59 ICJ Statute, judicial decisions and teachings of the most highly qualified publicists (Art. 38 (1) ICJ Statute). It is evident from the wording of Art. 38 (1) (d) ICJ Statute that the latter are of a subsidiary nature only. They do not actually qualify as sources of law but rather as means to establish the existence of sources of law.

**10** This provision identifies the sources which the ICJ is meant to apply in deciding a dispute submitted to it; it is also referred to as establishing the authentic list of the sources of international law (Thirlway). Although this view may find some justification in the Chapeau to Art. 38 ICJ Statute, it disregards the objective of this provision. It is the States concerned that eventually decide what constitutes international law (Higgins 18). If this approach is being followed, Art. 38 ICJ Statute states in a merely declaratory manner which sources of international law existed when this provision was drafted (Abi Saab). In addition to the sources listed, other sources exist, such as binding decisions of international organizations and unilateral acts. Therefore, Art. 38 (1) ICJ Statute does not provide for a complete list of sources of international law the ICJ may use, and in effect

has used, in its jurisprudence.

**11** Art. 38 (1) (a)–(c) ICJ Statute do not establish a hierarchy of the sources, although international courts and tribunals will, as a matter of convenience, invoke international treaties first. Apart from those provisions which are considered *ius cogens*, no such hierarchy exists. It is easily conceivable that the same matter is governed by treaty as well as customary international law and that these rules coexist or that customary international law is supplementing treaty law. The relationship between the sources is to be established on a case-by-case basis by having recourse to the established international law principles of interpretation, such as the *lex specialis derogat legi generali* rule or the *lex posterior derogat legi priori* rule (ILC).

## C. Law-Making Process in International Law

### 1. Introduction

**12** In general, international law lacks a central law-making power equivalent to the one in national legal systems. The characteristic feature of international law is that its main addressees are also the ones who create international law. Therefore, international law has elements of self-commitment as well as contractual elements, although it would be a simplification to qualify international law only or even predominantly from these two points of view. As already indicated, international law is not only based upon the consent of the States concerned but reflects and has to reflect principles such as justice, equity, and fairness. Such principles are—as can be taken from the evolution of the international community since the end of World War II—not static but develop progressively as required. Whereas traditionally, international law was considered as a legal system co-ordinating activities of States, it has developed under the aegis of the United Nations into a legal regime which is increasingly dominated by the principle of co-operation (Co-operation, International Law of). Some areas of international law, in particular the ones on economic relations or on the protection of the environment, are governed by the principle of solidarity (Solidarity, Principle of). The latter goes beyond the principle of co-operation in that it requires the subjects of international law not only to co-operate amongst each other but also to take into consideration the interest of others and to be guided by the interests of the international community as such. This, as well as the international human rights regime which influences other areas of international law, has an impact on the interpretation of international treaties and on the development of the sources of international law in general.

**13** It has already been stated that international law is not static but should also be considered as a process, which means it is in a process of establishment, modification, or conformation. This process should be seen as a unity; all modifications of one of the sources of international law should be understood and assessed from its impact upon international law as such (Besson 170).

### 2. The Making of Treaties

**14** The drafting and adoption of international treaties is tailored to the objective of achieving consent amongst the parties concerned. International treaties are developed in a contractual and thus consensual manner, although it would be misleading to consider international treaties from the point of view of contracts only. In particular, multilateral treaties designed to accommodate community interests are meant to establish an international legal order. The international law on treaties is further guided by the aim to preserve the stability of international treaties once accepted and, as far as multilateral treaties of a general nature are concerned, to achieve the maximum participation of parties in the legal regimes established by each of them.

**15** In international law treaties fulfil the function laws have under national law, as they set, besides other sources, law. It has been suggested that international treaties are not a source of law but

only a source of legal obligations amongst the parties (Fitzmaurice; see also Abi Saab). This view, however, focuses on bilateral treaties and, even as far as those are concerned, fails to acknowledge their contribution to the corpus of international law at large. In law-making treaties, the contribution to the corpus of international law outweighs the obligation owed to other parties. In fact, the rights of other parties in such treaties, for example, human rights treaties, are mechanisms of enforcement rather than substantial rights. Their emphasis is on giving the parties to such treaty regimes standing within the implementation and enforcement schemes provided by such treaties.

**16** The generation of international law is often referred to as law-making process (Besson 164). However, it has to be borne in mind that a law-making process which is equivalent to such a process under national law does not exist in international law, except in a few instances (denied by Posner 28). Only rarely do international organizations exercise law-making power (for details see Alvarez [2005]). International treaties are drafted by their potential addressees and the potential addressees have to express their consent to be bound, for example, by ratification, accession, or in other forms envisaged in Arts 11 et seq Vienna Convention on the Law of Treaties (1969). Their basis of legitimacy and the basis for them being binding is, accordingly, firstly the consent of the States concerned. In contrast thereto, in the municipal system, laws are enacted by the competent institutions in a settled law-making procedure and they are also binding on subjects who have not participated in their creation, since the acting institutions are empowered to enact binding rules. Hence, the procedure for drafting international treaties and national laws bears no similarities. Nevertheless, one can hardly deny that international treaties have equivalent functions in international relations to laws in a municipal legal system.

**17** The procedure of drafting international treaties is designed so as to generate consent among the participating States or other subjects of international law. Generally speaking, the whole process may be divided into four stages: first, the process of negotiating an international treaty and reaching a preliminary consent among the representatives of the States involved on the text (adoption of the treaty); second, the process during which the consent reached on the international plane is confirmed on the national level; and third, the expression of consent internationally. The fourth stage is the implementation of the international treaty, its interpretation, and its modification through revision, amendments, protocols, or other instruments and through subsequent practice.

**18** As far as the first stage is concerned, the drafting of bilateral agreements and of multilateral agreements differs. With respect to bilateral treaties, both sides will normally come with their drafts or positions prepared and try to find a compromise in the bilateral meeting or meetings. The situation is much more complex at multilateral conferences, in particular at conferences in which virtually all States participate. Here, the potential solutions are too numerous for the participants to foresee all of them. Historically, multilateral treaties were adopted by unanimity. According to Art. 9 Vienna Convention on the Law of Treaties—a default rule—a draft may be adopted by a two-thirds majority. On the one hand, this provides for some flexibility, especially since it precludes that one State can impede the acceptance of a draft. On the other hand, the two-thirds majority rule may lead to the adoption of a treaty against a minority, perhaps just that group of States whose interests are particularly affected. The alternative has become, at many international conferences, in particular the ones undertaken under the auspices of the UN, to apply the consensus rule. This means an agreement is adopted if no participant challenges the consensus reached by insisting on a formal vote. In fact, this does not mean that every participant fully agrees with the result achieved but that it considers its objections not to be serious enough to challenge the result as such. Very often this procedure is combined with a majority vote system. If a participant objects, the text will be accepted by the required majority. The consensus principle has significantly changed the negotiation techniques. It has strengthened the position of the chairpersons in charge. The consensus principle further encourages States to form interest groups. This means, in effect, that at multilateral conferences the integration of the individual objectives or claims of States into one, namely the draft treaty, takes place on several subsequent levels—interest groups, regional

groups, subject-oriented committees—until the final decision is reached. Finally, the consensus principle leads to ‘package deals’, which means trade-offs. Therefore, multilateral treaties are not as firmly based upon consent as bilateral treaties. The States participating therein are guided by other considerations besides their individual interests. Regional allegiances or overarching interest group policies may have an impact upon the decision of a State to accept the result achieved.

**19** After the conclusion of the negotiating process on the international level, the draft is submitted to the municipal acceptance procedure. The national procedures vary widely, in particular to the extent the parliamentary bodies are involved. As a matter of principle, States are free as to how to organize the national procedure of approval, in particular to the extent that the national parliament is to be involved. Only rarely does an international treaty require a particular action to be taken on the national level, although it is in the interest of international law to strengthen the basis of the national legitimacy of the commitments entered into by the States. Equally, international law does not regulate how States Parties to a treaty ensure that the commitments are implemented on the national level if such implementation is required. These are two lacunae which may result in weakening the legitimacy of international treaty law and render its implementation less effective.

**20** Once the national procedure of accepting an international treaty is complete, the consent to be bound is expressed; in the case of a bilateral treaty to the other party and in the case of a multilateral treaty to the community of States Parties of this particular treaty represented by a depositary.

**21** International treaties, once adopted, are not static; they are living instruments which develop through interpretation, and they may be amended, revised, or supplemented by subsequent instruments. They may also be changed through subsequent practice in accordance with Art. 31 (3) (b) Vienna Convention on the Law of Treaties. In particular, the latter mechanism constitutes a flexible mode to adjust international treaties to new facts or considerations.

### **3. The Development of Customary International Law**

**22** At the outset, international law was mainly constituted by customary international law. Under the aegis of the UN, a multitude of international treaties have been concluded, prompting some authors to express doubts concerning the remaining relevance of customary international law (Friedman 121–3). Others, however, emphasize that customary international law remains of high significance. They argue that, first, the development and adjustment of customary international law is more flexible than the development of treaty law; and second, customary international law is, by its very nature, universal, whereas treaty law binds the parties to these treaties only (D’Amato 12). This does not exclude the possibility of regional or even bilateral customary law. The development of customary international law reflects the characteristics of the international community understood as a legal community. It has the advantage that all States may share in the formulation of new rules and that customary international law can be modified, changed, or amended through this international community more easily than is possible for treaty law (Shaw 70). Certainly, customary international law is less precise than most treaty law but such a lack of precision also constitutes an amount of flexibility. In particular, it may be more easily and more quickly responsive to new factual developments.

**23** The term ‘customary international law’ may refer to both the generation of law and the result of that process. While there is agreement concerning the process nature of customary international law, its foundation and binding nature have been the subject of a long-standing controversy. One theory, that was particularly endorsed by Soviet writers, is that customary law is based upon a tacit agreement (Tunkin). This implies that customary international law depends on the will of States, as does treaty law. This, however, is a fiction which is rather difficult to sustain. According to a different approach, the binding nature of customary international law has its basis in the longstanding practice of States, allowing one to expect that this practice will continue (Kelsen). A

third group argues that customary international law develops spontaneously from within the international community and derives its legitimacy from the fact that such rules are needed for the well-being of the international community (Ago). This is reminiscent of natural law approaches.

**24** Apart from this controversy, it is accepted that customary international law consists of two elements: State practice and *opinio iuris*. Art. 38 ICJ Statute refers to 'international uniform custom, as evidence of a general practice accepted as law'. This formulation, however, is unsatisfactory (Van Hoof 87). It is generally accepted that custom is applied, and it is practice which serves as evidence for custom (Higgins 18). Still, it remains controversial whether the emphasis lies on State practice or on *opinio iuris*, what constitutes State practice, and how the *opinio iuris* is to be expressed.

**25** It is well established that both practice and *opinio iuris* are necessary to establish customary international law. This, however, does not imply that customary international law has a voluntative basis similar to international treaties. *Opinio iuris*, the belief that a certain conduct is required or permitted under international law, is in fact a conviction that such conduct is just, fair, or reasonable and for that reason is required under law. Such meta-legal or general legal considerations differ from the consent expressed in respect of treaty-based commitments. *Opinio iuris* develops in response to an assessment of foreign or own conduct. Only if this assessment leads to a positive result, namely that such conduct is to be considered as legally required, the necessary *opinio iuris* will form. If the assessment leads to a negative result it will not materialize; rather, the practice will be countered on legal grounds or at least will not be accepted. Therefore, every *opinio iuris* is the result of a value judgment, an element which is not inherent in (or at least not prominent in) expressing consent to an international treaty.

**26** Practice usually manifests itself in activities or omissions attributable to particular subjects of international law, mostly of States. These activities may have an internal character or may be exercised on the international level (Degan 149). International treaties can reflect a State practice relevant for the formulation of customary international law. The conclusion, for example, of numerous investment treaties may be seen to establish customary international law. However, one may also argue that if States feel the necessity to conclude such international agreements, they do not believe that the practice so far existing is a reflection of an obligation to that extent. Still, the practice of States is nowhere better reflected than in treaties. Also, judgments of international courts or tribunals are considered as being of relevance for the development of customary international law. This is so for two reasons. First, judgments of international courts or tribunals may refer to certain norms as being customary international law. As such, they do not create customary international law but they identify and formulate it, and to that extent they are a source of reference. Apart from that, judgments of international courts or tribunals may also contribute to customary international law. Custom may develop amongst States, but equally in international organizations. This does not mean to say that a custom develops directly from, for example, resolutions of the UN General Assembly; but it cannot be denied that a frequent repetition of certain principles by UN organs, in particular the General Assembly, may, over time, amount to custom.

**27** One of the elements which is considered to be of particular relevance for a practice is that such practice was carried on for a certain period of time (density and uniformity of the practice; Degan 150 et seq). It has been argued that custom may come about rather quickly or even instantly (Cheng). The law of outer space has been named as an example. The same may happen in response to widespread moral outrage regarding crimes committed in conflicts, such as those in Rwanda and Yugoslavia, that brought about the rapid formation of a set of customary international law rules concerning crimes committed in internal conflicts.

**28** Non-governmental organizations have no impact on the formulation of customary international law as long as their actions are not directly attributable to States. However, to the extent that such actors are engaged in the work of international organizations, they can at least indirectly influence

the formulation of customary international law. The International Committee of the Red Cross (ICRC) is an exception, though; it has contributed significantly to the development of customary international law.

**29** Not every usage transforms into customary international law, but only that which is carried by an *opinio iuris*. This has been emphasized by the jurisprudence of the ICJ (see for example in the advisory opinion on *Legality of the Threat or Use of Nuclear Weapons* paras 66 et seq; Nuclear Weapons Advisory Opinions). As indicated above, *opinio iuris* constitutes a value-based assessment of a certain practice which leads to the conclusion that this practice is required by law.

**30** It is subject to much debate how customary international law can be changed or modified. Does the breach of a customary international law rule lead to the abolition of the rule, or even to the creation of a new one? This has been argued (Higgins 19) on the grounds that customary international law is a process. But it is more than simply a process—customary international law also has a stabilizing effect through which it contributes to the establishment of an international legal order. This stabilizing function derives from established practice and the accompanying belief that the practice is accepted as law—*opinio iuris*. In the situation of a breach, an established practice is lacking, as is the belief that such practice is required by law. The breach of an established norm may trigger the development of new customary international law only if other States follow such an example and a corresponding *opinio iuris* develops. Until such development comes to a conclusion, the deviation from a norm of customary international law remains a breach. It is relevant to note at this point that the breach of a norm of international law may actually be the first step of reconciling law with reality. What is essential, though, is that this development cannot be achieved by one State alone but only if other States join in (or do not object to) this practice and develop a corresponding *opinio iuris*. This is what constitutes the responsiveness of customary international law towards new developments, may they be factual or changes of attitudes.

**31** Customary international law is frequently codified in treaties; customary law and treaty law then continue to exist side-by-side. This has the advantage that identical or at least similar rules are applied to States Parties and non-States Parties. However, it may happen that the customary international law rules change over time, whereas the treaty rules remain unchanged. In the past, this has caused some debate regarding the interpretation of the right to self-defence. Some argue that due to the increase of potential actors in armed conflicts, the scope of the right of self-defence under customary international law has changed.

**32** To conclude, it may be reiterated that customary international law is more than just a process since it has a stabilizing effect on international relations. It does not depend upon the will of States or other subjects of international law but upon their value-based assessment that such practice is required by law. The practice of one may be followed by others and a corresponding *opinio iuris* may form, developing such practice into customary international law. The situation may also be reversed; a political opinion may have formed, for example, in a resolution of the UN General Assembly or at a Summit, followed by corresponding practice while the political opinion mutates into an *opinio iuris*. What is essential is that all States may and do contribute to the development and shaping of customary international law, including those who express reservations. Although this participation is governed by the principle of equality of States, it is nevertheless evident that, as the ICJ expressed in the judgment on the North Sea Continental Shelf Cases (at paras 73–4), those States particularly affected by potential new rules of customary international law have a particular impact on the development or the non-development of a particular rule of customary international law (Virally). As such, customary international law is particularly suited to constitute a counterweight against and supplement to consent-based international treaties.

#### **4. The Development of General Principles**

**33** The term ‘principle’, generally speaking, may signify one of two things. It may either refer to



meta-legal principles—ie principles generated within a philosophical or ethical discourse and then introduced into a normative system (Accioly 33 et seq)—or it may refer to principles inherent in or developed from a particular body of law or law in general. In the following, only the latter will be dealt with.

**34** International and regional courts and tribunals make use of principles as an interpretative tool or as a source of concrete obligations. These two functions cannot be separated clearly.

**35** Principles may be derived from municipal law, from general considerations, or, by generalizing, from a particular treaty regime. The development and recognition of such principles does not depend on the will of States and all States equally contributing to their development. These principles may, in particular, introduce overarching considerations into international law and, as such, may supplement international treaty law, in particular by influencing the interpretation of the latter.

**36** Art. 38 (1) (c) ICJ Statute establishes that general principles derived from municipal law are sources of international law. The ICJ only sporadically referred to general principles in its judgments or advisory opinions. In none of these did the general principles referred to by the parties become a basis for the reasoning of the Court.

**37** On the other hand, the ICJ frequently made use of principles derived from general considerations as well as principles derived from a particular treaty regime. As to the former, reference may be made to its judgment in the Corfu Channel Case. Here the ICJ found that the Albanian authorities were under the obligation to make known the existence of a minefield in their territorial waters and to warn the approaching ships of the imminent danger. The ICJ said: 'Such obligations are based...on certain general and well-recognized principles, namely: elementary considerations of humanity, even more exacting in peace than in war; the principle of the freedom of maritime communication; and every State's obligation not to allow knowingly its territory to be used for acts contrary to the rights of other States' (*Corfu Channel Case [Judgment] [Merits]* 22). One of the prime examples for a principle derived from legal relations in general is the principle of good faith (*bona fide*) which, in the view of the ICJ, governs the creation and performance of legal obligations (*Nuclear Tests [Australia v France] [Judgment]* 268 and *Nuclear Tests [New Zealand v France] [Judgment]* 473; *Nuclear Tests Cases*).

**38** On numerous occasions, the ICJ has had recourse to principles derived from particular treaty regimes. An early example is the advisory opinion on *Reservations to the Convention on the Prevention and Punishment of the Crime of Genocide* where the ICJ noted that 'the principles underlying the Convention are principles which are recognized by civilized nations as binding on States, even without any conventional obligation' (at 23; *Genocide Convention, Reservations [Advisory Opinion]*). In the jurisprudence of the Court, frequent references have been made to the principles enshrined in Art. 2 United Nations Charter. In the Case concerning Certain Questions of Mutual Assistance in Criminal Matters (*Djibouti v France*), particular use was made of a treaty-based principle. The Court considered whether principles set out in the Treaty of Friendship and Co-operation between Djibouti and France of 1977 would inform the way in which the obligations under the Convention on Mutual Assistance in Criminal Matters of 1986 were to be interpreted (*[Judgment]* paras 104–114). Here, principles were used to bridge the gap between two separate treaties concluded between the same parties.

**39** Principles of law complement other sources of international law in various ways; they guide the interpretation of international treaties and, due to their abstract formulation, are the gateway for progressive interpretation. As the jurisprudence of the ICJ demonstrates, principles of international law may connect treaty regimes. They may be the starting point for the evolution of a new rule of customary international law and they have frequently had an influence on the interpretation of the latter. Principles of law have even been used as a basis for the development of new rights and obligations. In general, they may, and indeed have, become the motor of a progressive

development of international law.

## **5. The Contribution of International Organizations**

**40** International organizations are playing an increasing role in the establishment of an international normative order (Alvarez [2002] 218 et seq). Their functions vary considerably. While they may only have the role of an initiator and a facilitator of treaty-making conferences, sometimes they exercise truly legislative tasks.

**41** Even in those cases where international organizations only initiate legislative processes, which are then taken over by the participating States, their influence is not to be underestimated. Their technical expertise may give them—notably the respective secretariats—a significant influence concerning the issues and the outcome of the norm-creating process. So far, very few international organizations have prescriptive functions such as the International Civil Aviation Organization (ICAO), concerning the regulation of flights over the high seas, or the International Seabed Authority (ISA), which promulgates regulations on deep seabed mining. It has been suggested, in particular in respect of the protection of the international environment, to establish authoritative institutions exercising quasi-governmental functions concerning global problems.

**42** One may also speak of a 'norm-creating function' of the UN Security Council. Some decisions of the Security Council taken under Chapter VII of the UN Charter are of a normative nature since they regulate the relations amongst their addressees; provide for the establishment of institutions, such as international criminal courts, including the legal framework in which they function; and even create a regulatory order. The latter is true, for example, for Security Council Resolution S/687 (1991) of 3 April 1991, setting out the conditions for a ceasefire in the war against Iraq (see also UNSC Res 1373 [2001] 'Threats to International Peace and Security Caused by Terrorist Acts' [28 September 2001] SCOR [1 January 2001–31 July 2002] 291; UNSC Res 1540 [2004] 'Non-Proliferation of Weapons of Mass Destruction' [28 April 2004] SCOR [1 August 2003–31 July 2004] 214). Although Security Council decisions have a consensual origin, namely the acceptance of the UN Charter, the legitimacy of such decisions has been put into question (Weston). It is a salient question of whether the existing foundations of international law allow for the establishment of international organizations which have norm-creating functions not based upon consent of the addressees of the norms they prescribe.

**43** Resolutions of the UN General Assembly call for a differentiated view. They may play a significant role in law-making even though they are non-binding, notwithstanding the fact that their recommendatory character is based upon State consent. General Assembly resolutions may be declaratory of existing customary law. As such they are not law-making in the true sense of the word but only a means of reference. There have been instances of General Assembly resolutions starting a process which eventually led to the adoption of an international treaty. Finally, repeated General Assembly resolutions adopted by consensus or unanimously may be considered State practice, thus establishing new customary international law.

**44** So far, only the external effects of General Assembly resolutions and decisions have been addressed. It is well established that internally, certain decisions of the General Assembly have normative functions.

**45** Regional organizations and arrangements offer, due to the homogeneity of their membership, increased possibilities for the development of a regional normative order. It is worth considering whether one should acknowledge that the international community is formed of regions and consequently put more emphasis on regional integration; there are tendencies pointing in that direction.

## **6. The Contribution of Courts and Tribunals**

**46** The contribution of international courts, tribunals, and dispute settlement mechanisms (for example the International Centre for Settlement of Investment Disputes [ICSID]) to the establishment of an international normative order also deserves attention. Considering judgments of international courts merely as an interpretation of a given international agreement does not do justice to their role. Any such interpretation contributes to the further development of the relevant agreement or of customary international law. For example, the Appeals Chamber of the International Criminal Tribunal for the Former Yugoslavia (ICTY) in *Prosecutor v Tadić* held that customary international law rules concerning methods and means of warfare applicable in international conflicts may also apply to non-international conflicts (*[Jurisdiction]* para. 137). This reasoning was not based on State practice; rather, the Appeals Chamber argued that the concerns of humanity were the same and could not depend upon the nature of the conflict. Nevertheless, international courts and tribunals as a rule are not considered to have norm-creating functions, although the line between interpretation and law-making is sometimes fluid. The first argument is a positivistic one. International courts and tribunals are called upon to settle disputes on the basis of international law. As a matter of logic, this means the law has to exist. Apart from that, judgments of international courts and tribunals bind only the parties to that dispute (Art. 59 ICJ Statute), although the interpretation of the relevant source may be influenced by that case. International courts or tribunals referring to previous judgments, in particular those of the ICJ, do not do so because they feel bound, but rather as a matter of convenience (Fitzmaurice 172; Jennings 73). Finally, those who equate the functions of international courts and tribunals with law-making, fail to acknowledge the relevance of the international law-making process.

## **7. Others**

**47** Non-State actors are playing an increasing role in the norm-creating process. Even though they do not participate on an equal footing in codification conferences, they may be involved in the pre-normative process which leads to the development of new international legal regimes. Examples are the impact of non-governmental organizations on the drafting of the 1997 Ottawa Convention on the Prohibition of the Use, Stockpiling, Production and Transfer of Anti-Personnel Mines and on Their Destruction, and on the establishment of a mechanism for an individual complaint procedure under the 1979 Convention on the Elimination of All Forms of Discrimination against Women. Through this involvement, the views of representatives of the international society are introduced into the norm-creating process, eroding a monopoly of States. It has been argued that the proliferation and increasing influence of non-governmental organizations has strengthened the democratic element in international relations. Numerous international organizations have developed close links with non-governmental organizations engaging them in the norm-creating process they administer.

## **8. Ius Cogens**

**48** In national law there exists a complex hierarchy of legal sources: constitutions; acts of parliament; regulations; and administrative decisions.

**49** In international law—at least in traditional international law—a comparable hierarchy was unknown. However, there was a shift in emphasis in the late 1960s. Within the UN General Assembly, the view evolved that some international norms should be accorded higher rank than others, in particular the right to self-determination. This had already been proposed in the 17<sup>th</sup> and 18<sup>th</sup> centuries by scholars such as Samuel Rachel, Christian Wolff, Georg Friedrich de Martens, and Emerich de Vattel. The 1969 Vienna Convention on the Law of Treaties adopted this approach and provided that a treaty will be void if at the time of its conclusion it conflicts with a peremptory norm of general international law (Art. 53). The same principle would apply to customary international law. This clearly establishes a hierarchy of sources. Such a rule must be accepted and recognized by the international community of States as a whole, which makes it evident that a peremptory

norm of international law rests on the consent or at least acquiescence of the world community. This consensual foundation deprives the *ius cogens* concept of the function to transport meta-legal or general considerations into international law, a function this concept had in the eyes of the proponents of natural law (see also Natural Law and Justice; Legal Positivism).

**50** So far, no significant State practice has developed with respect to peremptory norms, in particular none which has qualified one concrete norm as being of peremptory nature (see also Art. 50 UN ILC 'Draft Articles on Responsibility of States for Internationally Wrongful Acts' [2001] GAOR 56<sup>th</sup> Session Supp 10, 43). No dispute has arisen amongst States in which a peremptory norm played a significant role. The notion is referred to mainly in academic writings and alluded to in advisory opinions of the ICJ (see *Legality of the Threat or Use of Nuclear Weapons* para. 79; Israeli Wall Advisory Opinion [Legal Consequences of the Construction of a Wall in the Occupied Palestinian Territory] para. 157).

## **D. Assessment**

### **1. Expanding Scope of International Law**

**51** The international normative order has significantly expanded over the last few years; international law now governs issues which would clearly have been considered domestic affairs up until the middle of the 20<sup>th</sup> century. But the international normative order has not only expanded as far as its scope is concerned. What is even more relevant is that it has a deeper and more direct impact on national law than ever before. New actors, besides States, have become involved in the shaping of the international normative order—international organizations; non-governmental organizations; and sometimes groups of individuals. Their influence cannot always be adequately described by reference to traditional mechanisms of international norm development. This has become a reality in spite of the warning not to blur the distinction between normative and non-normative rules and to differentiate between normative and pre-normative acts in the international norm-creating process (Weil 415).

**52** The international normative order comprises the legal rules governing and guiding international relations. It prescribes what its subjects are obliged to do, must not do or may do, and which factual situation they have to establish (Dupuy 371). Thus far, the international normative order constitutes a stabilizing factor in international relations. This does not imply, however, that the international normative order has the sole function of restraining States in their international relations. On the contrary, international law is designed and also used to establish alternative forms of State conduct or, to rule out particular forms of conduct, to create new relations and new situations. Recent examples where pre-normative or normative acts have played a proactive role in international law-making are those where legal principles have been established serving as a foundation of new legal regimes. The common heritage of mankind principle in the context of the law of the sea and the principle of sustainable development in the context of the international protection of the environment are cases in point. However, the international normative order is not limited to regulatory functions. It also has an effect concerning the formation of the international community. This effect is sometimes referred to as the 'constitutionalization' of international governance (Frowein; Tomuschat). In this capacity, the corpus of international law is a precondition for the very existence and for the further development of the international community. It reflects the need and desire of its members for a common structure. It constitutes the framework in which its members may seek to accommodate their mutual interests and through which the interests of the international community as a whole can be formulated and achieved.

**53** The rapid growth of international treaty law in recent times has occasionally resulted in changes in the texture of international treaties and in the way they have evolved. Currently, multilateral international treaties are developed step-by-step quite frequently. For example, the

1967 Outer Space Treaty (Treaty on Principles Governing the Activities of States in the Exploration and Use of Outer Space, Including the Moon and other Celestial Bodies) is based upon several resolutions of the UN General Assembly, while the 1969 Vienna Convention on the Law of Treaties was prepared by the International Law Commission (ILC). The creation of international treaties has thus been entrusted to a political forum or fora, or to a technical forum in combination with a political one (Wolfrum 'Introduction' in Wolfrum and Röben 1–13, at 3).

**54** International treaty law has particularly expanded in areas such as international environmental law; international economic law; international law of the sea; and international criminal law. It seems evident that the norm-creating impetus of international treaties is unbroken. Referring to international treaties as norm-creating means taking it for granted that they actualize the interests of the international community rather than just formulate the individual interests of the States participating in the negotiating process. This invokes the distinction between international treaties which simply accommodate the interests of the participating States and those which pursue community interests (*traités-contrats v traités-lois*). The latter creates a micro-legal system within the general international normative order. But apart from their regulatory effect, international treaties also become an important part of the practice of the States involved, which may lead to the establishment of new customary international law. Additionally, particular international treaties may influence the legal relations with and even amongst non-parties, such as treaties having *erga omnes* effect (Obligations erga omnes) or establishing the status of a particular territory or institution. Such international treaties have normative effects beyond the participating parties.

## **2. Mechanisms for a Progressive Development of Treaty Law**

**55** Many multilateral international treaties of the recent past have been designed as framework agreements whose provisions are supplemented by further rules. While in the past, international treaties frequently provided for supplementary law-making so as to adapt a legal regime most flexibly to changed needs or circumstances, this approach has now reached a new level as particular institutions are being entrusted with the progressive development of particular treaties (see Conference [Meeting] of States Parties). The system established by each of these international agreements thereby gains an additional dimension. Framework conventions establish 'living' treaty regimes with the prospect of continuous legislative activities. The formats developed display a significant variety.

**56** A parallel mechanism, although with less authority, exists concerning international human rights treaties; it also opens the possibility for further development of the respective agreements through interpretation and application. So-called treaty bodies, such as the Human Rights Committee or the Committee on the Elimination of Racial Discrimination (Human Rights, Treaty Bodies; Environmental Treaty Bodies), have the competence to issue general comments/recommendations which have an influence on the interpretation and application of the respective treaty.

## **3. Development Outside the Treaty-based Order**

**57** The development of the international normative order does not solely depend upon international treaties. The ILC, as far as State responsibility is concerned, did not initiate the finalization of the norm-creating process which commenced when it was entrusted with the codification of the respective rules. Instead, the ILC recommended that the UN General Assembly only take note of the Articles on State Responsibility rather than submit them to a codification conference, thus relying on the development of customary international law. In other areas, customary international law is also developing or has developed parallel to international treaty law, in part supplementing or modifying it. The relevant mechanism is subsequent State practice in accordance with Art. 31 (3) (b) Vienna Convention on the Law of Treaties.

**58** Apart from international treaty law, customary international law, and principles, other mechanisms have become increasingly important for the development of the international normative order. These are norms developed by self-established or politically mandated bodies; treaty-based conferences of parties; treaty bodies; international courts; and international organizations. The rules developed by such institutions have different impacts upon the international normative order. They may constitute restatements of international law or modify international treaty law.

**59** For example, the 1994 San Remo Manual on International Law Applicable to Armed Conflict at Sea or the 2009 Harvard Manual on International Law Applicable to Air and Missile Warfare, developed by experts, are designed as a contemporary restatement of the law applicable in armed conflict. State practice will show if they will be accepted. Other similar instruments exist, for example, in international economic law and in international environmental law (eg the Codex Alimentarius or the Code of Conduct for Responsible Fisheries). The Codex Alimentarius, prepared by the Food and Agriculture Organization of the United Nations (FAO) and the World Health Organization ('WHO'), is non-binding. Nevertheless, it has a significant influence on the international harmonization of food safety standards, as products consistent with these standards are presumed to be in compliance with the WTO Agreement on the Application of Sanitary and Phytosanitary Measures ('SPS Agreement'). The Code of Conduct for Responsible Fisheries is not, as such, a binding instrument, but it is implemented and used by the FAO as an instrument to generate new international norms. It is the particularity of these codes that they have been developed outside the context of an international treaty regime. Their legitimacy and their potential impact upon the international legal order depend upon them being drafted by experts and subsequently accepted in State practice (Wolfrum 'Introduction' in Wolfrum and Röben at 6).

**60** One should also consider to what extent the various sources influence each other. Non-treaty law standards may concretize treaty law provisions previously open for interpretation. For example, the *lex mercatoria* is used for that purpose. Non-treaty standards may be restatements of customary international law or may influence the formation of the latter. Also, treaty law influences the formation of customary international law. For example, the Geneva Conventions Additional Protocol I (1977) is considered by several national military manuals as customary international law, while the manuals themselves constitute State practice and contribute to the development of customary international law. International law sources form a unity and, as such, influence and supplement each other. They are, to a varying degree, susceptible to meta-legal and general consideration which is a mechanism for their progressive development, as well as the basis for their sustainable legitimacy.

**61** There are norms which may not be considered binding in a formal sense but which are nevertheless expected to be followed (see also Soft Law). In this category belongs, among others, the Basel Accords, which apply among the governors of the G20 central banks.

**62** Hortatory rules may also play an important role in the formation of the corpus of international law. Such rules constitute important phases in law-making (Boyle 904). For example, IAEA Guidelines were the basis for the adoption of the 1986 Convention on Early Notification of a Nuclear Accident. UNEP Guidelines were incorporated in the 1991 UNECE Convention on Environmental Impact Assessment in a Transboundary Context. In particular, non-binding norms may establish general principles which may in turn direct the establishment and shape of legally binding international norms. There is even a recent trend towards the enforcement of non-binding rules. This is the case, for example, for the FAO Code of Conduct for Responsible Fisheries.

**63** The formerly strict division of sources into legally binding ones and those that lack binding force is getting blurred. Not only do non-binding norms have an impact upon broadly-phrased treaty norms, but they also influence the development and shaping of principles of international law. What is more, there is a growing tendency to implement such non-binding norms. If this

development is consolidated, they will gain an established place in the corpus of international law besides the established sources.

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**WORLD TRADE  
ORGANIZATION**

WT/DS62/AB/R  
WT/DS67/AB/R  
WT/DS68/AB/R  
5 June 1998  
(98-2271)

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**Appellate Body**

**EUROPEAN COMMUNITIES - CUSTOMS CLASSIFICATION  
OF CERTAIN COMPUTER EQUIPMENT**

**AB-1998-2**

*Report of the Appellate Body*



WORLD TRADE ORGANIZATION  
APPELLATE BODY

**European Communities - Customs  
Classification of Certain Computer  
Equipment**

European Communities, *Appellant*  
United States, *Appellee*  
Japan, *Third Participant*

AB-1998-2

Present:

Beeby, Presiding Member  
Ehlermann, Member  
Lacarte-Muró, Member

**I. Introduction**

1. The European Communities appeals from certain issues of law covered in the Panel Report, *European Communities - Customs Classification of Certain Computer Equipment*<sup>1</sup> (the "Panel Report") and certain legal interpretations developed by the Panel in that Report. The Panel was established to consider complaints by the United States against the European Communities, Ireland and the United Kingdom concerning the tariff treatment of Local Area Network ("LAN") equipment and personal computers with multimedia capability ("PCs with multimedia capability").<sup>2</sup> The United States claimed that the European Communities, Ireland and the United Kingdom accorded to LAN equipment and/or PCs with multimedia capability treatment less favourable than that provided for in Schedule LXXX of the European Communities<sup>3</sup> ("Schedule LXXX") and, therefore, acted

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<sup>1</sup>WT/DS62/R, WT/DS67/R and WT/DS68/R, 5 February 1998.

<sup>2</sup>The United States submitted three requests for the establishment of a panel: *European Communities - Customs Classification of Certain Computer Equipment*, WT/DS62/4, 13 February 1997; *United Kingdom - Customs Classification of Certain Computer Equipment*, WT/DS67/3, 10 March 1997; and *Ireland - Customs Classification of Certain Computer Equipment*, WT/DS68/2, 10 March 1997. At its meeting of 20 March 1997, the Dispute Settlement Body (the "DSB") agreed to modify, at the request of the parties to the dispute, the terms of reference of the Panel established against the European Communities, so that the panel requests by the United States contained in documents WT/DS67/3 and WT/DS68/2 might be incorporated into the mandate of the Panel established pursuant to document WT/DS62/4. See WT/DS62/5, 25 April 1997.

<sup>3</sup>Schedule LXXX of the European Communities, *Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations*, done at Marrakesh, 15 April 1994.

inconsistently with their obligations under Article II:1 of the *General Agreement on Tariffs and Trade 1994* (the "GATT 1994").

2. The Panel Report was circulated to the Members of the World Trade Organization (the "WTO") on 5 February 1998. The Panel reached the conclusion that:

... the European Communities, by failing to accord imports of LAN equipment from the United States treatment no less favourable than that provided for under heading 84.71 or heading 84.73, as the case may be, in Part I of Schedule LXXX, acted inconsistently with the requirements of Article II:1 of GATT 1994.<sup>4</sup>

The Panel made the following recommendation:

The Panel recommends that the Dispute Settlement Body request the European Communities to bring its tariff treatment of LAN equipment into conformity with its obligations under GATT 1994.<sup>5</sup>

3. On 24 March 1998, the European Communities notified the DSB<sup>6</sup> of its intention to appeal certain issues of law covered in the Panel Report and legal interpretations developed by the Panel, pursuant to paragraph 4 of Article 16 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (the "DSU"), and filed a Notice of Appeal with the Appellate Body, pursuant to Rule 20 of the *Working Procedures for Appellate Review* (the "*Working Procedures*"). On 3 April 1998, the European Communities filed an appellant's submission.<sup>7</sup> On 20 April 1998, the United States filed an appellee's submission<sup>8</sup> and on the same day, Japan filed a third participant's submission.<sup>9</sup> The oral hearing, provided for in Rule 27 of the *Working Procedures*, was held on 27 April 1998. At the oral hearing, the participants and the third participant presented their arguments and answered questions from the Division of the Appellate Body hearing the appeal.

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<sup>4</sup>Panel Report, para. 9.1.

<sup>5</sup>Panel Report, para. 9.2.

<sup>6</sup>WT/DS62/8, WT/DS67/6 and WT/DS68/5, 24 March 1998.

<sup>7</sup>Pursuant to Rule 21(1) of the *Working Procedures*.

<sup>8</sup>Pursuant to Rule 22 of the *Working Procedures*.

<sup>9</sup>Pursuant to Rule 24 of the *Working Procedures*.

## II. Arguments of the Participants

### A. Appellant - European Communities

4. The European Communities requests the Appellate Body to review a number of errors of law and certain legal interpretations developed by the Panel. The European Communities submits that the Panel erred in law when it rejected the procedural objections of the European Communities concerning the lack of specificity of the request for the establishment of a panel of the United States, thus hampering the rights of defence of the responding Member and violating Article 6.2 of the DSU. The European Communities asserts that the Panel also erred in considering that the meaning of a particular heading of the Schedule of a WTO Member should be read in the light of the "legitimate expectations" of an exporting Member outside the context of a non-violation complaint under Article XXIII:1(b) of the GATT 1994. The European Communities also asserts that the Panel erred in finding that Article II:5 of the GATT 1994 confirms this view. Subordinately, the European Communities argues that even if the notion of "legitimate expectations" was relevant in the context of a violation complaint under Article XXIII:1(a) of the GATT 1994, those legitimate expectations should not be based on the classification practices for individual importers and individual consignments, or on the subjective perception of a number of exporting companies of an exporting Member. The European Communities submits that the Panel also erred in considering that, in any case, the onus of clarifying the scope of a tariff concession during a multilateral tariff negotiation under the auspices of the GATT/WTO shall necessarily be on the importing Member. The European Communities asserts that by so doing, the Panel has created new rules on the burden of proof which are inconsistent with the ones applicable to WTO dispute settlement procedures.

#### 1. Request for the Establishment of a Panel

5. The European Communities submits that the Panel erred in finding that the measures under dispute and the products affected by such measures were sufficiently identified by the United States to include measures other than Commission Regulation (EC) No. 1165/95 as far as it concerns LAN adapter cards.<sup>10</sup> The European Communities asserts that the findings of the Panel are based on several legal errors. First, the Panel disregarded the requirement under Article 6.2 of the DSU providing that the request for the establishment of a panel shall "identify the specific measures at issue". Second, the Panel misapplied the established procedural requirement according to which the product coverage of a claim has to be specified prior to the commencement of the Panel's

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<sup>10</sup>Commission Regulation (EC) No. 1165/95 of 23 May 1995 concerning the classification of certain goods in the combined nomenclature, Official Journal No. L 117, 24 May 1995, p. 15.

examination. Third, neglecting these procedural requirements which the European Communities invoked before the Panel results in a serious violation of the rights of defence of the European Communities and, as such, constitutes a breach of the demands of due process that are implicit in the DSU.

6. With respect to the identification of the specific measures at issue, the European Communities submits that the request of the United States for the establishment of a panel does not meet the minimum standards contained in Article 6.2 of the DSU. The European Communities asserts that in *European Communities - Regime for the Importation, Sale and Distribution of Bananas*<sup>11</sup> ("*European Communities - Bananas*"), the Appellate Body confirmed that the measures at issue in that dispute were adequately identified under Article 6.2 of the DSU by referring to the basic EC regulation at issue, by place and date of publication, in the request for the establishment of a panel. The European Communities states that this reading of Article 6.2 of the DSU, pursuant to which the request must at least specify one basic legal measure, is fully in line with the general rules of interpretation of public international law. In the view of the European Communities, the request of the United States for the establishment of a panel only identifies one specific measure, namely Commission Regulation (EC) No. 1165/95, which is said to "reclassify" LAN adapter cards and which, unlike the regulation at issue in *European Communities - Bananas*, is not a basic measure on which all the other actions complained about are founded. In response to a question asked at the oral hearing, the European Communities expressly accepted that the application of a tariff in an individual case on a consignment is a measure within the meaning of Article 6.2 of the DSU. However, in the view of the European Communities, the measures in question are only vaguely described in the request of the United States for the establishment of a panel. The type of measure, the responsible authority, the date of issue or the reference are not clearly defined. Furthermore, the European Communities argues that it is even unclear how many of these alleged measures are under dispute.

7. The European Communities also submits that under the minimum standard laid down in Article 6.2 of the DSU, relating to the identification of specific measures, it is also necessary to clearly define the product coverage of a claim raised in the framework of a dispute settlement procedure. The European Communities asserts that the Panel erroneously distinguished the present case from *EEC - Quantitative Restrictions Against Imports of Certain Products from Hong Kong*<sup>12</sup> ("*EEC - Quantitative Restrictions Against Hong Kong*") when holding that no new product was added by the United States in the course of the proceedings, and that the definition of LAN equipment provided by the United States, in responding to a question by the Panel, was an elucidation of the

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<sup>11</sup>Adopted 25 September 1997, WT/DS27/AB/R.

<sup>12</sup>Adopted 12 July 1983, BISD 30S/129.

product coverage already specified in the request of the United States for the establishment of a panel. According to the European Communities, this reasoning is based on at least two flawed assumptions: first, that LAN equipment and PCs with multimedia capability could each be considered as a single product; and, second, that the explanations of the United States before the Panel concerning product coverage were an "elucidation" rather than an unlawful "curing" of the defective product description in the request for the establishment of a panel.

8. With respect to the first assumption, the European Communities submits that LAN equipment is not a single product but a wide variety of different products used in a local area network. Furthermore, the United States has not been consistent regarding the definition of LAN equipment in the course of the panel proceedings. The European Communities also asserts that, like LAN equipment, PCs with multimedia capability are not a single product category. It is further argued by the European Communities that using such broad product categories when defining the scope of a claim is equivalent to adding the convenient phrase "including but not necessarily limited to" in the request for the establishment of a panel. In the view of the European Communities, the Appellate Body in *India - Patent Protection for Pharmaceutical and Agricultural Chemical Products*<sup>13</sup> ("*India - Patents*") vigorously rejected the use of this kind of loose language when holding that "the convenient phrase, 'including but not necessarily limited to', is simply not adequate to 'identify the specific measures at issue and provide a brief summary of the legal basis of the complaint sufficient to present the problem clearly' as required by Article 6.2 of the DSU".<sup>14</sup>

9. The European Communities submits that the second assumption on which the Panel based its reasoning was that the United States elucidated the product coverage of its panel request. The European Communities argues that the Panel appeared to agree that the United States had left the precise scope of the dispute in the dark and, after the first meeting of the Panel with the parties, allowed the United States to provide a definitive list of products with respect to which it alleged there had been a violation. The European Communities asserts that the Panel accepted this list as an "elucidation" and sufficient specification of the product coverage, thus regarding the vague product definition of the United States as cured. In the view of the European Communities, this finding of the Panel amounts to an error in law.

10. The European Communities asserts that in any judicial or quasi-judicial procedure, it is an essential procedural right of the responding party to be aware of the case held against it, and that the WTO dispute settlement system can only produce acceptable solutions to conflicts between WTO

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<sup>13</sup>Adopted 16 January 1998, WT/DS50/AB/R.

<sup>14</sup>*Ibid.*, para. 90.



Members if this fundamental rule of due process is adequately observed. The European Communities submits that the Appellate Body should, therefore, guarantee this essential procedural right by continuing to interpret Article 6.2 of the DSU strictly.

2. "Legitimate Expectations" in the Interpretation of a Schedule

11. According to the European Communities, the existence of a *common* intention forms the basis for the mutual consent of the signatories to be bound by an international agreement. This common intention finds its authentic expression in the text of the treaty, not in the subjective expectations of one or other of the parties to the agreement. The European Communities states that the rules of the *Vienna Convention on the Law of Treaties*<sup>15</sup> (the "*Vienna Convention*") on the interpretation of international agreements are based on this fundamental consideration. Furthermore, the European Communities asserts that the report in *Panel on Newsprint*<sup>16</sup> is based on the correct assumption that a Schedule is an agreed commitment between the contracting parties and is not just the unilateral perception of one of the Members involved in the multilateral negotiations. The European Communities also submits that "protocols and certifications relating to tariff concessions" are an integral part of the GATT 1994<sup>17</sup> and, therefore, are part of an international multilateral agreement which is the result of a "meeting of the minds" and not the sum of subjective perceptions or expectations.

12. The European Communities asserts that the complaint of the United States was founded *only* on the allegation that the European Communities had violated its obligations under Article II:1 of the GATT 1994, which indicates that the claim was based *only* on Article XXIII:1(a) of the GATT 1994. The European Communities also submits that it appears that, when presenting its legal position, the United States used the notion of "reasonable expectations" and "legitimate expectations" as synonymous. The European Communities states that the Panel has not drawn any particular conclusion from the varied definitions of this notion and has apparently, albeit implicitly, decided to consider that the two definitions can be used indifferently to describe the same concept. In the view of the European Communities, the same approach was used by the Appellate Body, in paragraphs 41-42 of its Report in *India - Patents* and, therefore, the European Communities suggests that for the sake of this appeal, the Appellate Body continues to consider the notion of "legitimate

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<sup>15</sup>Done at Vienna, 23 May 1969, 1155 U.N.T.S. 331; 8 International Legal Materials 679.

<sup>16</sup>Adopted 20 November 1984, BISD 31S/114.

<sup>17</sup>See paragraph 1(b)(i) of the language of Annex 1 A incorporating the GATT 1994 into the *Marrakesh Agreement Establishing the World Trade Organization* (the "*WTO Agreement*"), done at Marrakesh, Morocco, 15 April 1994.

expectations" used by the Panel and the parties to this dispute as equivalent to that of "reasonable expectations".

13. The European Communities submits that the Panel erred in law by *not* considering the object and purpose of the tariff concession in Schedule LXXX with respect to the products concerned but rather a supposed and erroneous object and purpose of Article II of the GATT 1994, i.e., the protection of "legitimate expectations". In the view of the European Communities, the Panel should have proceeded, pursuant to Article 31 of the *Vienna Convention*, with the interpretation of the *words* used in Schedule LXXX in the light of *their* object and purpose and within *their* context. The European Communities asserts that the context of the Schedule must include the negotiations, the legal situation in both the exporting and importing Members (including the classification practice of the United States during the entire period of the negotiations), the EC internal legislation applicable to such tariff treatment, the EC customs nomenclature existing at the time of the drafting of the Schedule and so on. Responding to a question asked by the Appellate Body during the oral hearing, the European Communities stated that on the basis of Article 31(3)(c) of the *Vienna Convention*, the *International Convention on the Harmonized Commodity Description and Coding System*<sup>18</sup> (the "*Harmonized System*") and its *Explanatory Notes*<sup>19</sup> would be relevant in interpreting the obligations of the European Communities under Schedule LXXX *vis-à-vis* WTO Members which are also Members of the World Customs Organization (the "WCO").

14. The European Communities argues that the Panel limited itself to an unmotivated affirmation that the context to be considered pursuant to Article 31 of the *Vienna Convention* was *only* Article II of the GATT 1994, and has proceeded to the totally separate and not directly relevant interpretation of the object and purpose of Article II and *not* of the Schedule. The European Communities asserts that "even more erroneously, [the Panel's] interpretation of Article II has been achieved through the reference to previous case law in a non-violation case, notwithstanding the fact that the present procedure is only concerned with a violation complaint".<sup>20</sup> Therefore, the context that the present Panel considered to be relevant for the interpretation of Schedule LXXX in a violation complaint has been deduced from the interpretation of Article II in a non-violation complaint. The European Communities further asserts that in paragraph 36 of the Appellate Body Report in *India - Patents*, the Appellate Body clearly indicates that the concept of the protection of reasonable expectations of contracting parties relating to market access was developed in the context of non-violation complaints under Article XXIII:1(b) of the GATT. Thus, according to the European Communities, the Panel's

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<sup>18</sup>Done at Brussels on 14 June 1983.

<sup>19</sup>*Explanatory Notes to the Harmonized Commodity Description and Coding System*, Customs Cooperation Council, Brussels, 1986.

<sup>20</sup>Appellant's submission of the European Communities, para. 50.

finding in paragraph 8.23 contradicts this interpretation and "melds the legally-distinct bases for 'violation' and 'non-violation' complaints under Article XXIII of the GATT 1994 into a uniform cause of action"<sup>21</sup> which is not consistent with Article XXIII.

15. It is further argued by the European Communities that, independently of the legal issues that were at stake in the two dispute settlement procedures, there is an extraordinary resemblance in the legal approach followed by the panel in *India - Patents* and that followed by the present Panel. The European Communities submits that as in *India - Patents*, this Panel: (i) was not about an Article XXIII:1(b) "non-violation" complaint but only about an Article XXIII:1(a) "violation" complaint; (ii) was not about a violation complaint concerning Articles III or XI of the GATT; (iii) was not concerned with the affectation of competitive relationship between imported and domestic products, but rather with the tariff treatment of certain products compared to the concessions scheduled by the European Communities in the WTO; and (iv) has considered the "legitimate expectations" of the parties not by examining whether they were reflected in the words of the treaty -- Schedule LXXX in this case -- but rather by "imputing" into the treaty considerations and subjective "understandings" which the Panel has considered to be the expectations of a Member and of private companies involved in the trade of the covered products and which were never reflected in the wording of the Schedule.

16. The European Communities also submits that the Panel's findings lead to "absurd practical consequences".<sup>22</sup> The European Communities questions how it is possible to determine the content of MFN tariff treatment on the basis of the "legitimate expectations" of *one* Member among all WTO Members. If the "legitimate expectations" of that Member diverges from the "legitimate expectations" of other Members, the consequence would be that a Member, in order to know exactly what is the tariff treatment to grant a given product, would have to verify the potentially divergent "legitimate expectations" of all other WTO Members. This is at odds with the aim affirmed by the Panel to protect the predictability and stability of the tariff treatment of that particular product. Moreover, in the view of the European Communities, the *balance* of mutual concessions among Members, which is the result of the successive rounds of tariff negotiations in the framework of the GATT/WTO, would be severely upset: the "legitimate expectations" of one Member would, through the MFN provision, apply to all other Members whose balance of reciprocal concessions was based on substantially different and variable "legitimate expectations". The European Communities further claims that, if the Panel's findings on this point were upheld, the whole purpose of Article II of the GATT 1994 and of the Members' Schedules would be altered. In the view of the European

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<sup>21</sup>Appellate Body Report, *India - Patents*, adopted 16 January 1998, WT/DS50/AB/R, para. 42.

<sup>22</sup>Appellant's submission of the European Communities, para. 54.

Communities, a tariff concession bound by a Member in its Schedule would no longer define a limit to the duty applicable upon importation of a given product, but would rather be determined by a unilateral perception of the advantages expected by the exporting Member.

17. The European Communities submits that the Panel violated the rules of interpretation of Articles 31 and 32 of the *Vienna Convention* and Articles 3.2 and 19.2 of the DSU by affirming that "[although] in nearly all instances, the ordinary meaning of the terms of the actual description in a tariff schedule accurately reflects and exhausts the content of the legitimate expectations ... [i]t must remain possible, at least in principle, that parties have legitimately formed expectations based on other particular supplementary factors".<sup>23</sup> According to the European Communities, what the Panel appears to pronounce here is the power to add elements which are not present in the text of the Schedules whereas, under Articles 3.2 and 19.2 of the DSU, a panel is required simply to clarify the provisions of the covered agreements. The European Communities submits that this would inevitably alter the very nature of the panel procedure which would be seen as replacing, or attempting to replace, the signatories of the *WTO Agreement*.

18. It is further claimed by the European Communities that the Panel erred by stating that the importance of "legitimate expectations" in interpreting tariff commitments can be confirmed by the text of Article II:5 of the GATT 1994. The European Communities submits that the Panel made two contradictory statements. On the one hand, the Panel stated that Article II:5 confirms the existence of the "legitimate expectations" in Article II:1. On the other hand, however, it stated that Article II:5 is a provision for the special bilateral procedure regarding tariff classification, which is not directly at issue in this case. In the view of the European Communities, there is a clear *non-sequitur* between the affirmation of the inapplicability of Article II:5 to the present case and its use for the interpretation of a different provision which is declared applicable to this case. According to the European Communities, either Article II:5 is relevant and applicable to the present case, in particular for the interpretation of Schedule LXXX, or it is not. It cannot be both at the same time. It is further argued by the European Communities that the only relevance of Article II:5 of the GATT 1994 could have been in the context of a procedure aimed at requesting a compensatory adjustment, which was never pursued by the United States. Thus, according to the European Communities, if the Panel was of the opinion that Article II:5 was relevant, it should have come to the conclusion that it was only relevant in establishing that the United States had never correctly followed it. Alternatively, the European Communities argues that Article II:5 is simply irrelevant.

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<sup>23</sup>Panel Report, para. 8.26.

19. The European Communities also submits that Article II:5 does not prove the existence of a notion of "legitimate expectations" in Article II of the GATT 1994 or, more generally, in the tariff treatment of a given product under the Schedule of a Member. The European Communities notes that the words "believes to have been contemplated" and "contemplated" in the first and second sentence of this provision are highlighted in the Panel Report and, therefore, argues that the Panel attached a special value to them in order to support its findings. The European Communities cannot see how these words, read in their context, could in any way be assimilated to the notion of "legitimate expectations" that was developed in the context of non-violation cases. In the view of the European Communities, there is nothing in the words "believes" or "contemplated" that indicates any reference to an objective entitlement to a tariff treatment that would be different from the one that derives from the *objective* interpretation of the content of the Schedule of the importing Member.

20. In the event that the Appellate Body considers that the notion of "legitimate/reasonable expectations" is relevant in the context of a violation dispute under Article XXIII:1(a) of the GATT 1994, the European Communities submits the following arguments for its consideration. According to the European Communities, the core of the Panel's argument regarding the notion of "legitimate expectations" can be summarized as follows: during a multilateral trade negotiation, the tariff treatment of a given product subject to negotiation is considered with respect to the "actual normal" tariff treatment at the time of the negotiation, unless there is a "manifestly anomalous" treatment that would indicate "the contrary". Therefore, the meaning of the tariff treatment which is bound in the importing Member's Schedule must correspond to the "actual normal" tariff treatment at the time of the negotiation. Otherwise, there will be a breach of the "legitimate expectations" of the exporting Member and, therefore, a violation of Article II:1 of the GATT 1994.

21. The European Communities submits that the Panel's reasoning is affected by errors in law and in logic in at least three respects. First, the European Communities argues that a duty imposed at a level which is currently lower than the duty bound in a Schedule does not constitute a right for the Members which temporarily benefit from the reduction. Second, the European Communities submits that it is not correct to assert, as the Panel does, that the current duty treatment is taken as the basis for the negotiations and, therefore, that treatment will be continued unless such treatment is manifestly anomalous or there is information readily available to the exporting Member that clearly indicates the contrary. Third, the European Communities argues that elements of subjective judgement such as "normally based", "manifestly anomalous", "information readily available" and "clearly indicates" are not legal elements that must, or even can, be taken into account when interpreting a Member's Schedule and/or Article II of the GATT 1994. These subjective appreciations are not included in Articles 31 and 32 of the *Vienna Convention*. Thus, in the view of the European Communities,

irrespective of the existence of any normality or abnormality, or of information readily or not readily available, the actual or current tariff treatment of a certain product could not be considered as an obligation under Article II if it cannot be demonstrated that it is reflected in the Schedule.

22. The European Communities also submits that the Panel should not have dealt with classification issues as the WTO system does deal with these issues in the covered agreements. According to the European Communities, there is no obligation under the GATT to follow any particular system for classifying goods, and a Member has the right to introduce in its customs tariff new positions or sub-positions as appropriate. The European Communities also argues that "[w]hat the Panel has *de facto* done here is weighing the number of *individual EC classification* decisions presented as evidence by the US against the opposite *EC individual classification* decisions presented as evidence by the EC in order to achieve the result that the former are correct and the latter are not".<sup>24</sup> The European Communities asserts that this is nothing less than a classification decision by the Panel in spite of the fact that the Panel itself rightly considers classification issues to be outside its terms of reference.

### 3. Clarification of the Scope of Tariff Concessions

23. The European Communities submits that the Panel erred in considering that the onus of clarifying the scope of a tariff concession during a multilateral tariff negotiation under the auspices of the GATT/WTO shall necessarily be placed on the side of the importing Member. In the view of the European Communities, the issue at stake in this dispute is not whether a requirement of clarification was on the United States or on the European Communities, but rather whether the agreement, which the United States claims it reached with the European Communities and other WTO Members, on certain tariff treatment of LAN equipment, really existed and was reflected in Schedule LXXX.

24. The European Communities asserts that the Panel dedicated three pages to the totally irrelevant issue of the burden of "clarification", which is treated separately from the issue of whether the United States has proven its assertion that Schedule LXXX contains an obligation to provide tariff treatment lower than the one applied. It is further argued by the European Communities that the Panel cannot rely on two contradictory assertions at the same time. *Either* the burden of proof and the burden of clarification are different notions, in which case the Panel should have explained to the parties and to the Members of the WTO how this is relevant in the present dispute, *or* the burden of clarification is identical with the notion of burden of proof or has, in any case, a bearing on the burden

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<sup>24</sup>Appellant's submission of the European Communities, para. 82.

of proof in such a way as to determine a different distribution of that burden between the party which asserts and the party which responds.

25. The European Communities submits that in this second scenario, the Panel has in fact created a newly invented rule on the burden of proof. According to this burden of proof, "the exporting Member that could show the existence of *practices* on the current classification of individual shipments by some 'prevailing' customs authorities of a Member would have proved its assertion that a tariff treatment was *agreed* in the Schedule, ... irrespective of whether it has actually *proved* that the existence of the *agreement* on a certain tariff treatment was actually reflected in the text of the agreement (or of the agreed Schedule). The burden of clarifying the content of the Schedule is on the importing Member: as a result, that Member is to blame for any misunderstanding".<sup>25</sup>

26. The European Communities cannot agree with this newly invented rule. This rule would allow the Member who asserts that a certain agreement was passed on the tariff treatment of a given product to shift the burden of proof to the responding Member without any need to submit evidence related to the words of the agreement. In the view of the European Communities, the result of such an "easy" shift of the burden of proof on the responding Member would be that, failing any written document, it would find itself in the practical impossibility of rebutting that assumption. An assertion would amount to a proof, and an almost un rebuttable one, which is fundamentally at odds with the finding of the Appellate Body in *United States - Measure Affecting Imports of Woven Wool Shirts and Blouses from India*<sup>26</sup> ("*United States - Shirts and Blouses*").

B. *Appellee - United States*

27. The United States endorses the findings and conclusions of the Panel. The United States submits that the Panel was correct in determining that the request of the United States for the establishment of a panel sufficiently identified the measures and products at issue. The United States also asserts that regardless of whether the Appellate Body accepts the Panel's reasoning and interpretation of "legitimate expectations", the findings of the Panel Report support its ultimate conclusion that the impairment of treatment resulting from actions of customs authorities in the European Communities is inconsistent with Article II:1 of the GATT 1994. The United States also submits that the Panel correctly followed the standard laid down by the Appellate Body in *United States - Shirts and Blouses* and that, contrary to the arguments of the European Communities, the Panel did not establish a new burden of proof rule.

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<sup>25</sup>Appellant's submission of the European Communities, para. 88.

<sup>26</sup>Adopted 23 May 1997, WT/DS33/AB/R.

1. Request for the Establishment of a Panel

28. The United States asserts that the Panel correctly followed the guidance of the Appellate Body decision in *European Communities - Bananas* in determining that the United States sufficiently identified the measures and products at issue. According to the United States, the meaning of the term "specific measures", as used in Article 6.2 of the DSU, was addressed in *European Communities - Bananas* where the panel found that the panel request complied with the requirements of Article 6.2 of the DSU because the measures contested by the complainants were "adequately identified", even though they were not listed explicitly. In the view of the United States, the panel and Appellate Body decisions in *European Communities - Bananas* "teach that the specificity requirement of Article 6.2 will be met if the responding party is provided sufficient notice and identification of the measure(s) at issue, even if those measures are not specifically identified".<sup>27</sup>

29. It is further argued by the United States that its panel request identified both the timing and nature of the measures at issue which, in the application since June 1995 by the customs authorities in the European Communities, consist of tariffs to LAN equipment higher than those provided for in Schedule LXXX.<sup>28</sup> The United States also submits that as of March 1997, both the European Communities and the United States agreed that Member State customs authorities were applying the higher tariff rates, under heading 85.17, to imports of LAN equipment. Accordingly, in the view of the United States, the European Communities has never had any basis to claim that it lacked sufficient information about the measures the United States sought to have modified at the time of the establishment of the panel. In applying the "adequate" or "sufficient" notice test of *European Communities - Bananas*, the United States submits that the European Communities had clear notice from the explicit terms used in the panel requests of the United States that the complaint concerned the application of higher tariffs for LAN equipment by customs authorities of Member States. Since the panel request identified the same measures which the European Communities acknowledged its customs officials were applying, the European Communities suffered, in the view of the United States, no prejudice, let alone prejudice sufficient to rise to the level of a violation of due process.

30. The United States submits that there is no basis for the assertion of the European Communities that the description of the United States of "all types of LAN equipment" and the allegedly inappropriate "curing" of the request for the establishment of a panel have led to a "serious violation of the European Communities' rights of defence". According to the United States, these

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<sup>27</sup>Appellee's submission of the United States, para. 33.

<sup>28</sup>We note that the United States also argued with regard to its two additional requests for the establishment of a panel (WT/DS67/3 and WT/DS68/2) that they also identified both the timing and nature of the measures at issue (appellee's submission of the United States, paras. 34 and 35).



arguments ignore the fact that the term, LAN equipment, is a recognized term of the trade and that, beginning as early as the pre-consultation stage of this dispute through the panel proceedings, the European Communities was made sufficiently aware of which products were the subject of the dispute. According to the United States, the argument of the European Communities also ignores the many contacts between officials of the European Communities and the United States prior to the submission of the panel request, in which the term, LAN equipment, was routinely used and understood. The United States disagrees with the European Communities regarding the need for parties to exhaustively detail every conceivable sub-grouping of more broader categories of products which are detailed in a request for the establishment of a panel. In the view of the United States, the appropriate standard to be applied to product coverage should be similar to that applied by the panel in *European Communities - Bananas* to the specificity of measures: whether the products are "sufficiently identified". According to the United States, applying the logic followed in *European Communities - Bananas*, such a test would be met if the complaining party identifies the general product grouping of the products concerned in terms of the ordinary meaning in a commercial context.

31. The United States submits that the Panel was correct when it stated that the more detailed definition of LAN equipment, provided by the United States to the Panel in response to a question, was an "elucidation" of the product coverage already specified in the requests of the United States for the establishment of a panel. According to the United States, the present case is quite different from the situation in *European Communities - Bananas* and *India - Patents* with respect to the addition of a new claim. In the request for the establishment of a panel against the European Communities<sup>29</sup>, the United States first defined the parameters of the products at issue -- all LAN products -- and then provided examples of some types of LAN products. The United States submits that it need not have provided any such examples to have complied with Article 6.2 of the DSU because the term LAN products is a sufficiently precise term of the trade. Nor should the United States or any other WTO Member be required to exhaustively enumerate all product category sub-groups in its panel request. The United States also asserts that since its request for the establishment of a panel properly identified LAN equipment, the Panel was correct in distinguishing the present case from the panel decision in *EEC - Quantitative Restrictions Against Hong Kong*.

32. In the view of the United States, if the arguments of the European Communities on the specificity of product definition are accepted, there inevitably will be long, drawn-out procedural battles at the early stage of the panel process in every proceeding. The United States submits that

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<sup>29</sup>See footnote 2 of this Report.

according to the theory of the European Communities, a complaining party would be required to list each and every product in detail in its panel request.

2. "Legitimate Expectations" in the Interpretation of a Schedule

33. The United States submits that the attack of the European Communities on the Panel's reasoning places form over substance. In the view of the United States, the substance of the findings of the Panel is its fact-finding which supports the conclusion that the ordinary meaning of "automatic data-processing machines and units thereof" includes LAN equipment. The Panel found that the meaning of the text of the concession in heading 84.71 can include LAN equipment and that, as a matter of fact, Member State customs authorities treated LAN equipment as automatic data-processing machines ("ADP machines") during the Uruguay Round and that the European Communities had given the United States and other trading partners reason to believe that this treatment would be continued. It is further argued by the United States that during the panel proceeding, the European Communities did not produce or prove facts demonstrating that LAN equipment was intended to be included in the binding in heading 85.17 of Schedule LXXX.<sup>30</sup>

34. Thus, in the view of the United States, regardless of whether the Appellate Body accepts the Panel's reasoning and interpretation of "legitimate expectations", the findings of the Panel Report support its ultimate conclusion that the European Communities, by failing to accord to imports of LAN equipment treatment no less favourable than that provided for in headings 84.71 or 84.73 of Schedule LXXX<sup>31</sup>, has acted inconsistently with its obligations under Article II:1 of the GATT 1994. The United States argues that the Panel's reasoning was correct but that, even if the Appellate Body should reverse certain aspects of this reasoning, the Appellate Body should affirm the Panel's ultimate conclusion.

35. The United States submits that the Panel has properly interpreted the obligations of the European Communities under Schedule LXXX and Article II of the GATT 1994 in accordance with Articles 31 and 32 of the *Vienna Convention*. The text of the concession in heading 84.71 of Schedule LXXX provides that this concession applies to "automatic data processing machines and units thereof". According to the United States, the ordinary meaning of "automatic data processing machines and units thereof" includes computers and computer systems, as well as units of computers

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<sup>30</sup>Heading 85.17 relates to "electrical apparatus for line telephony or line telegraphy, including such apparatus for carrier-current line systems" (hereinafter referred to as "telecommunications equipment").

<sup>31</sup>Heading 84.71 relates to "automatic data-processing machines and units thereof ..." and heading 84.73 relates to "parts and accessories (other than covers, carrying cases and the like) suitable for use solely or principally with machines of heading Nos. 84.69 to 84.72" (hereinafter referred to together as "ADP machines").

such as computer networking equipment, i.e., LAN equipment. The United States submits that the function of LAN equipment is not "line telephony or line telegraphy" but that of facilitation of shared processing and storage of data within a computer network or an extended computer system. The Panel found that the text of this concession *can* include LAN equipment and that to the extent the ordinary meaning of the concession is ambiguous, that ordinary meaning can be clarified by the practice of the importing Member. In the view of the United States, these findings are eminently reasonable and are consistent with prior GATT and WTO practice. They can and should be affirmed.

36. The United States asserts that an important factor in determining the "ordinary meaning" of a term used in a Schedule is how the negotiating Members treated the particular product at issue -- in this case, how the European Communities, the United States and interested third parties treated LAN equipment. According to the United States, while the Panel's analysis in paragraphs 8.23-8.28 labels such treatment as an element of "legitimate expectations", this label is not essential to the Panel's conclusion. The United States submits that regardless of the label, what is important is that the factual findings of the Panel, concerning the actual treatment of LAN equipment during the Uruguay Round, amount to a determination that the parties assumed and intended that the concession under heading 84.71 in Schedule LXXX would cover LAN equipment.

37. The United States argues that "factual indicia" of "legitimate expectations" which the Panel actually considered can also be regarded as the factual context of the concessions in Schedule LXXX as facts indicating the object and purpose of the concessions in Schedule LXXX, or as a "supplementary means of interpretation" admissible under Article 32 of the *Vienna Convention*. According to the United States, whether the Panel's analysis was phrased as an interpretation of "legitimate expectations", or whether it was an interpretation of the intentions and understandings of the negotiating parties, the conclusion is the same. The United States submits that the important point here is that the intentions of the United States, as well as the third parties in this dispute, were a relevant factor for the Panel to consider in interpreting the ordinary meaning of the terms used in Schedule LXXX.

38. Responding to a question asked by the Appellate Body during the oral hearing, the United States asserted that the *Harmonized System* and its *Explanatory Notes* could be deemed as part of the "circumstances of the conclusion" of the *WTO Agreement* within the meaning of Article 32 of the *Vienna Convention* and, therefore, could be used as a "supplementary means of interpretation" of Schedule LXXX. However, the United States also submitted that the *Explanatory Notes* are not generally treated as binding because they contain certain contradictions and are occasionally outdated.

Thus, the United States considered that although the *Explanatory Notes* are relevant under Article 32 of the *Vienna Convention*, they should be treated with caution.

39. The United States submits that the European Communities argues that the text is the *only* permissible input for interpreting a Schedule. According to the United States, such a position leads to the conclusion that whenever a treaty interpreter cannot determine whether a given product falls within the exact product composition of a concession on the basis of the text of that concession, the importing Member can make this determination unilaterally. If this is the case, then the tariff obligations provided for under Articles II:1(a) and (b) of the GATT 1994, and the tariff concessions in the Schedules, would be reduced to inutility.

40. The United States further argues that the Panel properly considered the concept of "legitimate expectations" of WTO Members in analysing whether LAN equipment is included within the scope of the EC's concession in heading 84.71. The United States believes that the Panel properly relied on the concept of "legitimate expectations" and that the decision in *India - Patents* does not require the rejection of the Panel's use of "legitimate expectations" as a factor in its analysis of whether the European Communities is in violation of its obligations under Article II of the GATT 1994.

41. The issue, as the United States sees it, is really whether the "legitimate expectations" of an exporting Member are a relevant factor in determining the intentions of the negotiators and thus in determining the ordinary meaning of the terms used in the concession in heading 84.71 of Schedule LXXX. The United States submits that the Panel properly used the concept of "legitimate expectations" in determining and clarifying the intentions of the parties in this case. According to the United States, such an interpretation is supported by the text and context of Article II, as well as its object and purpose. In the view of the United States, the concept of "legitimate expectations" is entirely relevant in the context of any dispute concerning the application of actual tariff concessions. Contrary to the argument of the European Communities, the United States submits that the Panel's analysis has nothing to do with a "melding" of a basis for complaint under Articles III or XI of the GATT and a basis for a "non-violation nullification or impairment" complaint.

42. The United States argues that the argument of the European Communities confuses and distorts the Appellate Body's reasoning in *India - Patents*, and that it twists this reasoning into an instrument for undermining the enforcement of bargained-for tariff concessions. In the view of the United States, the conclusions argued by the European Communities are by no means ordained by the Appellate Body's findings and conclusions in *India - Patents*. The United States asserts that the European Communities has attempted to conflate the concept of "legitimate expectations", as used by

the Panel, with the concept of "reasonable expectations" in the context of Article XXIII:1(b) of the GATT. The United States submits that these concepts are not the same thing. The phrases may exhibit accidental linguistic convergence, but are legally and historically distinct and deal with different situations. In the view of the United States, it is both possible and necessary to distinguish between the concepts employed in enforcing obligations under Articles III or XI of the GATT, the concepts involved in a "non-violation nullification or impairment complaint" and the concept of "legitimate expectations" employed by the Panel in the present dispute. According to the United States, all three concepts are intellectually and historically distinct and independent. They need not be distorted and conflated in the manner advocated by the European Communities.

43. The United States submits that as the Appellate Body pointed out in *India - Patents*, panels considering violation complaints concerning Articles III and XI of the GATT have developed the concept of protecting the expectations of contracting parties concerning the competitive relationship between their products and the products of other contracting parties. According to the United States, Article II of the GATT 1994 is different in nature from Article III. The obligations of Article II only apply to the extent that a Member has made tariff bindings in a Schedule. The United States asserts that Article II also has nothing to do with guaranteeing the equality of opportunity with regard to competitive conditions. The provisions of Article II permit and recognize the existence of tariffs and "other duties and charges" imposed at the border which imply an intentional competitive *inequality* between imports and like domestic products.

44. According to the United States, as the Appellate Body has noted in *India - Patents*, the non-violation provision of Article XXIII:1(b) was aimed at preventing contracting parties from using non-tariff barriers, or other policy measures, to negate the benefits of negotiated tariff concessions. Like Article II of the GATT 1994, the non-violation remedy under Article XXIII:1(b) recognizes the existence of tariff barriers at the border, as well as the terms, conditions or qualifications of tariff concessions, which create intentional competitive *inequality* between imports and like domestic products. Thus, the United States submits that Article II and the non-violation remedy are broadly alike in that they both protect bargained-for market access and the integrity of Schedules. However, Article II protects and enforces the tariff concession itself. According to the United States, tariff concessions safeguard the right to a particular tariff rate, and a Member's responsibility to charge a duty no higher than the level bound in its Schedule, on products covered by the tariff binding in question.

45. The United States submits that the Panel, in the present dispute, used "legitimate expectations" as an interpretative aid to determine what the concession in heading 84.71 means, as

well as whether LAN equipment was meant to be within the product composition of heading 84.71. If it is further argued by the United States that, on the other hand, the concept of "actions that could not reasonably have been anticipated" or "reasonable expectations" has been used in non-violation cases to answer the question that Article XXIII:1(b) raises, namely what GATT-legal impediments to market access an importing Member may impose without taking away the value of the concession (as opposed to violating the obligation to maintain the concession itself). Therefore, in the view of the United States, "legitimate expectations" are relevant in the interpretation of obligations under Article II of the GATT 1994, and actions which "could not reasonably have been anticipated" are relevant in the application of the non-violation remedy under Article XXIII:1(b). However, these two concepts apply under different conditions and for different purposes. The United States argues that the concept of "legitimate expectations" is entirely relevant in the context of any dispute concerning the violation of tariff concessions; the Panel's analysis has nothing to do with a "melding" of a basis for complaint under Articles III or XI of the GATT and a basis for a "non-violation nullification or impairment" complaint.

46. It is further argued by the United States that the context of the Uruguay Round Schedules, as defined by Article 31(2) of the *Vienna Convention*, clearly includes the GATT 1994 and, in particular, Article II thereof. The United States submits that the text of Article II:5 of the GATT 1994 is, therefore, a relevant part of this context and the Panel properly interpreted the meaning of tariff obligations in the light of Article II:5. According to the United States, in the text of Article II:5 the "treatment provided for" is to be understood as the "treatment contemplated by a concession". The United States asserts that the term used in Article II:5 is "contemplated" and that such a provision does not require that treatment has been "discussed" or "expressly agreed". In the view of the United States, the ordinary meaning of "contemplate" in this context is "to expect"; the "treatment" in question must be the treatment by the importing Member which was contemplated at the time. Thus, the United States concludes that the "treatment" provided by a concession is the treatment legitimately expected by the trading partners of the Member making the concession. According to the United States, in the present case, that treatment is the treatment these products were known to be receiving in the European Communities, openly and legally, at the time the binding was negotiated.

47. The United States asserts that it properly invoked Article II:5 of the GATT 1994 and complied with all its procedural requirements. However, discussions under Article II:5 stopped short when, as the European Communities itself recognizes, the European Communities refused to agree that the treatment contemplated was that claimed by the United States. According to the United States, it was this refusal that prevented any negotiations under Article II:5 with regard to a compensatory adjustment. Therefore, in the view of the United States, having frustrated the

procedures of Article II:5, the European Communities may not claim them as a defence to its own violation of Article II:1.

48. The United States disagrees with the alternative argument of the European Communities that the Panel erred in relying on particular types of evidence, namely Binding Tariff Information ("BTIs") and actual trade data, as a factual basis for its findings of fact concerning actual tariff treatment during the Uruguay Round and the "legitimate expectations" based on that treatment. According to the United States, the European Communities distorts the Panel Report by arguing that the Panel found that the tariff treatment bound in Schedules must correspond to the actual tariff treatment, or else there is a breach of the "legitimate expectations" of the exporting Member and therefore a violation of Article II:1 of the GATT 1994. The United States submits that the substance of the Panel's findings amounted to an interpretation of the ordinary meaning of the concession in heading 84.71, on the basis of its text, context, object and purpose. Thus, in the view of the United States, the Panel has, in essence, interpreted the intentions of the parties and has determined what, in fact, the actual tariff treatment of LAN equipment was as a factor in evaluating those intentions.

49. The United States asserts that the European Communities is arguing that, when interpreting a Schedule, the only evidence that may be taken into account is the text of the Schedule itself. The United States submits that this "text only" approach not only contradicts the guidance of the *Vienna Convention* and the Appellate Body, with regard to the interpretation of treaties, but also leads to establishing the right of an importing Member to arbitrarily change the duty treatment of products whenever the text of the relevant concession is ambiguous.

50. According to the United States, the Panel did not use BTIs in order to determine how LAN equipment should be classified. Rather, it used BTIs as a form of factual evidence concerning the actual tariff treatment of certain products during a particular historical period. Therefore, the United States submits that the Panel properly relied on the evidence before it, including BTIs, affidavits by exporters and actual trade data, as a basis for its findings of fact concerning the actual tariff treatment of LAN equipment during the Uruguay Round and the legitimate expectations based on that treatment. In the view of the United States, the Panel's fact-finding was within the scope of its discretion under Article 11 of the DSU and, because these findings are factual, they do not fall within the permissible scope of an appeal under Article 17.6 of the DSU.

3. Clarification of the Scope of Tariff Concessions

51. According to the United States, when the Panel rejected the assertion of the European Communities that the exporting Member bears the burden of clarifying the product composition of concessions during tariff negotiations, the Panel did not, as the European Communities suggests, create a new rule on the burden of proof in dispute settlement proceedings. Rather, the Panel correctly followed the standard laid down by the Appellate Body in *United States - Shirts and Blouses*. The United States submits that the Panel examined first, whether the United States had presented factual information sufficient to raise the presumption that its claim concerning the actual treatment of LAN equipment during the Uruguay Round was true and, second, whether the European Communities had presented evidence sufficient to rebut that presumption once raised. In the view of the United States, the Panel correctly found that the United States had raised such a presumption as a matter of fact and that the European Communities had failed to rebut that presumption.

52. Regarding the argument of the European Communities that the Panel Report dedicates three pages to the totally irrelevant issue of the burden of clarification, the United States submits that it finds this claim curious because it is in this section of the Panel Report<sup>32</sup> that the Panel addressed the purported defence of the European Communities that the United States should have clarified, during the negotiations, where LAN equipment would be classified. If the Panel had accepted this defence from the European Communities, the Panel would have imposed, according to the United States, a new rule limiting the scope of proof that could be brought forward by an exporting Member, in this situation, by restricting the exporting Member to textual arguments concerning the meaning of the terms in Schedule LXXX. Thus, the United States argues that if any change in the burden of proof is suggested, that suggestion comes from the European Communities and not the Panel or the United States.

53. The United States submits that the European Communities is wrong in asserting that the Panel's findings permitting exporting Members to present evidence of tariff treatment of individual shipments, practices of current classification and other such evidence, would permit the exporting Member to shift the burden of proof to the responding Member without any need to submit evidence related to the words of the agreement. The United States asserts that it submitted to the Panel evidence concerning the meaning of the term ADP machines in Schedule LXXX and the various products falling within that definition based on treatment by the WCO, the European Communities and industry. According to the United States, it never argued to the Panel -- and does not assert now -- that it could sustain its burden of proof in this case without setting out the meaning of the

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<sup>32</sup>Panel Report, paras. 8.48-8.55.



terms of the agreement. The United States sustained its burden of demonstrating that the term ADP machines included all types of LAN equipment.

C. *Third Participant - Japan*

54. Japan submits that the Panel's legal reasoning regarding "legitimate expectations" and the requirement of clarification was correct and, therefore, requests that the European Communities respect the conclusion of the Panel and bring its tariff treatment of LAN equipment into conformity with its obligations under the GATT 1994.

55. Japan asserts that "[g]enerally, ... the importing Member is obliged to identify products and relevant duties in its tariff schedules ... if the importing Member requests to limit or determine a scope of the tariff concession and relevant duties for the products, which are not classified under the heading of the Harmonized System Committee (HSC) of the CCC and therefore classified differently in several countries".<sup>33</sup> It is further argued by Japan that, "[i]n particular, the classification of the LAN equipment among the Members of the EC was not identical before the Uruguay Round. In other words, the common classification of the LAN equipment within the Members of the EC had not been established before the Uruguay Round, and the responsibility, the EC was required to discharge in this context, was inevitable".<sup>34</sup>

56. Japan submits that it agrees with the Panel that a tariff commitment is an instrument in the hands of an importing Member, in the light of its function to protect its own industry. Therefore, in the view of Japan, "[i]f the importing Member wishes to prove the expectations of the exporting Member, that a certain practice of its tariff classification will continue, are not legitimate, the importing Member as the effective bearer of its rights and responsibilities, will be in a position to correctly identify products and relevant duties in its tariff schedules, including such limitations or modifications as it intends to apply. Otherwise, no proof will be required to deny the legitimate expectations of the exporting Member that the tariff classification will continue and the predictability of protection through the imposition of tariffs would not be maintained".<sup>35</sup>

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<sup>33</sup>Japan's third participant's submission, para. 8.

<sup>34</sup>*Ibid.*

<sup>35</sup>Japan's third participant's submission, para. 9.

### **III. Issues Raised in this Appeal**

57. The appellant, the European Communities, raises the following issues in this appeal:
- (a) Whether the measures in dispute, and the products affected by such measures, were identified with sufficient specificity by the United States in its request for the establishment of a panel under Article 6.2 of the DSU;
  - (b) Whether the Panel erred in interpreting Schedule LXXX, in particular, by reading Schedule LXXX in the light of the "legitimate expectations" of an exporting Member, and by considering that Article II:5 of the GATT 1994 confirms the interpretative value of "legitimate expectations"; and
  - (c) Whether the Panel erred in putting the onus of clarifying the scope of a tariff concession during a multilateral tariff negotiation conducted under the auspices of the GATT/WTO, solely on the importing Member.

### **IV. Request for the Establishment of a Panel**

58. The first issue that we have to address is whether the measures in dispute, and the products affected by such measures, were identified with sufficient specificity by the United States in its request for the establishment of a panel under Article 6.2 of the DSU.

59. Article 6.2 of the DSU provides, in part, that the request for the establishment of a panel shall:

... identify the specific measures at issue and provide a brief summary of the legal basis of the complaint sufficient to present the problem clearly. ...

60. The Panel considered that:

... the substance of the present case is the actual tariff treatment by customs authorities in the European Communities and the evaluation of that treatment in the light of the tariff commitments in Schedule LXXX.<sup>36</sup>

The Panel found that:

Viewed from this perspective, ... the United States has sufficiently identified the measures subject to the dispute, which concerns tariff treatment of LAN equipment and multimedia PCs by customs authorities in the European Communities.<sup>37</sup>

61. The Panel found that the definitions given by the United States of the terms, LAN equipment and PCs with multimedia capability, are "sufficiently specific for the purposes of our consideration of this dispute".<sup>38</sup>

62. The European Communities appeals these findings and submits that:

The Panel erred where it found that the measures under dispute and the products affected by such measures were identified sufficiently specifically by the United States to include measures other than Commission Regulation (EC) No. 1165/95 as far as it concerns Local Area Network (LAN) adapter cards.<sup>39</sup>

63. According to the European Communities, the request of the United States for the establishment of a panel:

... identifies one specific measure, namely Commission Regulation (EC) No. 1165/95 ... [relating to] LAN adapter cards. The other alleged measures are only vaguely described, without clearly identifying the type of measure, the responsible authority, the date of issue and the reference.<sup>40</sup>

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<sup>36</sup>Panel Report, para. 8.12.

<sup>37</sup>*Ibid.*

<sup>38</sup>Panel Report, paras. 8.9-8.10.

<sup>39</sup>Notice of Appeal of the European Communities, para. 1.

<sup>40</sup>Appellant's submission of the European Communities, para. 19.

64. We note that the request of the United States for the establishment of a panel reads in relevant part:

Since June 1995, customs authorities in the European Communities, including but not limited to those in the United Kingdom and Ireland, have been applying tariffs to imports of all types of LAN equipment - including hubs, in-line repeaters, converters, concentrators, bridges and routers - in excess of those provided for in the EC Schedules. Those products were previously dutiable as automatic data-processing equipment under category 8471, but, as a result of the customs authorities' action, are now subject to the higher tariff rates applicable to category 8517, "telecommunications apparatus". In addition, since 1995, customs authorities in the European Communities, particularly those in the United Kingdom, have increased tariffs on imports of certain personal computers ("PCs") from 3.5 per cent to 14 per cent, which is above the rate provided for in the EC Schedules. These increases have resulted from the reclassification of PCs with multimedia capability from category 8471 to other categories with higher duty rates.<sup>41</sup>

65. We consider that "measures" within the meaning of Article 6.2 of the DSU are not only measures of general application, i.e., normative rules, but also can be the application of tariffs by customs authorities.<sup>42</sup> Since the request for the establishment of a panel explicitly refers to the application of tariffs on LAN equipment and PCs with multimedia capability by customs authorities in the European Communities, we agree with the Panel that the measures in dispute were properly identified in accordance with the requirements of Article 6.2 of the DSU.

66. With respect to the products affected by such measures, we note that the European Communities and the United States disagree on the scope of the terms, LAN equipment and PCs with multimedia capability. Regarding LAN equipment, the disagreement concerns, in particular, whether multiplexers and modems are covered by this term.

67. We note that Article 6.2 of the DSU does *not* explicitly require that the products to which the "specific measures at issue" apply be identified. However, with respect to certain WTO obligations, in order to identify "the specific measures at issue", it may also be necessary to identify the products subject to the measures in dispute.

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<sup>41</sup>WT/DS62/4, 13 February 1997.

<sup>42</sup>In an answer to a question at the oral hearing, the European Communities expressly accepted that "the application of a tariff in an individual case on a consignment is a measure" within the meaning of Article 6.2 of the DSU.

68. LAN equipment and PCs with multimedia capacity are both generic terms. Whether these terms are sufficiently precise to "identify the specific measure at issue" under Article 6.2 of the DSU depends, in our view, upon whether they satisfy the purposes of the requirements of that provision.

69. In *European Communities - Bananas*, we stated that:

It is important that a panel request be sufficiently precise for two reasons: first, it often forms the basis for the terms of reference of the panel pursuant to Article 7 of the DSU; and, second, it informs the defending party and the third parties of the legal basis of the complaint.<sup>43</sup>

70. The European Communities argues that the lack of precision of the term, LAN equipment, resulted in a violation of its right to due process which is implicit in the DSU. We note, however, that the European Communities does not contest that the term, LAN equipment, is a commercial term which is readily understandable in the trade. The disagreement between the European Communities and the United States concerns its exact definition and its precise product coverage.<sup>44</sup> We also note that the term, LAN equipment, was used in the consultations between the European Communities and the United States prior to the submission of the request for the establishment of a panel<sup>45</sup> and, in particular, in an "Information Fiche" provided by the European Communities to the United States during informal consultations in Geneva in March 1997.<sup>46</sup> We do not see how the alleged lack of precision of the terms, LAN equipment and PCs with multimedia capability, in the request for the establishment of a panel affected the rights of defence of the European Communities *in the course of* the panel proceedings. As the ability of the European Communities to defend itself was not prejudiced by a lack of knowing the measures at issue, we do not believe that the fundamental rule of due process was violated by the Panel.

71. The United States has stressed that "if the EC arguments on specificity of product definition are accepted, there will inevitably be long, drawn-out procedural battles at the early stage of the panel

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<sup>43</sup>Appellate Body Report, adopted 25 September 1997, WT/DS27/AB/R, para. 142.

<sup>44</sup>Answer of the European Communities to a question at the oral hearing.

<sup>45</sup>See, for example, the letter from the Vice-President of the Commission of the European Communities, Sir Leon Brittan, to the United States Trade Representative, Ambassador Michael Kantor, dated 7 December 1995 (first submission of the United States to the Panel, Attachment 26); and the letter from the United States Trade Representative, Ambassador Michael Kantor, to the Vice-President of the Commission of the European Communities, Sir Leon Brittan, dated 8 March 1996 (first submission of the United States to the Panel, Attachment 28).

<sup>46</sup>"Information Fiche" attached to letter from the Head of Permanent Delegation of the European Commission to the International Organizations in Geneva, Ambassador R.E. Abbott, to the Chargé d'Affaires of the United States to the WTO, Mr. A.L. Stoler, 13 March 1997 (first submission of United States to the Panel, Attachment 23).

process in every proceeding. The parties will contest every product definition, and the defending party in each case will seek to exclude all products that the complaining parties may have identified by broader grouping, but not spelled out in 'sufficient' detail".<sup>47</sup> We share this concern.

72. We agree with the Panel that the present case should be distinguished from *EEC - Quantitative Restrictions Against Hong Kong*. The request of the United States for the establishment of a panel refers to "all types of LAN equipment". Individual types of LAN equipment were only mentioned as examples. Therefore, unlike the panel in *EEC - Quantitative Restrictions Against Hong Kong*, we are not confronted with a situation in which an additional product item was added in the course of the panel proceedings.<sup>48</sup> This is not a case in which an attempt was made to "cure" a faulty panel request by a complaining party.<sup>49</sup>

73. In conclusion, we agree with the Panel that the request of the United States for the establishment of a panel fulfilled the requirements of Article 6.2 of the DSU.

## V. "Legitimate Expectations" in the Interpretation of a Schedule

74. The European Communities also submits that the Panel erred in interpreting Schedule LXXX, in particular, by:

- (a) reading Schedule LXXX in the light of the "legitimate expectations" of an exporting Member; and

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<sup>47</sup>Appellee's submission of the United States, para. 50.

<sup>48</sup>In paragraph 30 of the panel report in *EEC - Quantitative Restrictions against Hong Kong*, the panel stated:

The Panel considered that just as the terms of reference must be agreed between the parties prior to the commencement of the Panel's examination, similarly the product coverage must be clearly understood and agreed between the parties to the dispute.

We have already noted that Article 6.2 of the DSU does *not* require that the products at issue be specified in a request for the establishment of a panel. Also, Article 7 of the DSU provides that panels shall have standard terms of reference, unless the parties to the dispute agree otherwise within 20 days from the establishment of the panel.

<sup>49</sup>We recall that in our report in *European Communities - Bananas*, para. 143, we found that:

If a *claim* is not specified in the request for the establishment of a panel, then a faulty request cannot be subsequently 'cured' by a complaining party's argumentation in its first written submission to the panel or in any other submission or statement made later in the panel proceeding.

- (b) considering that Article II:5 of the GATT 1994 confirms the interpretative value of "legitimate expectations".

Subordinately, the European Communities submits that the Panel erred in considering that the "legitimate expectations" of an exporting Member with regard to the interpretation of tariff concessions should be based on the classification practices for individual importers and individual consignments, or on the subjective perception of a number of exporting companies of that exporting Member.

75. Schedule LXXX provides tariff concessions for ADP machines under headings 84.71 and 84.73 and for telecommunications equipment under heading 85.17. The customs duties set forth in Schedule LXXX on telecommunications equipment are generally higher than those on ADP machines.<sup>50</sup> We note that Schedule LXXX does not contain any explicit reference to "LAN equipment" and that the European Communities currently treats LAN equipment as telecommunications equipment. The United States, however, considers that the EC tariff concessions on ADP machines, and not its tariff concessions on telecommunications equipment, apply to LAN equipment. The United States claimed before the Panel, therefore, that the European Communities accords to imports of LAN equipment treatment less favourable than that provided for in its Schedule, and thus has acted inconsistently with Article II:1 of the GATT 1994. The United States argued that the treatment provided for by a concession is the treatment reasonably expected by the trading partners of the Member which made the concession.<sup>51</sup> On the basis of the negotiating history of the Uruguay Round tariff negotiations and the actual tariff treatment accorded to LAN equipment by customs authorities in the European Communities during these negotiations, the United States argued that it reasonably expected the European Communities to treat LAN equipment as ADP machines, not as telecommunications equipment.

76. The Panel found that:

... for the purposes of Article II:1, it is impossible to determine whether LAN equipment should be regarded as an ADP machine purely on the basis of the ordinary meaning of the terms used in Schedule LXXX taken in isolation. However, as noted above, the meaning of the term "ADP machines" in this context may be determined in light of the legitimate expectations of an exporting Member.<sup>52</sup>

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<sup>50</sup>See Panel Report, paras. 2.10 and 8.1.

<sup>51</sup>See Panel Report, para. 5.15.

<sup>52</sup>Panel Report, para. 8.31.

77. In support of this finding, the Panel explained that:

The meaning of a particular expression in a tariff schedule cannot be determined in isolation from its context. It has to be interpreted in the context of Article II of GATT 1994 ... It should be noted in this regard that the protection of legitimate expectations in respect of tariff treatment of a bound item is one of the most important functions of Article II.<sup>53</sup>

The Panel justified this latter statement by relying on the panel report in *European Economic Community - Payments and Subsidies Paid to Processors and Producers of Oilseeds and Related Animal-Feed Proteins*<sup>54</sup> ("EEC - Oilseeds"), and stated that:

The fact that the *Oilseeds* panel report concerns a non-violation complaint does not affect the validity of this reasoning in cases where an actual violation of tariff commitments is alleged. If anything, such a direct violation would involve a situation where expectations concerning tariff concessions were even more firmly grounded.<sup>55</sup>

78. The Panel also relied on Article II:5 of the GATT 1994, and stated that:

Although Article II:5 is a provision for the special bilateral procedure regarding tariff classification, not directly at issue in this case, the existence of this provision confirms that legitimate expectations are a vital element in the interpretation of Article II and tariff schedules.<sup>56</sup>

79. Finally, the Panel observed that its proposition that the terms of a Member's Schedule may be determined in the light of the "legitimate expectations" of an exporting Member:

... is also supported by the object and purpose of the WTO Agreement and those of GATT 1994. The security and predictability of "the reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade" (expression common in the preambles to the two agreements) cannot be maintained without protection of such legitimate expectations. This is consistent with the principle of good faith interpretation under Article 31 of the Vienna Convention.<sup>57</sup>

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<sup>53</sup>Panel Report, para. 8.23.

<sup>54</sup>Adopted 25 January 1990, BISD 37S/86, para. 148.

<sup>55</sup>Panel Report, para. 8.23.

<sup>56</sup>Panel Report, para. 8.24.

<sup>57</sup>Panel Report, para. 8.25.



80. We disagree with the Panel's conclusion that the meaning of a tariff concession in a Member's Schedule may be determined in the light of the "legitimate expectations" of an exporting Member. First, we fail to see the relevance of the *EEC - Oilseeds* panel report with respect to the interpretation of a Member's Schedule in the context of a violation complaint made under Article XXIII:1(a) of the GATT 1994. The *EEC - Oilseeds* panel report dealt with a non-violation complaint under Article XXIII:1(b) of the GATT 1994, and is not legally relevant to the case before us. Article XXIII:1 of the GATT 1994 provides for three legally-distinct causes of action on which a Member may base a complaint; it distinguishes between so-called *violation* complaints, *non-violation* complaints and *situation* complaints under paragraphs (a), (b) and (c). The concept of "reasonable expectations", which the Panel refers to as "legitimate expectations", is a concept that was developed in the context of *non-violation* complaints.<sup>58</sup> As we stated in *India - Patents*, for the Panel to use this concept in the context of a violation complaint "melds the legally-distinct bases for 'violation' and 'non-violation' complaints under Article XXIII of the GATT 1994 into one uniform cause of action"<sup>59</sup>, and is not in accordance with established GATT practice.

81. Second, we reject the Panel's view that Article II:5 of the GATT 1994 confirms that "legitimate expectations are a vital element in the interpretation" of Article II:1 of the GATT 1994 and of Members' Schedules.<sup>60</sup> It is clear from the wording of Article II:5 that it does not support the Panel's view. This paragraph recognizes the possibility that the treatment *contemplated* in a concession, provided for in a Member's Schedule, on a particular product, may differ from the treatment *accorded* to that product and provides for a compensatory mechanism to rebalance the concessions between the two Members concerned in such a situation. However, nothing in Article II:5 suggests that the expectations of *only* the exporting Member can be the basis for interpreting a concession in a Member's Schedule for the purposes of determining whether that Member has acted consistently with its obligations under Article II:1. In discussing Article II:5, the Panel overlooked the second sentence of that provision, which clarifies that the "contemplated treatment" referred to in that provision is the treatment contemplated by *both* Members.

82. Third, we agree with the Panel that the security and predictability of "the reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade" is an object and purpose of the *WTO Agreement*, generally, as well as of the GATT 1994.<sup>61</sup> However, we disagree with the Panel that the maintenance of the security and predictability of tariff

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<sup>58</sup>See Appellate Body Report, *India - Patents*, adopted 16 January 1998, WT/DS50/AB/R, paras. 36 and 41.

<sup>59</sup>Adopted 16 January 1998, WT/DS50/AB/R, para. 42.

<sup>60</sup>See Panel Report, para. 8.24.

<sup>61</sup>See Panel Report, para. 8.25.

concessions allows the interpretation of a concession in the light of the "legitimate expectations" of exporting Members, i.e., their *subjective* views as to what the agreement reached during tariff negotiations was. The security and predictability of tariff concessions would be seriously undermined if the concessions in Members' Schedules were to be interpreted on the basis of the subjective views of certain exporting Members alone. Article II:1 of the GATT 1994 ensures the maintenance of the security and predictability of tariff concessions by requiring that Members not accord treatment less favourable to the commerce of *other* Members than that provided for in their Schedules.

83. Furthermore, we do not agree with the Panel that interpreting the meaning of a concession in a Member's Schedule in the light of the "legitimate expectations" of exporting Members is consistent with the principle of good faith interpretation under Article 31 of the *Vienna Convention*. Recently, in *India - Patents*, the panel stated that good faith interpretation under Article 31 required "the protection of legitimate expectations".<sup>62</sup> We found that the panel had misapplied Article 31 of the *Vienna Convention* and stated that:

The duty of a treaty interpreter is to examine the words of the treaty to determine the intentions of the parties. This should be done in accordance with the principles of treaty interpretation set out in Article 31 of the *Vienna Convention*. But these principles of interpretation neither require nor condone the imputation into a treaty of words that are not there or the importation into a treaty of concepts that were not intended.<sup>63</sup>

84. The purpose of treaty interpretation under Article 31 of the *Vienna Convention* is to ascertain the *common* intentions of the parties. These *common* intentions cannot be ascertained on the basis of the subjective and unilaterally determined "expectations" of *one* of the parties to a treaty. Tariff concessions provided for in a Member's Schedule -- the interpretation of which is at issue here -- are reciprocal and result from a mutually-advantageous negotiation between importing and exporting Members. A Schedule is made an integral part of the GATT 1994 by Article II:7 of the GATT 1994. Therefore, the concessions provided for in that Schedule are part of the terms of the treaty. As such, the only rules which may be applied in interpreting the meaning of a concession are the general rules of treaty interpretation set out in the *Vienna Convention*.

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<sup>62</sup>Panel Report, *India - Patents*, adopted 16 January 1998, WT/DS50/R, para. 7.18.

<sup>63</sup>Appellate Body Report, *India - Patents*, adopted 16 January 1998, WT/DS50/AB/R, para. 45.

85. Pursuant to Article 31(1) of the *Vienna Convention*, the meaning of a term of a treaty is to be determined in accordance with the ordinary meaning to be given to this term in its context and in the light of the object and purpose of the treaty. Article 31(2) of the *Vienna Convention* stipulates that:

The context, for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:

- (a) any agreement relating to the treaty which was made between all the parties in connexion with the conclusion of the treaty;
- (b) any instrument which was made by one or more parties in connexion with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.

Furthermore, Article 31(3) provides that:

There shall be taken into account together with the context:

- (a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
- (b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
- (c) any relevant rules of international law applicable in the relations between the parties.

Finally, Article 31(4) of the *Vienna Convention* stipulates that:

A special meaning shall be given to a term if it is established that the parties so intended.

86. The application of these rules in Article 31 of the *Vienna Convention* will usually allow a treaty interpreter to establish the meaning of a term.<sup>64</sup> However, if after applying Article 31 the meaning of the term remains ambiguous or obscure, or leads to a result which is manifestly absurd or unreasonable, Article 32 allows a treaty interpreter to have recourse to:

... supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion.

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<sup>64</sup>R. Jennings and A. Watts (eds.), *Oppenheim's International Law*, 9th ed., Vol. I (Longman, 1992), p. 1275.

With regard to "the circumstances of [the] conclusion" of a treaty, this permits, in appropriate cases, the examination of the historical background against which the treaty was negotiated.<sup>65</sup>

87. In paragraphs 8.20 and 8.21 of the Panel Report, the Panel quoted Articles 31 and 32 of the *Vienna Convention* and explicitly recognized that these fundamental rules of treaty interpretation applied "in determining whether the tariff treatment of LAN equipment ... is in conformity with the tariff commitments contained in Schedule LXXX".<sup>66</sup> As we have already noted above, the Panel, after a textual analysis<sup>67</sup>, came to the conclusion that:

... for the purposes of Article II:1, it is impossible to determine whether LAN equipment should be regarded as an ADP machine purely on the basis of the ordinary meaning of the terms used in Schedule LXXX taken in isolation.<sup>68</sup>

Subsequently, the Panel abandoned its effort to interpret the terms of Schedule LXXX in accordance with Articles 31 and 32 of the *Vienna Convention*.<sup>69</sup> In doing this, the Panel erred.

88. As already discussed above, the Panel referred to the *context* of Schedule LXXX<sup>70</sup> as well as to the *object and purpose* of the *WTO Agreement* and the GATT 1994, of which Schedule LXXX is an integral part.<sup>71</sup> However, it did so to support its proposition that the terms of a Schedule may be interpreted in the light of the "legitimate expectations" of an exporting Member. The Panel failed to examine the context of Schedule LXXX and the object and purpose of the *WTO Agreement* and the GATT 1994 in accordance with the rules of treaty interpretation set out in the *Vienna Convention*.

89. We are puzzled by the fact that the Panel, in its effort to interpret the terms of Schedule LXXX, did not consider the *Harmonized System* and its *Explanatory Notes*. We note that during the Uruguay Round negotiations, both the European Communities and the United States were parties to the *Harmonized System*. Furthermore, it appears to be undisputed that the Uruguay Round

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<sup>65</sup>I. Sinclair, *The Vienna Convention on the Law of Treaties*, 2nd ed., (Manchester University Press, 1984), p. 141:

... the reference in Article 32 of the Convention to the circumstances of the conclusion of a treaty may have some value in emphasising the need for the interpreter to bear constantly in mind the historical background against which the treaty has been negotiated.

<sup>66</sup>Panel Report, para. 8.22.

<sup>67</sup>See Panel Report, para. 8.30.

<sup>68</sup>Panel Report, para. 8.31.

<sup>69</sup>As discussed above in paragraphs 76-84, the Panel relied instead on the concept of "legitimate expectations" as a means of treaty interpretation.

<sup>70</sup>See Panel Report, paras. 8.23-8.24.

<sup>71</sup>See Panel Report, para. 8.25.

tariff negotiations were held on the basis of the *Harmonized System's* nomenclature and that requests for, and offers of, concessions were normally made in terms of this nomenclature. Neither the European Communities nor the United States argued before the Panel<sup>72</sup> that the *Harmonized System* and its *Explanatory Notes* were relevant in the interpretation of the terms of Schedule LXXX. We believe, however, that a proper interpretation of Schedule LXXX should have included an examination of the *Harmonized System* and its *Explanatory Notes*.

90. A proper interpretation also would have included an examination of the existence and relevance of subsequent practice. We note that the United States referred, before the Panel, to the decisions taken by the Harmonized System Committee of the WCO in April 1997 on the classification of certain LAN equipment as ADP machines.<sup>73</sup> Singapore, a third party in the panel proceedings, also referred to these decisions.<sup>74</sup> The European Communities observed that it had introduced reservations with regard to these decisions and that, even if they were to become final as they stood, they would not affect the outcome of the present dispute for two reasons: first, because these decisions could not confirm that LAN equipment was classified as ADP machines in 1993 and 1994; and, second, because this dispute "was about duty treatment and not about product classification".<sup>75</sup> We note that the United States agrees with the European Communities that this dispute is not a dispute on the *correct* classification of LAN equipment, but a dispute on whether the tariff treatment accorded to LAN equipment was less favourable than that provided for in Schedule LXXX.<sup>76</sup> However, we consider that in interpreting the tariff concessions in Schedule LXXX, decisions of the WCO may be relevant; and, therefore, they should have been examined by the Panel.

91. We note that the European Communities stated that the question whether LAN equipment was bound as ADP machines, under headings 84.71 and 84.73, or as telecommunications equipment,

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<sup>72</sup>We recall, however, that in reply to our questions at the oral hearing, both the European Communities and the United States accepted the relevance of the *Harmonized System* and its *Explanatory Notes* in interpreting the tariff concessions of Schedule LXXX. See paras. 13 and 38 of this Report.

<sup>73</sup>See Panel Report, para. 5.12.

<sup>74</sup>As noted in para. 6.34 of the Panel Report, Singapore pointed out, before the Panel, that:

... the WCO's HS Committee had recently decided that LAN equipment was properly classifiable in heading 84.71 of the HS. The HS Committee had specifically declined to adopt the position advanced that heading 85.17 was the appropriate category ... The EC had suggested that the HS Committee decision was intended solely to establish the appropriate HS classification for future imports. It ignored that the language interpreted by the HS Committee was the same language appearing in the EC's HS nomenclature and in the EC's concession schedule at the time of the negotiations and afterwards.

<sup>75</sup>Panel Report, para. 5.13.

<sup>76</sup>See Panel Report, para. 5.3.

under heading 85.17, was *not* addressed during the Uruguay Round tariff negotiations with the United States.<sup>77</sup> We also note that the United States asserted that:

In many, perhaps most, cases, the detailed product composition of tariff commitments was *never* discussed in detail during the tariff negotiations of the Uruguay Round ...<sup>78</sup> (emphasis added)

and that:

The US-EC negotiation on Chapter 84 provided an example of how two groups of busy negotiators dealing with billions of dollars of trade and hundreds of tariff lines relied on *a continuation of the status quo*.<sup>79</sup> (emphasis added)

This may well be correct and, in any case, seems central to the position of the United States. Therefore, we are surprised that the Panel did not examine whether, during the Tokyo Round tariff negotiations, the European Communities bound LAN equipment as ADP machines or as telecommunications equipment.<sup>80</sup>

92. Albeit, with the mistaken aim of establishing whether the United States "was entitled to legitimate expectations"<sup>81</sup> regarding the tariff treatment of LAN equipment by the European Communities, the Panel examined, in paragraphs 8.35 to 8.44 of the Panel Report, the classification practice regarding LAN equipment in the European Communities during the Uruguay Round tariff negotiations. The Panel did this on the basis of certain BTIs and other decisions relating to the customs classification of LAN equipment, issued by customs authorities in the European Communities during the Uruguay Round.<sup>82</sup> In the light of our observations on "the circumstances of [the] conclusion" of a treaty as a supplementary means of interpretation under Article 32 of the *Vienna Convention*<sup>83</sup>, we consider that the classification practice in the European Communities during the Uruguay Round is part of "the circumstances of [the] conclusion" of the *WTO Agreement* and may be used as a supplementary means of interpretation within the meaning of Article 32 of the *Vienna Convention*. However, two important observations must be made: first, the Panel did *not* examine the

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<sup>77</sup>See Panel Report, para. 5.28.

<sup>78</sup>Appellee's submission of the United States, para. 26.

<sup>79</sup>Panel Report, para. 5.31.

<sup>80</sup>We note that in paragraph 8 of its third participant's submission, Japan stated that: "[i]n particular, the classification of the LAN equipment among the Members of the EC was not identical before the Uruguay Round".

<sup>81</sup>Panel Report, para. 8.60.

<sup>82</sup>The lists of the BTIs and classification decisions in the form of a letter, submitted by the parties and considered by the Panel, were attached to the Panel Report as Annex 4 and Annex 6 thereof.

<sup>83</sup>See para. 86 of this Report.

classification practice in the European Communities during the Uruguay Round negotiations *as a supplementary means of interpretation* within the meaning of Article 32 of the *Vienna Convention*<sup>84</sup>; and, second, the value of the classification practice as a supplementary means of interpretation is subject to certain qualifications discussed below.

93. We note that the Panel examined the classification practice of only the European Communities<sup>85</sup>, and found that the classification of LAN equipment by the United States during the Uruguay Round tariff negotiations was not relevant.<sup>86</sup> The purpose of treaty interpretation is to establish the *common* intention of the parties to the treaty. To establish this intention, the prior practice of only *one* of the parties may be relevant, but it is clearly of more limited value than the practice of all parties. In the specific case of the interpretation of a tariff concession in a Schedule, the classification practice of the importing Member, in fact, may be of great importance. However, the Panel was mistaken in finding that the classification practice of the United States was *not* relevant.

94. In this context, we also note that while the Panel examined the classification practice during the Uruguay Round negotiations, it did not consider the EC legislation on customs classification of goods that was applicable at that time. In particular, it did not consider the "General Rules for the Interpretation of the Combined Nomenclature" as set out in Council Regulation 2658/87 on the Common Customs Tariff.<sup>87</sup> If the classification practice of the importing Member at the time of the tariff negotiations is relevant in interpreting tariff concessions in a Member's Schedule, surely that Member's legislation on customs classification at that time is also relevant.

95. Then there is the question of the *consistency* of prior practice. Consistent prior classification practice may often be significant. Inconsistent classification practice, however, *cannot* be relevant in interpreting the meaning of a tariff concession. We note that the Panel, on the basis of evidence relating to *only* five out of the then 12 Member States<sup>88</sup>, made the following factual findings with regard to the classification practice in the European Communities:

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<sup>84</sup>It examined the actual classification practice to determine whether the United States could have "legitimate expectations" with regard to the tariff treatment of LAN equipment.

<sup>85</sup>See Panel Report, paras. 8.36-8.44.

<sup>86</sup>See Panel Report, para. 8.60. We note that in paragraph 8.58 of the Panel Report, the Panel stated that the classification of LAN equipment by other WTO Members was not relevant either.

<sup>87</sup>Title I, Part I of Annex I of Council Regulation (EEC) No. 2658/87 of 23 July 1987, Official Journal No. L 256, 7 September 1987, p. 1.

<sup>88</sup>With regard to the manner in which the Panel evaluated the evidence regarding classification practice during the Uruguay Round tariff negotiations, we note that in paragraph 8.37 of the Panel Report, the Panel accepted certain BTIs submitted by the United States as relevant evidence, while in footnote 152 of the Panel Report, it considered similar BTIs submitted by the European Communities to be irrelevant.

To rebut the presumption raised by the United States, the European Communities has produced documents which *indicate* that LAN equipment had been treated as telecommunication apparatus by other customs authorities in the European Communities.<sup>89</sup> (emphasis added)

... it would be reasonable to conclude at least that the practice [regarding classification of LAN equipment] was not uniform in France during the Uruguay Round.<sup>90</sup>

Germany appears to have consistently treated LAN equipment as telecommunication apparatus.<sup>91</sup>

... LAN equipment was *generally* treated as ADP machines in Ireland and the United Kingdom during the Uruguay Round.<sup>92</sup> (emphasis added)

As a matter of logic, these factual findings of the Panel lead to the conclusion that, during the Uruguay Round tariff negotiations, the practice regarding the classification of LAN equipment by customs authorities throughout the European Communities was *not* consistent.

96. We also note that in paragraphs 8.44 and 8.60 of the Panel Report, the Panel identified Ireland and the United Kingdom as the "largest" and "major" market for LAN equipment exported from the United States. On the basis of this assumption, the Panel gave special importance to the classification practice by customs authorities in these two Member States. However, the European Communities constitutes a customs union, and as such, once goods are imported into any Member State, they circulate freely within the territory of the entire customs union. The export market, therefore, is the European Communities, not an individual Member State.

97. For the reasons set out above, we conclude that the Panel erred in finding that the "legitimate expectations" of an exporting Member are relevant for the purposes of interpreting the terms of

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<sup>89</sup>Panel Report, para. 8.40.

<sup>90</sup>Panel Report, para. 8.42.

<sup>91</sup>Panel Report, para. 8.43.

<sup>92</sup>Panel Report, para. 8.41. In this paragraph, the Panel stated that the only direct counter-evidence against the claim of the United States that customs authorities in Ireland and the United Kingdom consistently classified LAN equipment as ADP machines during the Uruguay Round negotiations is a BTI issued by the UK customs authority to CISCO, classifying one type of LAN equipment (routers) as telecommunications apparatus. The Panel dismisses the value of this BTI as evidence on the basis that it "became effective only a week or so before the conclusion of the Uruguay Round negotiations [15 December 1993]". Similarly, in footnote 152 of the Panel Report, the Panel did not consider other BTIs issued by the UK customs authorities to be relevant because they became valid after the conclusion of the Uruguay Round negotiations. We note, however, that all of these BTIs became valid in December 1993 or February 1994, i.e., before the end of the verification process, to which all Schedules were submitted and which took place between 15 February 1994 and 25 March 1994 (MTN.TNC/W/131, 21 January 1994). Therefore, in our view, the Panel should have considered these BTIs.



Schedule LXXX and of determining whether the European Communities violated Article II:1 of the GATT 1994. We also conclude that the Panel misinterpreted Article II:5 of the GATT 1994.

98. On the basis of the erroneous legal reasoning developed and the selective evidence considered, the Panel was not justified in coming to the conclusion that the United States was entitled to "legitimate expectations" that LAN equipment would be accorded tariff treatment as ADP machines in the European Communities<sup>93</sup> and, therefore, that the European Communities acted inconsistently with the requirements of Article II:1 of the GATT 1994 by failing to accord imports of LAN equipment from the United States treatment no less favourable than that provided for in Schedule LXXX.<sup>94</sup>

99. In the light of our conclusion that the "legitimate expectations" of an exporting Member are not relevant in determining whether the European Communities violated Article II:1 of the GATT 1994, we see no reason to examine the subordinate claim of error of the European Communities relating to the evidence on which the "legitimate expectations" of exporting Members were based.

## **VI. Clarification of the Scope of Tariff Concessions**

100. The last issue raised by the European Communities in this appeal is whether the Panel erred in placing the onus of clarifying the scope of a tariff concession during a multilateral tariff negotiation, held under the auspices of the GATT/WTO, solely on the importing Member.

101. In paragraph 8.60 of the Panel Report, the Panel concluded that:

We find that the United States was entitled to legitimate expectations that LAN equipment would continue to be accorded tariff treatment as ADP machines in the European Communities, based on the actual tariff treatment during the Uruguay Round, particularly in Ireland and the United Kingdom ... We further find that the United States was not required to *clarify the scope* of the European Communities' *tariff concessions* on LAN equipment ... (emphasis added)

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<sup>93</sup>See Panel Report, para. 8.60.

<sup>94</sup>See Panel Report, para. 9.1.

Prior to this conclusion, the Panel stated the following:

... we find that the European Communities cannot place the burden of clarification on the United States in cases where it has created, through its own practice, the expectations regarding the continuation of the actual tariff treatment prevailing at the time of the tariff negotiations. It would not be reasonable to expect the US Government to seek clarification when it had not heard any complaints from its exporters, who were apparently satisfied with the current tariff treatment of LAN equipment in their major export market -- Ireland and the United Kingdom.<sup>95</sup>

102. The European Communities appeals these findings, and argues that:

... the Panel erred where it considered that, in any case, the onus of clarifying the scope of a tariff concession during a multilateral tariff negotiation ... shall necessarily be put on the side of the importing Member. By doing so, the Panel has created and applied a new rule on the burden of proof in the dispute settlement procedure which is outside its terms of reference and is beyond the powers of a panel.<sup>96</sup>

103. We do not agree that the Panel has created and applied a new rule on the burden of proof. The rules on the burden of proof are those which we clarified in *United States - Shirts and Blouses*.<sup>97</sup>

104. The Panel's findings in paragraphs 8.55 and 8.60 on the "requirement of clarification" are linked to the Panel's reliance on "legitimate expectations" as a means of interpretation of the tariff concessions in Schedule LXXX. They serve to complete and buttress the Panel's conclusion that "the United States was entitled to legitimate expectations that LAN equipment would continue to be accorded tariff treatment as ADP machines in the European Communities".<sup>98</sup>

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<sup>95</sup>Panel Report, para. 8.55.

<sup>96</sup>Notice of Appeal of the European Communities, para. 4.

<sup>97</sup>Adopted 23 May 1997, WT/DS33/AB/R, p. 14. See also, Appellate Body Report, *EC Measures Concerning Meat and Meat Products (Hormones)*, adopted 13 February 1998, WT/DS26/AB/R, WT/DS48/AB/R, paras. 97-109.

<sup>98</sup>Panel Report, para. 8.60.

105. We note that the Panel's findings in paragraphs 8.55 and 8.60 on the "requirement of clarification" were, in fact, the Panel's response to the question whether:

... the exporting Member has any inherent obligation to seek clarification when it has been otherwise given a basis to expect that actual tariff treatment by the importing Member will be maintained.<sup>99</sup>

106. We also note the Panel's references<sup>100</sup> to the panel report in *Panel on Newsprint* and the report by the Group of Experts in *Greek Increase in Bound Duty*.<sup>101</sup> In both of these reports, the conclusions on the obligations of the importing contracting party under Article II:1 of the GATT 1994 were reached on the basis of the ordinary meaning of the wording of the respective Schedules. These reports also assume that the tariff concessions made by the importing contracting party would have had to be limited by "conditions or qualifications" if they were to be interpreted restrictively. That the Panel reads these two reports in this way is evident from the Panel's concluding remark that "these cases ... confirm that the onus of clarifying tariff *commitment* is generally placed on the importing Member" (emphasis added).<sup>102</sup>

107. However, the case before us raises a different problem. The question here is whether the European Communities has committed itself to treat LAN equipment as ADP machines under headings 84.71 or 84.73, rather than as telecommunications equipment under heading 85.17 of Schedule LXXX. We do not believe that the "requirement of clarification", as discussed by the Panel, is relevant to this question.

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<sup>99</sup>Panel Report, para. 8.48.

<sup>100</sup>See Panel Report, paras. 8.51-8.54.

<sup>101</sup>L/580, 9 November 1956. We note that while the panel report in *Panel on Newsprint* was adopted by the CONTRACTING PARTIES, the report by the Group of Experts in *Greek Increase in Bound Duty* was not.

<sup>102</sup>Panel Report, para. 8.54.

108. The Panel also based its conclusions on the "requirement of clarification" on a certain perception of the nature of tariff commitments. The Panel stated:

... that a tariff commitment is an instrument in the hands of an importing Member which inherently serves the importing Member's "protection needs and its requirements for the purposes of tariff and trade negotiations". ... It is for this reason that it behooves the importing party, as the effective bearer of its rights and responsibilities, to correctly identify products and relevant duties in its tariff schedules, including such limitations or modifications as it intends to apply.<sup>103</sup>

109. We do not share this perception of the nature of tariff commitments. Tariff negotiations are a process of reciprocal demands and concessions, of "give and take". It is only normal that importing Members define their offers (and their ensuing obligations) in terms which suit their needs. On the other hand, exporting Members have to ensure that their corresponding rights are described in such a manner in the Schedules of importing Members that their export interests, as agreed in the negotiations, are guaranteed. There was a special arrangement made for this in the Uruguay Round. For this purpose, a process of verification of tariff schedules took place from 15 February through 25 March 1994, which allowed Uruguay Round participants to check and control, through consultations with their negotiating partners, the scope and definition of tariff concessions.<sup>104</sup> Indeed, the fact that Members' Schedules are an integral part of the GATT 1994 indicates that, while each Schedule represents the tariff commitments made by *one* Member, they represent a common agreement among *all* Members.

110. For the reasons stated above, we conclude that the Panel erred in finding that "the United States was not required to clarify the scope of the European Communities' tariff concessions on LAN equipment".<sup>105</sup> We consider that any clarification of the scope of tariff concessions that may be required during the negotiations is a task for *all* interested parties.

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<sup>103</sup>Panel Report, para. 8.50.

<sup>104</sup>MTN.TNC/W/131, 21 January 1994. See also *Marrakesh Protocol to the General Agreement on Tariffs and Trade 1994*, para. 3.

<sup>105</sup>Panel Report, para. 8.60.

## **VII. Conclusions**

111. For the reasons set out in this Report, the Appellate Body:

- (a) upholds the finding of the Panel that the request of the United States for the establishment of a panel met the requirements of Article 6.2 of the DSU;
- (b) reverses the findings of the Panel that the United States was entitled to "legitimate expectations" that LAN equipment would be accorded tariff treatment as ADP machines in the European Communities and, therefore, that the European Communities acted inconsistently with the requirements of Article II:1 of the GATT 1994 by failing to accord imports of LAN equipment from the United States treatment no less favourable than that provided for in Schedule LXXX; and
- (c) reverses the ancillary finding of the Panel that the United States was not required to clarify the scope of the European Communities' tariff concessions on LAN equipment.

Signed in the original at Geneva this 19th day of May 1998 by:

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Christopher Beeby

Presiding Member

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Claus-Dieter Ehlermann

Member

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Julio Lacarte-Muró

Member

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institution's decision. Through the duty to give reasons, the private party can force the institution to explain clearly on what grounds it has based its decision. A common objective of the umbrella-principle of good administration may be defined as promoting transparency, legal certainty and predictability within administrative procedures.

### 3.2.2.1.1 The Principle of Due Diligence

The principle of due diligence has been applied by Community courts in a wide range of situations and under varying forms. The name of the principle has also varied. The obligations incumbent on the institutions discussed here have been labelled as due diligence,<sup>13</sup> principle of care,<sup>14</sup> and principle of good,<sup>15</sup> proper,<sup>16</sup> or sound<sup>17</sup> administration. Its core can be described as a procedural tool for private parties to ensure that Community institutions handle the affairs of individuals with care, by giving individuals a right to influence the basis for the public authority's decisions both as to how the matter is handled and how the substantive aspects are assessed and weighed by the institutions. In two cases establishing the principle of due diligence in the early 1990:s, *TU München* and *Nölle*, the European Court of Justice held that the institutions have a duty to examine carefully and impartially all the relevant aspects of the individual cases<sup>18</sup> and to give special attention to aspects that speak for private parties.<sup>19</sup> The field of application of the principle of due diligence can thus be divided into two types of situations. Firstly, from the demand to *examine carefully and impartially all the relevant aspects*, follows a duty for the institutions to handle matters diligently and to carefully follow any procedures laid down in secondary legislation or as general principles. Secondly, *to give special attention to aspects that speak for private parties* includes a duty to use the principle of due diligence as a counterweight to the discretionary powers of the institutions in the decision-making process itself.

When applied in the first manner, the principle of due diligence functions as a standard for the good behaviour of institutions. In the *Fresh Marine Company*-case, the Commission received a report from a Norwegian salmon company in an anti-dumping matter that contained some unclear figures. The Commission proceeded by unilaterally changing the figures, with the result that the Norwegian company appeared to have transgressed the anti-dumping agreement. It was later shown

13. See case C-49/88 *Al-Jubail v Council* ECR 1991, p. I-3187, para. 17.

14. See case T-167/94 *Nölle v Council and Commission* ECR 1995, p. II-2589, paras 68 and following.

15. See case 223/85 *RSV v Commission* ECR 1987, p. 4617, para. 12.

16. See case T-105/96 *Pharos v Commission* ECR 1998, p. II-285, para. 73.

17. See case C-29/05 *P Office for Harmonisation in the Internal Market v Kaul AG* ECR 2007, p. I-2213 para. 47.

18. See case C-269/90 *TU München v Hauptzollamt München-Mitte* ECR 1991, p. I-5469, para. 14.

19. See case C-16/90 *Nölle v Hauptzollamt Bremen-Freihafen* ECR 1991, p. I-5163, para. 35.



that the changes made by the Commission were inaccurate. The Court of First Instance held that there was a duty of diligence incumbent upon the Commission and that the error committed by the Commission was such that it 'would not have been committed in similar circumstances by an administrative authority exercising ordinary care and diligence'.<sup>20</sup> The European Court of Justice, in plenum, came to the same conclusion regarding the action of the Commission, even though the Court of Justice did not explicitly refer to the principle of due diligence.<sup>21</sup>

Similarly, Community institutions must be careful to observe and fulfil more general duties laid down in secondary legislation, so that mistakes and substandard practises of the institutions will not adversely affect private parties in individual matters. The Court of First Instance in several cases has applied the principle of due diligence to customs cases, where the Commission has an obligation to monitor trade between the EU and third countries. In the *Eyckeler & Malt*-case regarding the import of Hilton beef from Argentina, the Court of First Instance found that the Commission had failed in its obligation, leading to a breach of Article 211 EC and of the principle of good administration.<sup>22</sup> In the area of Community trade mark law, the European Court of Justice held equally in the *Bayer*- case that the principle of sound administration, as it was referred to, together with the principle of legal certainty, implied a duty to uphold time-limits and procedural rules in such a way as to ensure the proper conduct and effectiveness of proceedings.<sup>23</sup> A third example can be taken from the area of classification and control of foodstuffs, veterinary and medical matters, where the Commission enjoys a role as a legislator. Here, the Court of First Instance has applied the principle of due diligence or good administration as a standard in liability cases, *CEVA Santé Animale* and *Monsanto Company*.<sup>24</sup> In the both cases, the European Court of Justice, in plenum, overturned the verdicts of the Court of First Instance. In *Ceva Santé Animale*, the European Court of Justice did not review the principle of sound administration in itself, but held that that Court of First Instance had erred when it had not established what scope of discretion the Commission enjoyed.<sup>25</sup> In *Monsanto Company*, the European Court of Justice referred to the principle of

20. See case T-178/98 *Fresh Marine Company v Commission* ECR 2000, p. II-3331, paras 81–82.

21. See case C-472/00 P *Commission v Fresh Marine Company* ECR 2003, p. I-7541, paras 30–31. A further example of the principle of due diligence being applied in this context is the case T-231/97 *New Europe Consulting v Commission* ECR 2003, p. 9189, paras. 163–165.

22. See Case T-42/96 *Eyckeler & Malt v Commission* ECR 1998, p. II-401, para. 165. For similar cases, See case T-329/00 *Bonn Fleisch Ex- und Import v Commission* ECR 2003, p. II-287, paras. 64 and 89, case T-330/99 *Spedition Wilhlem Rotermund v Commission* ECR 2001, p. II-1619, paras. 52–53 and case T-186/97 *Kaufring v Commission* ECR 2001, p. II-1337.

23. See case C-29/05 P. *Bayer*, paras. 47–48. See also case C-104/01 *Libertel* ECR 2003, I-3793, para. 59, regarding the principle of sound administration and the interest of ensuring that trade marks whose use could successfully be challenged before the courts are not registered.

24. See case T-112/97 *Monsanto Company v Commission* ECR 1999, p. II-1277 and case T-344/00 *CEVA Santé Animale v Commission* ECR 2003, p. II-229. On the other hand, See case T-13/99 *Pfizer Animal Health v Council* ECR 2002, p. II-3305, where the Court of First Instance in a similar type of question in an action for annulment applied the principle of due diligence as a counterweight to the discretion of the Commission in scientific matters.

25. See case C-198/03 P *Commission v CEVA Santé Animale* ECR 2005, p. I-6357, paras 69–71.

sound administration and the duty of care, but found, in contrast to the Court of first Instance, that the Commission was not in breach of the principle. The European Court of Justice performed a more individualised test of the principle, as described below, balancing the interest of the private parties concerned against the interest of the Commission. The European Court thus held that in the present case, Monsanto Company had not established, or even sought to establish, that the decision at issue was adopted in disregard of the principle of sound administration and the duty of care.<sup>26</sup> In what circumstances the principle is to be understood as a standard or as an individual guarantee does not seem to be clear at all.

When the principle of due diligence is applied in the second manner as described above, the principle functions as a counterweight to the discretionary powers of the institutions. The principle gives the private party a tool to influence the substantive outcome of the decision-making procedure, by enabling the party to give input to the basis of the decision and to how it should be assessed. In this form, the principle of due diligence is a procedural rule with a close connection to the substantive evaluation of the case, as the duty to investigate carefully necessarily will be closely connected to the interpretation of the legal question at stake. Substantively irrelevant circumstances need not to be investigated as carefully.<sup>27</sup> The principle of due diligence can further be used as a supplementary tool to other procedural guarantees, such as the right to be heard, in order to ensure that Community institutions give appropriate attention to the arguments put forward by private parties. This may be useful for private parties who do not enjoy a formal standing in the administrative procedure, such as third parties. This application of the principle was described by Advocate General Poiares Maduro, in *max.mobil*.<sup>28</sup>

In the case-law, these safeguards are understood as a means, first, of laying down limits to the Commission's discretionary power and, second, of protecting third parties whose interests are affected but who have no procedural protection equal to that of persons to whom decisions are addressed.

Advocate General Maduro referred to *Schlüsselverlag J.S. Moser*<sup>29</sup> and *Sytraval*,<sup>30</sup> two cases in which the European Court of Justice found that the views put forward by private (third) parties should have prompted the Commission to take those considerations into account in its decision-making. Another case where the principle of due diligence was applied in this connection, is *TU-München*,<sup>31</sup> as

26. See C-248/99 P France v Monsanto Company and Commission ECR 2002 p. I-1, paras. 92–93.

27. See case T-44/90 La Cinq v Commission ECR 1992, p. II-1, para. 94, where the Court of First Instance stated that the Commission failure to fulfil its obligation to take account of all the relevant facts in the case amounted to a manifest error of appraisal and not a procedural error, which would have been more logical. See further case T-7/92 Asia Motor France v Commission ECR 1993, p. II-669, para. 37.

28. See opinion of Mr Advocate General Poiares Maduro in case C-141/02 P *max.mobil* (T-Mobile Austria) ECR 2005, p. I-1283, para. 81.

29. See case C-170/02 P *Schlüsselverlag J.S. Moser v Commission* ECR 2003, p. I-9889.

30. See case C-367/95 P *Commission v Sytraval* ECR 1998, p. I-1719.

31. See case C-269/90 *TU München*.

mentioned above. The common ground in these cases is the interpretation of the private parties' legitimate interest in having a decisive influence over the institutions decision-making, especially in cases where the Community institution has a wide power of appraisal or where complex economic or technical issues are at stake.

### 3.2.2.1.2 The Principle of a Right to be Heard

The right to be heard in administrative proceedings was developed by the European Court of Justice in its very early case law as an independent general principle. In a staff case in 1962, *Alvis*, the European Court of Justice held that according to a generally accepted principle of administrative law in force in the Member States, the administrations of these states must allow their servants the opportunity of replying to allegations before any disciplinary decision is taken concerning them. This rule, which the European Court of Justice found to a part of 'sound justice and good administration', was to be followed by the Community institutions. In *Transocean Marine Paint* from 1974, the right to be heard was introduced as a general principle of administrative procedure.<sup>32</sup>

The right to be heard in Community law is ensured to private parties that in some way are affected by a measure taken by a Community institution, and first and foremost to those who are adversely affected. The typical situation is where an institution initiates proceedings of some kind against a private party, involving sanctions, fines and or penalty payments. The decision does not necessarily have to be addressed to a party for that party to be considered targeted. Third parties that might lose a benefit through the Community measure may also be 'targeted'.<sup>33</sup> It is more questionable whether there is a right to be heard in a situation where a private party turns to the institution in order to apply for a benefit. In *Windpark Grothusen*, a company had applied for financial support for an energy project administered by the Commission, together with 700 other applicants. When the application was denied, the company maintained that they had not been given a right to be heard. Both the Court of First Instance and the European Court of Justice found that the company did not have such right, as the company had not been adversely affected in the way understood by case law.<sup>34</sup> On the other hand, in *TU München* mentioned above in the context of the principle of due diligence, the party in the case, a university, was considered to have a right to be heard in regards to an application of exemption of import duties.<sup>35</sup> In *TU München*, the ground for promoting administrative procedural guarantees for the private party was the fact that the Commission had a wide power of appraisal in deciding the matter and that the importing university could be an important source of information, since they were

32. See case 17/74 *Transocean Marine Paint Association v Commission* ECR 1974, p. 1063, para. 15.

33. See case T-260/94 *Air Inter v Commission* ECR 1997, p. II-997, para. 62.

34. See case T-109/94 *Windpark Groothusen v Commission* ECR 1995, p. II-3007 and C-48/96 *P Windpark Groothusen v Commission* ECR 1998, p. I-2873.

35. See case C-269/90 *TU München*, para. 25.



Decision No. 253

Walter Prescott,  
Applicant

v.

International Bank for Reconstruction and Development,  
Respondent

1. The World Bank Administrative Tribunal, composed of Francisco Orrego Vicuña, President, Thio Su Mien and Bola A. Ajibola, Vice Presidents, and A. Kamal Abul-Magd, Robert A. Gorman, Elizabeth Evatt and Jan Paulsson, Judges, has been seized of an application, received on February 25, 2000, by Walter Prescott against the International Bank for Reconstruction and Development. In *Prescott*, Decision No. 234 [2000], the Tribunal denied the Bank's request to declare the application inadmissible for lack of jurisdiction. The parties thereafter submitted their written pleadings on the merits. A request made by the Applicant to hold oral proceedings was granted by the Tribunal. After a postponement at the request of the Applicant, the hearing took place on November 26, 2001. The case was listed on November 27, 2001.

2. This case concerns a claim for pension credits and related benefits during the period the Applicant held a Non-Regular Staff (NRS) Temporary appointment before April 15, 1998. The claim is based on arguments that the Bank pursued policies in violation of the Principles of Staff Employment and the relevant Staff Rules and that it misclassified the Applicant's position.

#### **The Applicant's career in the Bank**

3. The Bank hired the Applicant on December 2, 1985 as a Temporary Messenger to serve in the Administrative Services Department on an initial six-month appointment. The Applicant's Temporary appointment was extended continuously for six-month or one-year periods. Sixteen extensions of his contract were made between 1985 and 1999. Other than a six-month assignment in 1987 as a Telephone Operator, the Applicant performed the same messenger functions through December 1988.

4. In January 1989, the Applicant moved to the Information Technology and Facilities Department (ITF), Internal Documents Unit (ITFIO), as a Records Clerk. ITF later became the Information Solutions Group (ISG). The clerical functions the Applicant performed remained essentially the same and were subject to the changes in priorities and technologies periodically introduced in ITF and later in ISG. Training was provided to enable the Applicant to take on additional duties.

5. In 1999, ISG advertised a two-year Term position for an Information Technician that corresponded to the Applicant's functions. Having applied for this position, the Applicant was selected and appointed to it effective August 1, 1999.

6. When the Applicant joined the Bank, a Temporary appointment was defined as a "full-time appointment to the staff of the World Bank for a specified period of time, less than one year in duration." Although the length of the period specified in the Rule changed over time, it was always short-term. Conversely, a Regular appointment was a "full-time appointment of indefinite duration."

7. The Applicant's initial appointment as a Temporary employee allowed for participation in the Medical Insurance Plan, annual and sick leave and overtime pay, but did not allow for participation in the Staff Retirement Plan (SRP).

#### **The Human Resources Policy Reform**

8. As a result of the Human Resources Policy Reform enacted in 1998, the Applicant, like other NRS, commenced participation in the SRP and the corresponding accrual of service credit toward retirement benefits and retiree medical benefits on April 15, 1998. It is important to note in this respect that notwithstanding specific requests by the Staff Association to the effect that credit should also be received for employment prior to April 15, 1998, the Executive Directors expressly decided that no past service credit would be granted.

9. The Human Resources Policy Reform also led to a new policy concerning the phasing out of long-term NRS appointments by December 31, 2000. Staff holding this kind of appointment would be either selected for a Term or Open-Ended appointment or their appointment would expire by that date. It is in this context that the Applicant was appointed to a Term position in 1999.

10. The Applicant's first argument is that the Bank's management, by means of intentional and improper policy decisions, created incentives for an unjustified differentiation against particular NRS. He further argues that while lower-level management did not intentionally engage in *détournement de procédure* and unjustifiable differentiation, such abuses nevertheless resulted from the policy framework in which management had to operate. He mentions dollar budgeting, different comparators to determine pay rates, power inequalities and considerations based on nationality as particular policies that created incentives for managers to hire NRS instead of Regular staff. He maintains that they led to violations of the Principles of Staff Employment requiring proper process, equal treatment and equitable compensation.

11. The Respondent answers that at all times staff employment followed the applicable Staff Rules and Principles of Staff Employment, and that there was no abuse of power or any form of unjustifiable differentiation.

12. The policy questions involved in the Human Resources Policy Reform were discussed and decided by the Tribunal in *Caryk* (Decision No. 214 [1999]) and *Madhusudan* (Decision No. 215 [1999]). After examining various initiatives and decisions taken by the Bank in order to correct the adverse consequences of dollar budgeting, recruitment practices and, generally, the condition of NRS, the Tribunal then concluded:

These examples of policy initiatives or studies ... show that the Respondent, far from being involved in a *détournement de pouvoir* and *détournement de procédure*, was sensitive to a wide range of different, and occasionally conflicting, factors. The task of the Tribunal cannot possibly be to judge whether the Respondent could have been wiser.

(*Caryk* at para. 40; *Madhusudan* at para. 49.) The Respondent, during the Human Resources Policy Reform, was particularly sensitive to the situation in ISG, which had the highest percentage (50.9 percent) of NRS in the Bank.

13. Consistent with this jurisprudence, the Tribunal concludes that to the extent the issue before it involves a question of general policy pertaining to the ambit of managerial discretion, there is no basis for a finding of *détournement de procédure* or *de pouvoir* on the facts of this case. This does not, of course, obviate an examination of whether the implementation of the Bank's policies in fact resulted in a violation of the Applicant's conditions of employment.

#### **Regularization under the Staff Rules**

14. Regularization of NRS was governed at the time by Staff Rule 4.01. The 1986 version of this Rule allowed for the regularization of staff members in two situations: (i) if the Director of the Personnel Management Department or a designated official, at his or her discretion, authorized such regularization and the staff member met the eligibility criteria for the Regular position (para. 7.01); or (ii) the staff member was selected on a competitive basis against qualified external candidates for a Regular position (para. 7.02). Staff Rule 4.01 was amended in November 1991 and remained in effect until July 1998. Paragraph 7.02(b) of the amended Rule provided:

Staff holding Consultant or Temporary appointments before September 30, 1990 who have remained in continuous service and in the same job for four years or more, may be appointed ... to a Regular or Fixed-Term position if (i) before September 30, 1995, the vice president responsible for the hiring unit has selected the staff member, after determining that the staff member meets the criteria required for the new appointment, that the Bank Group's requirements for the work are likely to continue, and that the expected needs of the Bank Group indicate the staff member's skills should be secured by converting the existing appointment ....

15. The policy embodied in the Rule was first set out by the President of the Bank in an August 1, 1991 memorandum. This document stated that a special effort was to be made to regularize NRS who met similar criteria. The Tribunal referred to this memorandum in *Caryk* and *Madhusudan* when discussing the initiatives undertaken by Bank management to improve the conditions of NRS. (*Caryk* at para. 38; *Madhusudan* at para. 47.)

16. In the present case, the situation of the Applicant was addressed in a memorandum directed to him by the Acting Director of ITF on October 9, 1991, and communicated in exactly the same terms to other staff in ITF. This memorandum explicitly referred to the initiative of the President of the Bank to regularize NRS. It concluded, however, that

[a]s you had less than four years in your current assignment as of September 30, 1991, a final decision on your case cannot be taken at this time. You should be aware, however, that it is unlikely that you will be considered for regularization even if you do accumulate the necessary service. ... Arrangements for contract renewal remain unchanged and will continue to be based on the ongoing need for your services.

17. The Bank has argued that the Applicant, who was well aware of the fact that as a Temporary staff member he was not entitled to pension benefits, cannot plausibly complain now before the Tribunal since he could have brought a grievance many years ago. In particular, so the Bank argues, he could have complained on the occasion of one of the numerous renewals of his contract. Having failed to do so, he should not be allowed to rewrite his employment history by alleging that it had been wrong to maintain his NRS status.

18. In this respect, the Tribunal concludes, however, that the Applicant did ask to have his situation addressed. The Applicant's testimony, which the Tribunal views as credible in the circumstances (and which the Bank did not seek to rebut), is that during his early years of employment he had a number of conversations with his managers about his prospects for regularization, and was consistently told that this would not be possible at the moment because of budget constraints but not to be concerned because "[his] job would still be there." As for the October 1991 memorandum, the Applicant testified that it came as "quite a shock," that he "immediately confronted [his] supervisor," and that he was told "this is probably just temporary.... Everything changes in the Bank.... Be patient." When the Applicant's position was regularized in August 1999, he realized, as the Tribunal accepted in its decision on jurisdiction, that this brought into question the propriety of his NRS status over many years. The Applicant then took action without delay and in a timely manner to challenge his prior NRS condition and his exclusion from participation in the SRP prior to April 15, 1998. It is only because the Applicant has satisfied in a timely manner the indispensable jurisdictional requirements imposed by the Tribunal's Statute that the Tribunal is now in a position to consider his claim on the merits.

19. Although regularization under Staff Rule 4.01, paragraph 7.02(b), was not mandatory, as indicated by the expression "may," there was a clear indication in the Rule and the related policies that the matter should be considered if the terms of the Rule and the policies were met. The application of the Rule was conditioned on various cumulative elements. First, there had to be a continuous service for at least four years. Second, service had to be "in the same job." On this point, the Tribunal accepts the Applicant's argument that the term "same job" does not necessarily mean that the staff member performs precisely the same tasks over the relevant period.

20. Between 1985 and 1988, the Applicant held the Temporary messenger position described above. In 1989, he



undertook a new job in ITF. Even though there may have been some continuity between the two, the fact is that the ITF position was a new job. The Applicant himself speaks of having "undergone training in different functions of a new job."

21. However, from January 1989 the Applicant held one single job, which involved filing reports into archives, duplicating microfiche, making photocopies, coordinating electronic mail, and ordering and stocking office supplies. Over time, some of these functions diminished considerably and new functions were added to this job, such as operating a new imaging system, printing reports, and maintaining the condition and performance of the printers. The Applicant was particularly successful in handling these assignments, as evidenced by the fact that by 1997 manual processing had been largely discontinued and the functions performed formerly by three staff members were now handled by the Applicant alone. This same job is the one currently held by the Applicant as an Information Technician after his regularization.

22. Other requirements of Staff Rule 4.01, paragraph 7.02(b), included that the work envisaged was likely to continue and that the staff member's skills met the expected needs of the Bank. The Bank has explained, particularly at the oral hearing, that it had expected that the Applicant's responsibilities would be either discontinued – through the development of the computer network – or absorbed by different departments. The Bank argues that it had anticipated these plans to begin as early as 1989 and finalized within a decade's time. Because of these plans, the Bank further argues, the Applicant's contract was appropriately extended for only short periods of time. Any long extensions, in the Bank's view, would have given the Applicant an expectation of continued employment and would have committed the Bank on a long-term basis.

23. The Bank's arguments are untenable. There can be no doubt that the work of the Applicant was expected to continue as in fact it did continue and does so presently. It may be true, as the Respondent has argued, that the specific tasks of the Applicant "changed significantly" over time; however, the general nature of his work remained substantially the same. As noted above, the Applicant was particularly successful in handling new assignments, thus evidencing that he also had the skills to meet the expected needs of the Bank. All the elements required under Staff Rule 4.01, paragraph 7.02(b), were thus met. The Respondent's argument that ITF experienced significant changes over time does not alter the fact that the core functions of the Applicant remained the same over time and that he proved to be capable of adapting to new methods.

24. The question then arises as to why, if the Applicant met all the criteria under Staff Rule 4.01, paragraph 7.02(b), and performed competently, he was not regularized between the date when he achieved four years in the job and the last date on which regularization was permitted under the Rule, that is to say September 29, 1995. Not only did he complete four years in the same job as of January 1993, but he also had the skills that met the expected needs of the Bank and his functions were expected to continue.

25. As a general principle, the Bank did not have an obligation to regularize the Applicant. This was a discretionary decision, which was final unless the decision constituted an abuse of discretion, being arbitrary, discriminatory, improperly motivated or carried out in violation of a fair and reasonable procedure. But under the applicable policy and rules, and in the context of contemporaneous communications to staff and managers, the Bank had an obligation to consider his regularization after four years in the light of the unique circumstances of the case. The Bank undertook no such consideration and thus failed to comply with this obligation. Moreover, the Bank at the time offered no valid reason for this failure.

26. Reasons now invoked by the Respondent, such as technological advances mentioned above, or the policy relied upon to regularize only staff having critical technological skills, were only raised by the Respondent for the first time in its pleadings, and most certainly not explained to the Applicant. In fact, the Tribunal, as noted, has been persuaded that there was an ongoing need for the Applicant's services.

27. In light of the above, the Tribunal concludes that the managers responsible for ITF/ISG decisions in this case abused their discretion in not considering and determining the Applicant's regularization before September 30, 1995 despite the clear terms of Staff Rule 4.01, paragraph 7.02(b), and of the President's directive of August 1, 1991. This directive should have weighed heavily in favor of regularization as it mandated the managers to make a "special effort" to regularize NRS who met the established criteria. The directive, in effect, placed the burden on the Respondent to show – when NRS met the criteria, but were not regularized – that there were particular reasons which justified a negative outcome. Here, however, although the Applicant satisfied the criteria, no special effort was made to regularize him and no particular reasons were offered at any material time to justify this failure.

28. This was not the result of a general policy of the Bank, which was leading in the opposite direction, nor of a deceitful purpose aiming at the denial of benefits, but rather of the failure to apply the policy on regularization to the Applicant. If all the legal and policy elements point in one direction and the managers choose to go the opposite way, probably relying on how things had been done in the past, there is an element of arbitrariness amounting to an abuse of discretion. In the light of this finding, the question of misclassification becomes moot.

#### **Interpretation of the SRP**

29. Because of the finding of abuse of discretion, there is likewise no need to address the question of interpretation of the SRP in respect of the definition of "service," "participant," and "days of service" that the Applicant has raised. Nor is it necessary to discuss questions of practice in the Bank and the International Monetary Fund. (See *Yang*, Decision No. 252 [2001], paras. 37 and 38.)

30. The Respondent has argued that under Staff Rule 11.01, paragraph 2.01, a Statute of Limitations would apply were the Applicant to establish an entitlement to past pension and medical service credits. This Rule provides as follows: "[T]he right of a staff member to claim any refund, allowance or payment due but unpaid or any benefit not credited shall lapse three years after the date on which a right to the benefit, allowance or payment claimed arose."

31. The Applicant has argued that this is a jurisdictional provision and not one related to the determination of substantive rights. The Tribunal agrees with this view. (See *Singh*, Decision No. 240 [2001], para. 22; *Thomas*, Decision No. 232 [2000], para. 21; and *Mitra*, Decision No. 230 [2000], para. 14.) The jurisdictional aspect of the

case has already been settled. Moreover, as a right to pension and other credits shall be established only as a consequence of this judgment, the three-year statute of limitations would only apply, if at all, as from the date of the decision establishing the right.

**Date for commencing participation in the SRP and related benefits**

32. The Tribunal must now establish the date from which participation in the SRP and related medical benefits is recognized. The Applicant's first three years of service in the Bank do not qualify under the terms of Staff Rule 4.01, paragraph 7.02(b), because he had a different kind of job that lasted less than four years. The Applicant began his work with ITF in January 1989. After four years in this last job and having met all the other conditions of the Staff Rule and the Bank's stated policy, the Applicant was entitled to be given fair consideration for regularization and participation in the SRP and related benefits as from January 1, 1993. He was not given such consideration, and the Bank's explanations for this failure, as seen above, do not overcome the finding of arbitrariness. This is the date accordingly identified by the Tribunal for commencing SRP participation and entitlement to related medical benefits.

33. Account must be taken of the Applicant's obligation to make contributions to the SRP as from January 1, 1993 and until the date he began his present participation. However, as the Bank has been found at fault in this matter, it should provide the Applicant with an adequate time frame for completing these contributions and grant the appropriate facilities to this effect, as has been done on other occasions regarding the bridging of benefits.

**Decision**

For the above reasons, the Tribunal decides to:

- (i) direct the Respondent to allow the Applicant to participate in the Staff Retirement Plan and to receive related benefits beginning on January 1, 1993; and
- (ii) award costs to the Applicant in the amount of \$15,000.

/S/ Francisco Orrego Vicuña  
Francisco Orrego Vicuña  
President

/S/ Nassib G. Ziadé  
Nassib G. Ziadé  
Executive Secretary

At Washington, D.C., December 4, 2001

**The World Bank Administrative Tribunal**

1900 Pennsylvania Avenue, NW  
MSC 9-009, Washington, DC 20431 USA  
TEL: (202) 458-0271 FAX: (202) 522-3581 EMAIL: [Tribunal@worldbank.org](mailto:Tribunal@worldbank.org)  
Staff based in country offices may reverse the telephone charges, or may provide a number where they may be reached.  
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**Arbitration CAS 2000/A/284 Sullivan / The Judo Federation of Australia Inc., the Judo Federation of Australia Inc. Appeal Tribunal and Raguz, award of 14 August 2000\***

Panel: Mr. Malcolm Holmes (Australia), President, Mrs. Tricia Kavanagh (Australia); Mr. David Grace (Australia)

*Judo*  
*Olympic Games*  
*Selection dispute*

**Any power to amend the criteria for selection must be subject to a limitation that it could not be exercised retrospectively once that allocation of points (earned in selection events and relevant for the selection in the 2000 Australian Olympic Team) had been made and once it had been scrutinised and confirmed.**

Ms. Rebecca Sullivan (“The Applicant”) is a competitor in the sport of judo and has made herself available for selection in the 2000 Australian Olympic Team.

The Judo Federation of Australia Inc. (“The First Respondent”) is the governing body of the sport of Judo in Australia.

The First Respondent is responsible for nominating to the Australian Olympic Committee Inc. (“the AOC”) athletes and officials for selection by the AOC as members of the 2000 Australian Olympic Team.

In the lead up to the 2000 Olympic Games the AOC desired to promote awareness and a clear understanding of its selection criteria by all athletes involved in the sport of Judo. For its part the First Respondent desired to have certainty in the selection criteria for athletes in the sport of judo and to ensure that its athletes and officials were aware and had a clear understanding of the manner in which athletes and officials would be nominated to the AOC for selection in the 2000 Australian Olympic Team.

By an Agreement made the 27<sup>th</sup> day of September 1999 (“the Agreement”) the AOC and the First Respondent reflected their respective, but common, intentions as outlined above.

The Agreement purported to be a comprehensive agreement detailing nomination, participation and selection criteria. Annexed to the Agreement were the following:

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\* NB: This award has been challenged before the New South Wales Court of Appeal (Australia) (réf. CA 40650/00); cf. Judgment of 1 September 2000, delivered by the New South Wales Court of Appeal (Australia) in the case *Angela Raguz v Rebecca Sullivan & Ors.*



- *Annexure A* comprising the Participation and Qualification Criteria for athletes for the 2000 Olympic Games determined from time to time by the International Judo Federation (hereinafter referred to as “the IJF”) and the International Olympic Committee (hereinafter referred to as “the IOC”).
- *Annexure B* comprising the 2000 Australian Olympic Team Selection Criteria.
- *Annexure C* comprising the 2000 Australian Olympic Team Nomination Criteria developed by the First Respondent.
- *Annexure D* comprising the 2000 Australian Olympic Team Athlete Nomination Form.
- *Annexure E* comprising the 2000 Australian Olympic Team Officials Nomination Form.
- *Annexure F* (which was not put in evidence) comprising the 2000 Olympic Team Membership Agreement - Athletes.

Clause 5.3 of the Agreement provides that selection of an athlete in the Olympic Team is conditional upon the AOC confirming that the athlete has met all the applicable criteria for nomination and selection including the signing of the Team Membership Agreement (Annexure F).

The First Respondent has accepted that at all material times the Applicant has been eligible for nomination to the AOC for selection in the 2000 Australian Olympic Team.

Clause 7 of the Agreement has the heading “Appeal Process”. Clause 7.1 provides as follows:

*“Subject to clause 7.2, any dispute regarding an Athlete’s nomination or non-nomination of an athlete by the NF to the AOC and whether arising during the term of this Agreement or after its termination will be according to the following procedure:*

- (1) *The appeal process is two tier, with the appeal being first heard by the Judo Federation of Australia’s Appeal Tribunal (“Tribunal”) with any subsequent appeal to be heard by the Court of Arbitration for Sport.*
- (2) *The sole grounds for any appeal are that the Nomination Criteria have not been properly followed and/or implemented.*
- (3) *Any appeal by an athlete against non-nomination to the AOC must be made to the Tribunal. Any appeal must accord with the following procedure:*
  - (a) *The appellant must give written notice of his appeal to the chief executive officer of the NF within 48 hours of the announcement of the decision against which the appeal is made.*
  - (b) *Within 5 working days of submitting his or her written notice of appeal, the appellant must submit to the chief executive officer of the NF the grounds of that appeal accompanied by a non-refundable deposit of \$100 payable to the NF.*
  - (c) *Unless otherwise agreed in writing between the AOC and the NF, the Tribunal will comprise the following persons appointed by the Board of the NF:*
    - (i) *a barrister or solicitor who will act as Chairman;*
    - (ii) *a person with a thorough knowledge of the Sport and who preferably has had recent international competition experience in the Sport; and*
    - (iii) *one other person of experience and skills suitable to the function of the NF Appeal Tribunal.*

*No person is eligible to be appointed to the Tribunal if he or she is a member of Board of the NF or its selection panel or by reason of his or her relationship with the appellant or any member of the Board of the NF or its selection panel would be reasonably considered to be other than impartial.*

- (d) *The Tribunal will convene a hearing as soon as possible after the submission of the grounds of appeal. The hearing may occur in such manner as the Chairman decides, including telephone or video conferencing. The Tribunal is not bound by the rules of evidence but must observe the principles of procedural fairness.*
  - (e) *Prior to the hearing, the selection panel will provide the Tribunal and the appellant with a written statement as to the reasons for the decision against which the appeal is made.*
  - (f) *The Tribunal will give its decision as soon as practicable after the hearing and will provide the chief executive officer of the NF and the appellant with a statement of the reasons for its decision.*
  - (g) *The decision of the Tribunal will be binding on the parties and, subject only to any appeal to the Court of Arbitration for Sport pursuant to clause 7.1(4), it is agreed that neither party will institute or maintain proceedings in any court or tribunal other than the said Tribunal.*
- (4) *Any appeal from a decision of the Tribunal must be solely and exclusively resolved by the Court of Arbitration for Sport according to the Code of Sports-Related Arbitration. The decision of the said Court will be final and binding on the parties and it is agreed that neither party will institute or maintain proceedings in any court or tribunal other than the said Court.*
  - (5) *An athlete wishing to appeal to the Court of Arbitration for Sport must give written notice of that fact to the chief executive officer of the NF within 48 hours of the announcement of the decision against which the appeal is made and must then file his or her statement of appeal with the Court of Arbitration for Sport within 5 working days.*
  - (6) *Failure to observe the above time limits will render any appeal a nullity provided that an athlete may apply to the body to hear the appeal in question for an extension of time in which to commence an appeal. The body to hear the appeal in question may grant such an extension of time only in extenuating circumstances outside the control of the athlete concerned.”*

Both the Applicant and Ms. Angela Raguz (“the Third Party”) were competitors for selection in the Australian Olympic Team in Judo in the 52-kilogram weight division. Under the Agreement the only events in respect of which points were to be awarded and upon which the selection was to be based were the following:

- (a) the 1999 Senior World Championships which were held between 4 and 11 October 1999;
- (b) the 1999 USA Open Championships which were held between 23 and 24 October 1999;
- (c) the Oceania Judo Union Championships which were held between 11 and 12 March 2000.

The Applicant competed in all three selection events and the Third Party participated in the latter two selection events. Their results were as follows:

<b>Event</b>	<b>Sullivan</b>	<b>Raguz</b>
1999 World Championships	9 <sup>th</sup> place	Did not compete
1999 USA Open Championships	7 <sup>th</sup> place	5 <sup>th</sup> place
2000 Oceania Judo Union Championships	2 <sup>nd</sup> place	1 <sup>st</sup> place

After the final selection events, the Applicant said in evidence that the first indication that she received that she had not been nominated was when she was not invited to attend a meeting of the proposed Olympic Team in March 2000.

On or about 17 March 2000 the Applicant wrote to the First Respondent expressing her belief that she would not be nominated by the First Respondent for selection in the 2000 Australian Olympic Team.

On 10 April 2000 the Applicant wrote to the First Respondent requesting urgent advice as to when it was intended that the First Respondent would nominate its team to the AOC and when the Applicant would know whether she had been so nominated. The letter also foreshadowed a request to refer any non-nomination to the Judo Federation of Australia Inc. Appeal Tribunal (“the Second Respondent”).

On 14 May 2000 the First Respondent’s Committee of Management met to discuss, inter alia, its nominations to the AOC for the 2000 Australian Olympic Games Team. The Committee of Management of the Respondent unanimously passed a motion that in the Women’s under 52-kilogram weight division Angela Raguz be the nominated athlete with the Applicant being a reserve athlete in that weight division. The First Respondent’s Committee of Management further resolved that the Applicant be advised that her Appeal should be lodged with the Oceania Judo Union and that the First Respondent’s Committee of Management had nominated this division to the AOC through the Oceania Judo Union selection criteria. On 11 June 2000 the Applicant wrote to the Oceania Judo Union appealing the decision by the First Respondent not to nominate her to the AOC. On 12 June 2000 the Oceania Judo Union wrote to the Applicant advising her that the Oceania Judo Union had no jurisdiction to hear the Applicant’s appeal.

On 19 June 2000 the Oceania Judo Union wrote a further letter to the Applicant confirming that the Applicant’s appeal should be directed to the First Respondent and further confirming that the Oceania Judo Union had no jurisdiction in the matter.

On 22 June 2000 the First Respondent wrote to the Applicant confirming her correspondence to the Second Respondent on 10 April 2000 and further confirming that her appeal must proceed pursuant to Clause 7.1 of the Agreement (set out above). Attached to that letter was a circular letter forwarded to the Applicant from the Section Manager Judo 2000 Olympic Games and dated 23 June 2000 advising the names of those athletes that had been nominated to the AOC by the First Respondent for selection in the 2000 Australian Olympic Games Team. That letter advised the procedures to follow in the case of an appeal and specified that the sole grounds for any appeal were that the Nomination Criteria had not been properly followed and/or implemented.

By letter dated 24 June 2000 the Applicant appealed to the Second Respondent against her non-nomination by the First Respondent to the AOC for selection to the 2000 Australian Olympic Team.

On 30 June 2000 the Applicant wrote to the First Respondent setting out the Applicant's Grounds of Appeal together with a request for clarification, information and documentation. The letter requested advice, amongst other things, as to the date, time and proposed venue for the Appeal Tribunal hearing. The letter also advised the intention to call Ms Sharon Rendle to give evidence at the hearing.

By letter dated 28 June 2000, Mr. Gerry Hay, Solicitor and Barrister of Rockdale NSW, advised the President of the First Respondent, Mr. J Deacon, that he had convened a panel to consider the Applicant's appeal. The other appointed members of the panel were Mrs. Margeurite Wilson and Mrs. Dianne Moffit. He further advised that the relevant documentation had been delivered to the nominated panel members the same day.

By letter dated 5 July 2000 Mr. Hay wrote to the Applicant's Solicitors advising that the Appeal Tribunal was "*now in operation*" and that he anticipated "*that the Tribunal would complete its task within the next week*". In relation to the intention to call Ms Sharon Rendle to give evidence on behalf of the Applicant Mr. Hay stated "*I note your intention to call Ms Sharon Rendle to the Appeal and I must point out that the initial process does not involve examination of the parties concerned but relies on the documentation provided by all the relevant parties. Any subsequent appeal is a matter for the Court of Arbitration for Sport where examination processes are available.*" Mr. Hay then proceeded to answer each of the Grounds of Appeal, in effect rejecting each of the grounds. The letter concluded that "*the initial appeal has commenced and is almost completed*" and that "*the Tribunal had reached a decision to consider the evidence in the first instance, on the documents provided by the parties*".

By letter dated 6 July 2000 the Applicant's Solicitors wrote to Mr. Hay advising that the Applicant had not received the Selection Panel's Written Statement of Reasons as contemplated by Clause 7.1(3)(e) of the Agreement. The letter also requested the documents which had been requested in the 30 June 2000 letter to the First Respondent. The letter also complained that the Second Respondent had not been constituted in accordance with Clause 7.1(3)(c) of the Agreement, that the Tribunal was required to convene a hearing, allow the Applicant to give evidence, provide documents and call witnesses and that generally the Appeal procedure set out in the Agreement had not been followed. A copy of that letter to Mr. Hay was forwarded to the First Respondent on 6 July 2000.

By letter dated 11 July 2000 Mr. Hay wrote to the Applicant's Solicitors enclosing previously requested documentation, clarifying a number of matters that had been raised in previous correspondence and advising that he had "*a wide scope of choice in the format in which*" the Appeal Tribunal operated. He stated that "*sufficient documentation was available to indicate to the Tribunal that the Appellant did not meet the criteria*" and that "*the hearing may occur in such a manner as the Chairman decides, including telephone or video conferencing. My method of conducting this Tribunal was to provide all the relevant*

*information to my colleagues along with permission for them to ring the Appellant if necessary and discuss with her, any query that they may have. I am informed that one of the members of the Tribunal did use this method to gain information for herself. I am now in the process of writing to Rebecca Sullivan and give her the decision of the Tribunal ...”.*

On 13 July 2000 the Applicant’s Solicitors wrote to Mr. Hay acknowledging receipt of his letter dated 11 July 2000 on 13 July 2000 and requesting that any decision of the Tribunal be delayed until the Solicitors had the opportunity to respond to Mr. Hay’s letter. The author further indicated that he would respond in writing by “close of business tomorrow”. By letter dated 12 July 2000 which appears to have been faxed on 13 July 2000 the First Respondent wrote to the Applicant via her Solicitors advising that Mr. Hay had advised “that the Tribunal has met and concluded the investigation and has upheld the selection criteria as applied” by the First Respondent.

By letter dated 14 July 2000 the Applicant’s Solicitors wrote to the First Respondent and gave notice that pursuant to Clause 7.1(4) of the Agreement the Applicant wished to appeal to the Court of Arbitration for Sport.

By letter dated 19 July 2000 the Applicant’s Solicitors wrote to the Court of Arbitration for Sport enclosing an application form together with other relevant documentation.

The application form outlined the relief sought by the Applicant as being “an order nominating Rebecca Sullivan to the AOC for selection in an OJU place at the 27<sup>th</sup> Olympiad in the Women’s Judo under 52 kg weight division.”

Pursuant to the Order of Procedure, a copy of the Applicant’s Appeal Brief was served on the Third Party and she was invited to attend and participate in the proceedings and the hearing on Saturday 12 August 2000.

At the commencement of the hearing, the Applicant indicated to the Court that the sole ground to be relied upon was that the nomination criteria had not been properly followed and/or implemented and that if properly followed then the Applicant would have been the nominated athlete. The other ground which related to discretionary considerations was then abandoned.

Pursuant to the Order of Procedure the First Respondent was required to provide by 12pm on Tuesday 10<sup>th</sup> August 2000 the written statement of reasons of the First Respondent’s selection panel referred to in clause 7.1(3)(e) of the Agreement and the statement of reasons of the First Respondent’s Appeal Tribunal for its decision. Neither of these documents (if indeed they are in existence as appears unlikely) was supplied to the Applicant or the Court.

## LAW

1. At the hearing the sole Ground of Appeal was that on the true construction of the Agreement, the Nomination Criteria had not been properly followed and/or implemented. The Applicant submitted that the Nomination Criteria were inconsistent with the Participation Criteria and pursuant to clause 4.3 of the Agreement the Participation Criteria prevailed over the Nomination Criteria to the extent of the inconsistency.

2. The Applicant submitted that:

*“The inconsistency between the Participation criteria and the Nomination criteria lies in the different points awarded towards an Oceania Judo Union (“OJU”) place in the Olympics for an athlete who places ninth in the 1999 world championship. The participation criteria awarded 8 points to such an athlete; the nomination criteria only awarded 6 points”.*

The Applicant relied upon the fact that Rebecca Sullivan was placed 9<sup>th</sup> in the 1999 World Championships and therefore earned 8 points whilst Angela Raguz did not compete in those championships. Further points relied upon were that the Applicant was placed 7<sup>th</sup> in the 1999 USA Open and thereby earned 3 points; Angela Raguz was placed 5<sup>th</sup> in the 1999 USA Open and thereby earned 6 points. The Applicant was placed second in the 2000 OJU championships and thereby earned 12 points; Angela Raguz was placed first in the 2000 OJU championships and thereby earned 15 points. The Applicant submitted that she has, therefore, accrued 23 points and Angela Raguz has accrued only 21 points. The nomination of Angela Raguz had been based on Rebecca Sullivan only being credited with 6 points as a result of her 9<sup>th</sup> place at the 1999 World Championships.

3. The only issue for determination therefore on the appeal was the proper construction and effect of the Agreement. If the construction and effect contended for by the Applicant was correct then she would have accumulated 23 points and the Third Party 21 points and the Applicant should have been nominated. If the construction and effect contended for by the First Respondent was correct then both parties would have accumulated 21 points and as the Third Party achieved a higher place in the 2000 OJU Championships, the Third Party was correctly nominated.
4. The Court was not asked nor required to consider the respective abilities or performances of both athletes. All parties proceeded on the basis that both were suitable for nomination and no other athletes matched them in their division of the sport. The Court was not asked or required to make any evaluation of the merits or appropriateness of the selection system adopted by the First Respondent. No discretionary matters or subsequent circumstances were relied upon by any of the parties.
5. All parties proceeded on the basis that if the construction and effect of the Agreement contended for by the Applicant was correct then the Applicant should be nominated and if unsuccessful then the Third Party's nomination would stand. No party submitted that if the

appeal should be upheld then the issue of whom should be nominated should be remitted back to the First Respondent or its selection panel for further consideration. The sole issue for determination by the Court was thus the proper construction and effect of the Agreement.

6. It is necessary to consider in detail the terms of the Agreement and the various annexures which were attached to the Agreement when executed on 27 August 1999.
7. There are five Recitals to the Agreement. Recital D provides that:  
*“The AOC wishes to promote awareness and a clear understanding of its Selection Criteria throughout the Sport.”*
8. Recital E provides that:  
*“The NF desires to have certainty in the selection criteria for athletes and to ensure that its athletes and officials are aware and have a clear understanding of the manner by which it will decide to nominate Athletes and Officials to the AOC for selection in the Team.”*
9. Clause 1.1 of the Agreement defines certain terms. Amongst those terms are “Nomination Criteria”, “Participation Criteria” and “Selection Criteria”. The Nomination Criteria were included in Annexure C, the Participation Criteria included in Annexure A and the Selection Criteria included in Annexure B.
10. Clause 1.2(6) provides that:  
*“The Recitals to this Agreement are incorporated into the operative portion of this Agreement as if repeated in full.”*
11. The Agreement critically imposes on the First Respondent in clause 3.1 the obligation to *“abide by the Selection Criteria and this Agreement in nominating Athletes for selection as members of the Team”*. The essence of the case for the Applicant is that she would have been nominated had the First Respondent abided by the Selection Criteria and the Agreement.
12. Clauses 3.1 and 4.3 of the Agreement, collectively, provide that:
  - (a) the Participation Criteria will prevail over both the Selection Criteria and the Nomination Criteria (clauses 3.1 and 4.3); and
  - (b) the Selection Criteria will prevail over the Nomination Criteria (clause 4.3).
13. Clause 4.3 of the Agreement states:  
*“The NF will develop the Nomination Criteria no later than 12 months prior to the NF’s first nomination event for the Games, or as agreed with the AOC. The Nomination Criteria will be at all times subject to:*
  - (1) *the prior approval of the AOC;*
  - (2) *the Participation Criteria; and*
  - (3) *the Selection Criteria.*

*In the event that the Nomination Criteria are inconsistent in any way with the Participation Criteria and the Selection Criteria, the latter will prevail to the extent of that inconsistency.*

*Once the Nomination Criteria are so developed and approved, they will be deemed to be automatically incorporated into this Agreement as Annexure C and the NF will publish them to all persons to whom it has provided a copy of the Agreement”.*

14. Clause 4.4 of the Agreement ensures that the Nomination Criteria must be applied in a way to ensure that “no Athlete is nominated to the AOC where another Athlete is, or other Athletes, are entitled to be nominated in priority”.
15. Clause 8.3 and 8.4 of the Nomination Criteria (Annexure C of the Agreement) provide as follows:
  - 8.3 *To qualify for an OJU place, an athlete must comply with the selection criteria set out in Attachment 2. (OJU Olympic Selection System).*
  - 8.4 *Subject to clause 8.2 and 12, the NCC will nominate an athlete who has qualified for an OJU place, provided that athlete meets the preconditions for nomination set out in clause 11.”*

The Applicant submitted that as she qualified for an OJU place the First Respondent was obliged to nominate her and accordingly this court should substitute the Respondent’s decision.

16. The Respondents contended, supported by the Third Party, that as clause 7.1(2) states that the sole ground for an Appeal is that the Nomination Criteria have not been properly followed and/or implemented, the Applicant was restricted to a complaint about a breach of the words found in Annexure C, Nomination Criteria, as being the basis of the Appeal. The difficulty with this submission is that within the Annexure C itself there is an obligation in Clause 6.2.2 that in order to be selected athletes must satisfy the requirements in the Selection Criteria in Annexure B. It is a requirement of Clause 5(1)(a) of the Selection Criteria in Annexure B that the athlete “*must have met the Participation and Qualification Criteria*”. The language used both in the operative provisions of the Agreement and each of the Annexures makes it clear that they are interlinked and should be read together. It is the Court’s view that on the proper construction of the Agreement the ground for an Appeal should not be so restricted and that the Court is able to determine whether there has been a breach of the Nomination Criteria by reading the Agreement as a whole.
17. The first question which arises is whether any rights flow to potential Olympic Athletes pursuant to the Agreement. It is clear from Recital E quoted above that certainty in Selection Criteria for Athletes and the ensuring that Athletes are aware of the manner by which nominations will be decided are the objectives of the parties to the Agreement. As a matter of the ordinary and natural meaning of the language used in the Agreement the parties intended an immediate and clear benefit to accrue to those Athletes. This is reinforced by the fact that clause 2.4 of the Agreement provides that:
 

*“The NF will provide a copy of this Agreement to each member of the Shadow Team and all other individuals*



*and organisations with a legitimate interest in the selection procedures. The NF will, if requested by the AOC, provide that the AOC written acknowledgement from each such Athlete that the Athlete has read and is aware of this Agreement.”*

18. The Agreement defines the class of persons intended to be benefited by the Agreement. It is also reinforced by the definition of “Athlete” contained in Clause 1.1 of the Agreement which states:

*“means those athletes who participate in the sport and are registered members or recognised athletes of the N.F.”*

Further support is found in clause 11 of Annexure C (Nomination Criteria) which provides, inter alia, that in order for an Athlete to fulfil certain conditions prior to being considered for nomination, the Athlete must be a registered member of his or her State/Territory Judo Association which is a registered financial member of the First Respondent. In the opinion of the Court it is clear from the language used that the Agreement was intended to confer rights and legitimate expectations in relation to the Athletes in relation to whom it is directed from the time of its execution on 27 September 1999. It is clear that the Agreement including the Annexures form a comprehensive code in relation to the nomination and selection of Athletes, as defined, in the sport of Judo for the 2000 Olympic Games. The Agreement became the terms of reference for the Athletes and the Athletes by their participation in the selection events accepted and were entitled to rely upon the Agreement. We conclude that Athletes vying for selection in the 2000 Olympic Games Team in the sport of Judo have and at all times from 27 September 1999 have had a legitimate expectation that the provisions of the Agreement would be complied with.

19. The crucial question which then arises is whether the Respondents were required to apply the points table contained in Annexure A (which provided that 8 points would be provided for ninth place at the 1999 World Championships) or the points table contained in Annexure C (which provided that 6 points would be allocated for ninth placing at the 1999 World Championships). The terms of the Agreement and the Annexures provide a clear answer to this question. Where there is inconsistency then the provisions of Annexure A prevail over Annexure C, e.g. Clause 3.1, Clause 4.3 of the Agreement, Clause 1 and Clause 5(1)(a) of Annexure B and Clause 6.2.2 of Annexure C.
20. The Respondents sought support from evidence extraneous to the agreement notwithstanding that the Agreement contained an “entire agreement” clause in clause 9.1. This clause states that the *“Agreement contains the entire agreement between the parties”*. Any reliance on earlier discussions about a draft proposal is inconsistent with the terms and objects of the Agreement.
21. The evidence from the Respondent’s coaching director, who also held the position of technical director of the OJU, Mr. Peter Hermann, was that at a training camp held in late August 1999, the Applicant, together with other Athletes at the training camp was advised of a draft proposal to change the points table contained in Annexure A and to reduce the points

- allocated for ninth place at the 1999 World Championships from 8 points to 6 points. In order for that draft proposal to become effected, it was necessary for the Executive of the Oceania Judo Union to approve the proposal. The draft proposal and the eventual amendment after all the Selection Events had been completed had a long history.
22. At the Executive Meeting of the OJU on 22 January 1998, its executive adopted a 2000 Olympic Selection System which, inter alia, provided 8 points for ninth place at the 1999 World Championships. By letter dated 11 March 1999, Mr. Hermann in his capacity as Technical Director of the OJU wrote to the Executive and proposed some amendments which included an amendment to the points tables so that the points would be reduced from 8 points to 6 points. On 6 September 1999, the Secretary of the OJU distributed a copy of the proposed amended points system to the Presidents of the member countries although it was not incorporated in the Participation Criteria annexed as Annexure A to the Agreement when executed on 27 September 1999. The Agreement in Annexure A allocated 8 points for ninth place at the 1999 World Championships. Accordingly any prior inconsistent or informal discussion was in the circumstances irrelevant.
  23. Mr. Hermann stated that the Agreement including the Annexures thereto were forwarded to the Athletes, Coaches and Officials shortly after execution by the First Respondent but as the whole Judo Team was overseas at the time with most of the Athletes, Coaches and Officials returning to Australia at the end of October/November 1999, those Athletes, Coaches and Officials would not have received the document until after their return. Some time in late November 1999 Mr. Hermann was advised by the Judo Section Manager that there was an inconsistency between the points table of the Oceania Judo Union and that of the International Judo Federation. The Third Party had queried the inconsistency with him, together with another Athlete. Mr. Hermann wrote a letter dated 6 December 1999 to the Sports Director of the International Judo Federation advising of the inconsistency. The Sports Director of the International Judo Federation was confused and sought clarification in relation to the proposed amendment and by letter dated 17 December 1999 Mr. Hermann wrote to him and provided further information. Some delay then ensued.
  24. It was not until 3 March 2000 that the International Judo Federation sent the proposed changes to the Oceania Judo Union qualification system and sought verification from Mr. Hermann that it was appropriate to seek confirmation with the International Olympic Committee. Mr. Hermann replied on 8 March 2000 confirming that the draft proposal be processed. On 23 March 2000 the IOC wrote to the National Olympic Committees of Oceania and advised them that an amendment had been made to the Oceania Judo Union qualification procedure for the Sydney 2000 Olympic Games. The result was a purported amendment to the qualification system by a change to the points awarded for a ninth placing at the 1999 World Championships from 8 points to 6 points.
  25. By letter dated 14 March 2000, however, Peter Hermann as Technical Director of the OJU, wrote to the General Secretary of the Union setting out the final ranking for the 2000 Olympic Games of the OJU Athletes to be recommended for selection and in so doing

applied the proposed amendment to the points retrospectively system which gave the Third Party 21 points and the Applicant 21 points but ranked the Third Party ahead of the Applicant in accordance with the term of the Agreement which gave priority to that Athlete who achieved a higher place at the 2000 OJU Championships.

26. The Applicant relied upon Clause 5 under the heading “Oceania Judo Union” of Annexure A as emphasising the fact that when the points are gained by Athletes at the various competitions, the allocations occur at that time and not at a later time. Furthermore, if this was permissible it would produce the anomalous result that allocated points could be taken away from the Athlete after all the selection events have been completed. Clause 5 of Annexure A provides that the OJU points system will be the basis used by the Oceania Judo Union to recommend their representatives for the 2000 Olympic Games selection. Subclauses provide, *inter alia*, that points would be allocated for Athletes of all OJU member countries, points gained by Athletes “will be allocated at all selected Olympic selection events” (clause 5.1.3), points allocated at the 2000 Olympic selection will be constantly scrutinised by the OJU Technical Director or his delegate and confirmation of points claimed must be provided to the Technical Director by the President of the member country by supplying copies of the relevant draw sheets pertaining to each Athlete. At all material times the Technical Director was Peter Hermann.
27. The Respondents, supported by the Third Party, relied substantially upon the meaning of the phrase “Participation Criteria” contained in clause 1.1 of the Agreement. That clause defines that phrase as meaning “the Participation and Qualification Criteria for the Games for Athletes determined from time to time by the IF and the IOC and attached as Annexure A”. The Respondents contended that the definition makes clear that the Participation Criteria as at the time of entry into the Agreement may change from time to time and that by the time the Nomination Criteria came to be developed and formulated the Participation Criteria had in fact changed by reducing the number of points to be allocated for ninth placing from 8 points to 6 points. This was so, it was contended, because at the time of the decision of the First Respondent to nominate its Athletes to the AOC, namely in May 2000, the points table contained within the Participation Criteria had in fact been amended. Thus the Respondents submitted the change to the number of points to be awarded even though made after all the selection events had been held was merely the result of the exercise of a right or power in the Agreement itself.
28. The Court finds that whatever may have been the subjective intention of the First Respondent in pursuing a change to the relevant points table the proposed change was not effective until after the three selection events had taken place. The language used in the Agreement and in the Annexures required action to be taken in relation to the points accrued at the 1999 World Championships. Any power to amend must be subject to a limitation that it could not be exercised retrospectively once that “allocation” had been made and once it had been scrutinised and confirmed. Furthermore no indication in writing had been given by the First Respondent to any of the potential Olympic nominees for selection that the points table was proposed to be changed prior to the change occurring.

29. The Court finds that in the particular circumstances of this case, all Athletes had a legitimate expectation that the issue of the nomination to the AOC would be governed by the documentation existing on 27 September 1999 which had not been amended prior to the selection decision by the Oceania Judo Union. The documentation as at that date, as it had at all times from 27 September 1999, objectively assured the Athletes that there would be awarded 8 points for a placing of ninth in the 1999 World Championships.
30. The Court concludes that as a matter of the proper construction of the Agreement, the Nomination Criteria were not properly followed and/or implemented in that they required the points table contained in Annexure A which remained in its unamended form until 23 March 2000 to be applied in the nomination by the First Respondent of Athletes to the AOC for selection for the 2000 Olympic Games Australian Judo Team.
31. Accordingly, the Court upholds the Appeal of the Applicant and orders that First Respondent nominate to the AOC the Applicant in substitution for the Third Party.
32. The Panel finds that the Second Respondent conducted a procedurally flawed appeal process. The Applicant was never given a statement of reasons by the selectors, as contemplated by the Agreement, nor any associated documentation or a proper chance to be heard, although she had notified the First Respondent of her concern at the selection processes as far back as 17 March 2000.
33. As a result of a determination of the Respondents not to consider her various complaints at the various stages, the other parties and the Court have been drawn into a full appeal on 12 August 2000. The Third Party has been led to believe from a March 2000 meeting of the proposed members of the Olympic Team that she was to be the nominated Athlete. For some five months she has held a belief that she would represent Australia and compete in the 2000 Olympic Games. This is a matter of grave concern. Responsibility for this is solely due to the actions and inactions of the Respondents.

**The Court of Arbitration for Sport hereby rules :**

1. The appeal is upheld and the decision of the Judo Federation of Australia Inc to nominate Angela Raguz to the Australian Olympic Committee for selection in the Women's Under 52-kilogram Division is set aside.
2. The Judo Federation of Australia Inc is directed to forthwith advise the Australian Olympic Committee that its nomination of Angela Raguz is withdrawn and substituted by the nomination of Rebecca Sullivan.

3. The award setting forth the results of the proceedings shall be made public unless all parties agree.

(...)

## CASES

International Centre for  
Settlement of Investment Disputes

SOUTHERN PACIFIC PROPERTIES  
(MIDDLE EAST) LIMITED

## V.

ARAB REPUBLIC OF EGYPT  
CASE No. ARB/84/3

## AWARD ON THE MERITS

*President* : Dr. Eduardo JIMENEZ DE  
ARECHAGA  
*Members of the Tribunal* : Dr. Mohamed Amin EL MAHDI  
Robert F. PIETROWSKI, Jr., Esq.  
*Secretary of the Tribunal* : Mr. Nassib G. ZIADE

In Case No. ARB/84/3,  
*between* Southern Pacific Properties (Middle East) Limited and  
Southern Pacific Properties Limited,  
represented by  
Mr. Peter Munk, as Agent; assisted by: Mr. William Lau-  
rence Craig, Mr. Jan Paulsson, Mr. Paul D. Friedland, Mr.  
Jean-Claude Najjar, Mr. Harvey McGregor, Q.C., Mr.  
Mohammed Kamel, Mr. Charles Kaplan and Mr. Michael  
Polkinghorne, as Counsel; and Dr. Aron Broches, as  
Consultant,

*and*

The Arab Republic of Egypt,  
represented by  
Dr. Iskandar Ghattas; assisted by: Mr. Hassan Baghdadi,  
Professor Fawzy Mansour, Professor Jean-Denis Bredin,  
Mr. Robert Saint-Esteben, Mr. Ahmed Medhat and Pro-  
fessor Emmanuel Gaillard, as Counsel; and Dr. Rudolf  
Dolzer, as Consultant,

THE TRIBUNAL,

Composed as above,

*Makes the following Award:*

## I. THE PROCEEDINGS

1. On August 24, 1984, the International Centre for Settlement of Investment Disputes ("the Centre" or "ICSID") received a Request for Arbitration from Southern Pacific Properties (Middle East) Limited ("SPP(ME)" or "the Claimant"), a Hong Kong corporation. The Request stated that SPP(ME) wished to institute arbitration proceedings under the Convention on the Settlement of Investment Disputes between States and Nationals of Other States ("the Washington Convention") against the Arab Republic of Egypt ("the ARE" or "the Respondent"), and asked for the following relief:

"SPP(ME) respectfully requests ICSID to establish an arbitral tribunal to:

1. determine that the ARE has undertaken obligations and incurred duties in respect to SPP(ME) both according to the terms of Law No. 43 and according to the Heads of Agreement of September 1974 specifically entered into by a Member of its Government, as well as by a Supplemental Agreement "approved, agreed and ratified" by the same Member of its Government.
2. determine that the ARE violated its obligations thereunder,
3. adopt and incorporate as its own the pertinent findings of fact made by the ICC Arbitral Tribunal concerning SPP(ME)'s performance of its obligations under its agreements, the dismissal of EGOH's counterclaim therein, and the acts bringing about termination of the investment project,
4. determine the liability of the ARE to compensate SPP(ME) for the termination of its investment agreements and to award the full measure of indemnification to SPP(ME) on account of the destruction of its investment, increased by the additional costs, including all direct and indirect costs of the present proceedings, occasioned by ARE's wrongful refusal to honor the ICC award of February 16, 1983, or otherwise compensate SPP(ME), as well as interest at commercial rates."

2. On August 28, 1984, the Secretary-General of ICSID sent an acknowledgment of the Request to SPP(ME) and transmitted a copy of the Request to the Respondent. On the same day, the Secretary-General registered the Request in the Arbitration Register and notified the Parties accordingly.

3. On August 29, 1984, the Secretary-General notified the Parties by telex that:

"... the Arabic text of Article 8 of Law No. 43 of 1974 refers to the settlement of disputes within the framework of the ICSID Convention in the cases where it (i.e., the Convention) applies, and not, as erroneously mentioned in the English translation, where Law No. 90 of 1971 ratifying the Convention applies. I have, thus, registered the request of SPP without prejudice to the question whether said Article eight constitutes consent for the purposes of the ICSID Convention or merely includes a reference to this Convention in the cases where consent for ICSID jurisdiction is issued separately. This matter, if raised, will be for the Arbitral Tribunal to decide."

4. On August 29, 1984, the Centre received from SPP(ME) a proposal that a sole arbitrator be appointed pursuant to Rule 2(1)(a) of the Centre's Rules of Procedure for Arbitration Proceedings ("Arbitration Rules"), or, alternatively, that the Parties jointly nominate an individual as President of the Tribunal.

5. In a communication received by the Centre on November 12, 1984, the Respondent stated that it contested the Centre's competence with respect to the present dispute, and that no action undertaken in proceedings concerning SPP(ME)'s request could be deemed a renunciation of the Respondent's jurisdictional objections. The Respondent rejected SPP(ME)'s proposals for the constitution of the Tribunal and proposed as an alternative a Tribunal consisting of three members, with Dr. Eduardo JIMENEZ DE ARECHAGA serving as President of the Tribunal.

6. In accordance with Rule 4 of the Centre's Arbitration Rules, the Parties agreed on November 26, 1984 to extend to December 3, 1984 the period for nominating their respective arbitrators and for agreement on the President of the Tribunal.

7. On November 26, 1984, the Respondent designated Dr. Mohamed Amin EL MAHDI, an Egyptian national, as an arbitrator pursuant to Rule 3 of the Centre's Arbitration Rules. SPP(ME) informed the Centre on November 30, 1984 that it did not object to the nationality of the arbitrator named by the Respondent, as it might have done under Rule 3(1)(a)(i) of the Arbitration Rules, and that it was designating Mr. Robert F. PIETROWSKI, Jr., a U.S. national, as an arbitrator. Further, SPP (ME) informed the Centre that it consented to the Respondent's proposal that Dr. JIMENEZ DE ARECHAGA be

appointed President of the Tribunal. Dr. JIMENEZ DE ARECHAGA accepted his appointment on December 5, 1984 and Mr. PIETROWSKI accepted his appointment on December 7, 1984. On December 18, 1984, the Centre received notice that Dr. EL MAHDI accepted his appointment as an arbitrator, and the Secretary-General informed the Parties that the Tribunal was constituted and that the proceedings were deemed to have begun in accordance with Rule 6(1) of the Arbitration Rules.

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8. On February 8, 1985, the Tribunal conducted a preliminary meeting with the Parties at the Permanent Court of Arbitration in the Hague. The Parties placed on record their agreement to the effect that:

"the Tribunal has been properly constituted in accordance with Section 2 of the ICSID Convention and Chapter 1 of the Arbitration Rules."

In accordance with Rule 20 of the Centre's Arbitration Rules, it was decided that the Arbitration Rules in effect up to September 26, 1984 would apply; that the procedural languages would be English and French; and that the seat of the arbitration would be Washington.

9. The Tribunal decided at the preliminary meeting to suspend the proceedings on the merits pending a decision on the Respondent's jurisdictional objections, and that the proceedings on jurisdiction would consist of written pleadings and oral argument. The Tribunal then fixed a schedule for the filing of the written pleadings on jurisdiction, with the Respondent's observations to be filed by May 8, 1985 and the Claimant's observations to be filed by June 19, 1985.

10. The observations of both Parties were filed within the prescribed time limits. The Respondent in its observations submitted that the Tribunal should

"pour l'ensemble des motifs ci-dessus exposés, se dire incompétent pour connaître des demandes présentées par SPP(ME)."

The observations of the Claimant submitted that the Tribunal should

"reject Respondent's objections to the Centre's jurisdiction over this dispute between SPP(ME) and the Government of Egypt regarding the State's failure to compensate this foreign investor for the losses it suffered as a result of the State's cancellation of the Pyramids Oasis project."

11. On July 8, 1985, the Centre received from the Respondent a further pleading addressing certain arguments made by the Claimant in its observations.

12. Oral argument on the question of jurisdiction was held at the Permanent Court of Arbitration in the Hague on July 10 and 11, 1985. The hearings were recorded in the form of a verbatim transcript in the English and French languages. At the end of the oral proceedings, the Tribunal requested that the Parties submit certain additional materials concerning Egypt's Law No. 43 of 1974 concerning the Investment of Arab and Foreign Funds and the Free Zones.

13. On July 23, 1985, the Parties advised the Centre that Southern Pacific Properties Limited ("SPP"), the parent company of SPP(ME) and also a Hong Kong corporation, had been joined as a claimant in the proceedings subject to the Respondent's reservation of jurisdictional defenses.

14. In response to the request made by the Tribunal at the end of the oral proceedings, SPP and SPP(ME) ("the Claimants") and the Respondent filed supplemental materials concerning Law No. 43 on August 21 and August 27, 1985, respectively.

15. On November 27, 1985, the Tribunal rendered a Decision on Preliminary Objections to Jurisdiction. In this decision, the Tribunal unanimously rejected certain of the Respondent's objections concerning jurisdiction and stayed the proceedings on the Respondent's remaining jurisdictional objections pending final disposition by the French courts of certain concurrent proceedings involving the same dispute. The operative part of the Tribunal's decision provided:

"THE TRIBUNAL UNANIMOUSLY DECIDES:

- A. To reject the objections to its jurisdiction raised by the Respondent alleging that Article 26 of the ICSID Convention, as well as the pursuit by the Claimants of alternative remedies, bar the claim in the present case;
- B. To reject the objection to its jurisdiction raised by the Respondent alleging the withdrawal from the Claimant of the benefits of Law No. 43;
- C. To reject the objection to its jurisdiction raised by the Respondent contending that the provisions of Article 8 of Law No. 43 do not apply to this investment dispute; and
- D. To stay the present proceedings on the Respondent's remaining objections to the Centre's jurisdiction until the proceedings in the French courts have finally resolved the question of whether the Parties agreed to submit their dispute to the jurisdiction of the International Chamber of Commerce."

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16. On January 6, 1987, the French *Cour de Cassation* issued a decision the effect of which was to finally determine that the Respondent had not agreed to submit the present dispute to arbitration under the auspices of the International Chamber of Commerce ("ICC").

17. On January 29, 1987, the Claimants filed a request with the Tribunal asking that the present proceedings be resumed in view of the *Cour de Cassation's* decision of January 6, 1987.

18. On March 24, 1987, at the request of the Respondent, the Tribunal invited the Parties to file further written pleadings and supporting materials.

19. The Respondent filed its *Mémoire*, dated April 30, 1987, and requested further hearings on the remaining jurisdictional issues. The Claimants then filed their "Observations on Respondent's Jurisdictional Memorandum," dated May 20, 1987.

20. The Tribunal met in London on May 25-27, 1987. After reviewing the new materials filed by the Parties, and in consideration of its Decision on Preliminary Objections to Jurisdiction of November 27, 1985 and the decision of the French *Cour de Cassation* of January 6, 1987, the Tribunal unanimously decided to accede to the Respondent's request for further hearings on the question of the Centre's jurisdiction.

21. The final hearings on the question of jurisdiction were held in Paris on September 8, 1987. At the conclusion of the hearings, the Tribunal instructed the Parties to present their final written submissions on the jurisdictional issues, together with an enumeration of the specific arguments relied on to support those submissions, by September 25, 1987.

22. The Claimants' "Final Submission on Jurisdiction" dated September 25, 1987 submitted that the Tribunal should

"determine in favor of Claimants the remaining jurisdictional issue, to rule that the Arab Republic of Egypt ("A.R.E.") has consented to ICSID arbitration in conformity with the requirement of Article 25(1) of the ICSID Convention, and to take jurisdiction over the investment dispute between the parties."

23. The Respondent's *Mémoire en Réplique* dated September 25, 1987 did not contain formal submissions as such, but reiterated certain points made by the Respondent's counsel at the hearing held in Paris on September 8, 1987, and responded to arguments made by counsel for the Claimants at that hearing.

24. The Tribunal conducted its final deliberations on the question of jurisdiction in Washington on December 7-12, 1987. On April 14, 1988, a majority Decision on Preliminary Objections to Jurisdiction was signed. The operative part of the Tribunal's decision provided:



“THE TRIBUNAL DECIDES:

(A) To reject the objection to its jurisdiction raised by the Respondent alleging that Article 8 of Law No. 43 does not suffice to establish Egypt's consent to the Centre's jurisdiction;

(B) To reject the submission of the Claimants that the Tribunal adopt and incorporate as its own the pertinent findings of fact made by the ICC tribunal; and

(C) Consequently, and in accordance with Rules 25 and 41, to instruct the President to fix the time limits for further proceedings on the merits in consultation with the Parties.”

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25. On October 5, 1988, the Tribunal fixed December 5, 1988 as the date for the filing of the Claimants' Memorial on the merits. On November 17, 1988, this time limit was extended to January 5, 1989 and on January 4, 1989 it was further extended to February 15, 1989. At the same time, the Tribunal fixed June 25, 1989 as the time limit for the filing of the Respondent's Counter-Memorial. The Centre received the Claimants' Memorial on February 16, 1989.

26. Meanwhile, on November 14, 1988, the Centre received from the Respondent an application for annulment of the Tribunal's Decision on Preliminary Objections to Jurisdiction of April 14, 1988. In a letter dated December 9, 1988, the Acting Secretary-General of ICSID notified the Respondent of his decision not to register the application for annulment on the ground that the Tribunal's decision of April 14, 1988 was not an “award” as that term is used in Article 52 of the Washington Convention and Rule 50 of the Centre's Arbitration Rules.

27. The time limit for filing the Respondent's Counter-Memorial was extended on May 16, 1989 to September 7, 1989, and again on August 31, 1989 to September 15, 1989. The Centre received the Respondent's Counter-Memorial on September 18, 1989.

28. On October 12, 1989, the Tribunal fixed a schedule for the filing of the remainder of the written pleadings, with the Claimants' Reply to be filed by December 5, 1989 and the Respondent's Rejoinder to be filed by February 20, 1990. The Centre received the Claimants' Reply on December 28, 1989 and the Respondent's Counter-Reply on February 22, 1990.

29. On March 14, 1990, the President of the Tribunal held a consultation with representatives of the Parties in order to agree on the date and place

for the final hearings on the merits. It was agreed to hold the final hearings in Paris.

30. On April 16, 1990, the President of the Tribunal issued a procedural order fixing September 3–11, 1990 as the dates for the hearings on the merits in Paris and providing further directions to the Parties including, *inter alia*, directions that they file written summaries of the relief claimed after the hearings. Following agreement by the Parties on certain procedures for the oral proceedings, the Tribunal, on August 23, 1990, issued a procedural order in respect of the conduct of the hearings.

31. The final hearings on the merits were held in Paris during the period September 3–11, 1990. The Tribunal heard testimony by witnesses and experts, as well as oral argument. The witnesses and experts appearing on behalf of the Claimants were: Mr. Ralph M. Grierson, Mr. Gerald Walker, Mr. Norbert Stibrany, Mr. William D. Birchall, Mr. A. Anthony McLellan, Mr. Ronald Blainey and Mr. David H. Gilmour. The witnesses and experts appearing on behalf of the Respondent were Professor Rainer Stadelmann, Mr. Michael Renshall, Ms. Soheir Azab and Professor Abdel Moneim Awadallah. In addition, the Respondent submitted an affidavit by Mr. Atif M. El-Azab.

32. At the close of the hearings, the Tribunal—in response to a request by the Respondent—ruled that the Respondent could submit written comments on the exhibits that had been produced for the first time during the hearings by the Claimants' witnesses and experts. The Tribunal asked that these comments be submitted by October 31, 1990.

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33. On September 21, 1990, the Claimants, pursuant to the Tribunal's procedural order of April 16, 1990, submitted a document entitled “Final Conclusions and Prayer for Relief” which summarized the relief sought by the Claimants as follows:

“The Claim

A. The Claimants claim primarily:

(1) the value of the investment in ETDC computed at \$41,000,000, or such other sum as the Tribunal may award, on the basis of (i) the DCF methodology and/or (ii) the share sales to the Saudi Princes; and

(2) the amount of the loan to ETDC, amounting to \$1,650,000; and

(3) post-cancellation costs for 1978 and 1979, amounting to \$623,000; and

(4) post-cancellation, legal, audit and arbitration costs from 1980 to 1990, amounting to \$5,108,000;

together with interest:

a. on the value of the investment ((1) herein) at 12.6% compounded annually, amounting (on a value of \$41,000,000) to \$125,000,000; and

b. on (3) herein at 12.6% compounded annually, amounting to \$1,874,000; and

c. on the loan to ETDC ((2) herein) at the contractual rate, amounting to \$6,931,000.

B. The Claimants claim secondarily, as an alternative to A above, the value of its investment in ETDC on the basis of its out-of-pocket expenses (items 1-6), on the view that the project would necessarily have realized, at the very least, the amount invested in it, and an additional amount (item 7) to compensate for loss of the chance or opportunity of making a commercial success of the project:

(1) the amount of the loan to ETDC, amounting to \$1,650,000; and

(2) further monies lent at no interest to ETDC, amounting to \$408,000; and

(3) the capital invested, amounting to \$1,310,000; and

(4) development costs pre-cancellation, amounting to \$2,254,000; and

(5) post-cancellation costs for 1978 and 1979, amounting to \$623,000; and

(6) post-cancellation, legal, audit and arbitration costs from 1980 to 1990, amounting to \$5,108,000; and

(7) such additional amount as shall be fixed by the Tribunal to compensate for the loss of the chance or opportunity of making a commercial success of the project;

together with interest:

a. on the loan to ETDC ((1) herein) at the contractual rate, amounting to \$6,931,000; and

b. on (3) herein at 12.6%, compounded annually, amounting to \$4,303,000; and

c. on (4) herein at 12.6%, compounded annually, amounting to \$7,404,000; and

d. on (5) herein at 12.6%, compounded annually, amounting to \$1,874,000.

C. The Claimants claim as a further, subsidiary alternative to A and B above the out-of-pocket expenses represented by items B (1)-(6) above, together with interest as set forth in items B a-d above.

Interest on all items has been calculated to 31 August 1990. The Claimants ask that further interest be added to take the computation to the date of award.

Post-Award Interest

The Claimants claim post-award interest at a commercial rate on the final sums awarded, commencing 30 days after the date of the award and running until the date of payment.

The Object of the Award

Claimants claim that any and all amounts recognized by the Tribunal under claims A, B and C above should be awarded:

(i) to SPP (Middle East) Limited and Southern Pacific Properties Limited, jointly; and

(ii) to the extent that the prayer in part (i) herein is not recognized, then to SPP (Middle East) Limited alone; and

(iii) to the extent that the prayers in parts (i) and (ii) herein are not recognized, then to Southern Pacific Properties Limited alone.

Respondent's Counterclaim

Respondent's counterclaim and the relief sought by it should be denied in all respects."

34. The Respondent filed a summary of the relief claimed on September 25, 1990, requesting that the Tribunal decide the case as follows:

"SOUS la réserve expresse de la question de la compétence juridictionnelle (ID2) (1)(1), la R.A.E. demande au Tribunal arbitral qu'il lui plaise dire et juger:

(1) On désigne ci-après:

- le Mémoire en Réponse de la R.A.E. du 15/9/1989,

Facts: *I F*; Droit: *I D*

- le Mémoire en Réplique du 20/2/1990,

Facts: *II F*; Droit: *II D*

*II SUR LE DROIT APPLICABLE AU LITIGE*

1) Qu'en désignant expressément, notamment dans le Heads of Agreement, avec différentes lois égyptiennes, la loi 43/74, les parties ont choisi le droit égyptien comme loi applicable à leurs litiges, y compris le droit administratif, et ce conformément à l'article 42.1, 1ère phrase de la Convention de Washington (ID, 12 et s.; IID 32 et s.);

2) Que le droit égyptien incorpore différents principes et normes de droit international, et spécialement la Convention de l'UNESCO du 16 novembre 1972 pour la protection du Patrimoine Mondial, culturel et naturel applicable à l'espèce; qu'en revanche sont inapplicables les deux Traités bilatéraux entre l'Egypte et le Royaume Uni invoqués par SPP et SPP (ME) (ID 21 et s. ; II, D, 40 et s.)

3) Que, de toute manière, la Convention précitée de l'UNESCO s'impose à l'Egypte en tant qu'obligation internationale.

## II/ SUR LES DEMANDES DE SPP (ME) ET SPP

### A/ SUR L'IRRECEVABILITE DES DEMANDES

1) Que SPP (ME) ne justifie pas que son Projet ait été régulièrement approuvé par le "Board of directors" de l'Autorité Générale des Investissements (G.I.A.) conformément à l'article 1 de la loi 43/74 et aux articles 33 et suivants du Règlement 91/1975 portant application de cette loi (ID 3 et s. ; II D, 16 et s.).

2) Qu'en conséquence, le décret du 4 décembre 1975 du Ministre de l'Economie ne peut pas valoir approbation régulière ni du Projet de SPP (ME), ni de l'incorporation d'E.T.D.C. dans le cadre de la loi 43/75, II D, 28 et s.

3) Que SPP n'a présenté dans ses mémoires écrits aucune demande pour son compte ; que les demandes de paiement à son profit présentées verbalement et subsidiairement au cours des audiences des 3/11 septembre 1990, sont irrecevables comme étant tardives et non conformes aux dispositions du Règlement de Procédure d'arbitrage du CIRDI; qu'au surplus, elles n'ont été assorties d'aucune justification.

4) Qu'en tout état de cause, les demandes de SPP et SPP (ME) sont irrecevables et en tout cas mal fondées en raison des faits de corruption que révèlent les comportements de SPP et SPP (ME) notamment quant aux "développement costs" non imputés à E.T.D.C.; que, subsidiairement, il conviendrait d'ordonner une expertise pour vérifier la réalité de ces coûts, et les destinataires réels des paiements intervenus (II, F 117 et s. ; II D, 110 et s.).

### B/ SUR LE MAL FONDE DES DEMANDES de SPP (ME) et SPP

#### B.1 Principalement

Que la R.A.E. n'a ni nationalisé ni confisqué les droits de SPP (ME) sur un "Projet" au sens de la loi 43/74, art. 7.

a) Qu'il n'y a pas eu de *nationalisation* à défaut de transfert desdits droits et du Projet au profit de l'Etat ou d'une collectivité publique (I D 36 ; II D 62).

b) Que la mesure de classement et d'expropriation pour cause d'utilité publique du terrain du Plateau était non seulement licite (ce qui n'est pas contesté) mais même obligatoire en raison de la Convention de l'UNESCO de 1972 précitée (I D 92 et s. ; II D 68 et s.)

c) Qu'il n'y a pas eu de "confiscation" des droits des demandeurs sur le Projet; qu'en effet, il n'y a pas eu privation de tels droits, le Projet étant seulement modifié dans l'une des ses modalités d'exécution conformément au droit administratif égyptien ; que, plus précisément,

1) les droits sur RAS EL HEKMA étaient intacts, ce qui n'est pas discuté (I D 111 et s. ; II D 83 et s.) ;

2) le blocage des comptes de E.T.D.C., puis la nomination d'un administrateur judiciaire constituait des mesures provisoires et conservatoires (I D 114; II D) ;

3) Il fut offert notamment lors des négociations de 1979 un terrain de remplacement proche des sites initiaux permettant la réalisation d'un projet analogue à celui qui avait été prévu en particulier dans le Heads of Agreement et le contrat du 12 décembre 1974, offre qui fut refusée sans examen sérieux (pièces F 37, F 43, F 51) (II F 111 et s. ; I D 150 et s. ; II D 87 et s.).

Que si, par extraordinaire, un doute subsistait, le Tribunal ordonnerait soit un transport sur le site, soit une expertise aux fins de vérifier la possibilité de réalisation d'un projet touristique sur ledit site de remplacement (I D 150).

4) La R.A.E. a également offert, au même moment, un dédommagement monétaire pour compenser les conséquences du changement de site (II D 91 et s.).

5) SPP (ME) n'a pas négocié de bonne foi, tant au regard du site de remplacement qu'elle a refusé d'étudier sérieusement, qu'au regard de la compensation monétaire, alors qu'elle présentait des demandes totalement dépourvues de justification, notamment quant aux "development costs" susmentionnés (I D 116 et s. ; II F 117 et s. ; II D 90 et s.).

6) Enfin, les droits de SPP (ME) sur le Projet étaient annulables ou résiliables en raison des causes de nullité du Projet et des fautes commises, précisées dans les Mémoires, (I F 169 et s. ; I D 124 et s. ; II F 101 et s. ; II D 100 et s.) et en particulier :

- de l'illégalité du Décret n 475/75 qui ne comprenait pas de carte en annexe et concernait un terrain déjà classé en partie domaine public, par le décret n 136 de 1955 (I F 129 et s. ; I D 125 et s.).

- de la dérive immobilière ("Housing") du Projet, contraire aux articles 3 et 4 de la loi 43/74 aux contrats et aux études de faisabilité présentées par SPP (I F 139 et s. ; I D 126 et s. ; II F 101 et s. ; II D 104 et s.).

#### B.2 Très subsidiairement, sur le préjudice

a) que la compensation doit être la "compensation appropriée", tenant compte des circonstances particulières de l'espèce (I D 76 et s. et 140 et s. ; III D 119 et s.).

b) Que parmi ces circonstances particulières figure au premier plan le fait -non contesté- que la R.A.E. ne s'est pas enrichie, et même s'est appauvrie sans autre raison que de protéger le patrimoine culturel mondial et de respecter une obligation internationale.

c) Qu'en tout état de cause, le *lucrum cessans* est exclu, en raison du caractère licite, et même obligatoire, des mesures (I D 73 et s. et 146 et s. ; II D 126 et s.).

d) Que les transactions exploitées comme références ne sauraient être retenues comme critère valable (II D 140 et s.), notamment à raison de leur caractère spéculatif.

e) Que la méthode D.C.F est inappropriée en raison de l'absence d'avancement suffisant du Projet, de même qu'est impossible toute prise en compte d'une quelconque "profitabilité" surtout pour un Projet aussi peu avancé (I D 156 ; II D 143 et s.).

f) Que l'évaluation des éléments de calcul de la méthode D.C.F sont contestables comme les experts de la R.A.E. l'ont établi (pièces F 50, D 26, D 27, D 28 ; II D 143).

g) Que les autres chefs de préjudice ne sont pas établis (II D 115 et 143).

Que la R.A.E. n'a pas pu vérifier les nombreux volumes de pièces produits par SPP aux audiences des 3/11 septembre 1990 à l'appui de ses demandes ; que si ces pièces tardives devaient être déclarées recevables, une expertise s'avèrerait indispensable pour les vérifier.

g) Que les intérêts moratoires sont soumis au droit égyptien et sont limités, en matière civile y inclus les contrats administratifs, à 4%, à partir du jugement, le montant total ne pouvant dépasser le capital (I D 159 ; II D 145 et s.).

Qu'en tout cas, le retard antérieur à janvier 1986, dû à la procédure C.C.I. engagée à tort par SPP ne saurait être imputé à la R.A.E.

### III. SUR LA DEMANDE RECONVENTIONNELLE DE LA R.A.E.

I D 165 ; II D 155)

Dire et juger que SPP, et subsidiairement SPP (ME) sont responsables à l'égard de la R.A.E. de la non réalisation des Projets, et qu'elles devront payer une somme forfaitaire de 30 millions de USD à titre de réparation du préjudice, incluant les frais de procédure.

Qu'en tout état de cause, SPP et SPP (ME) seront condamnées aux entiers dépens et frais de procédure."

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35. On November 27, 1990, the Tribunal extended the time limit for the submission of the Respondent's comments on the documents submitted by the Claimants' witnesses during the hearings on the merits to December 5, 1990. These comments, together with certain additional documents, were received by the Centre on December 3, 1990.

36. On December 21, 1990, the Claimants responded to certain points made by the Respondent in its submission of December 3, 1990.

37. On February 11 to 13, 1991, the Tribunal met in London and on February 13 it issued a procedural order requesting further information from the Parties as follows:

"1. Whereas, the Claimants have explained that they have incurred certain expenses in connection with what they describe as the planning, developing, financing and management of the project, adding that said expenses have been capitalized as development costs in the accounts of SPP(ME) before and after the measures taken in May 1978 by the Respondent.

2. Whereas, the Claimants have submitted as Exhibit 170 a letter dated 19 January 1981 from Coopers & Lybrand, with a summary of SPP(ME)'s development costs for the years 1975-1979, broken down by categories of expense.

3. Whereas, the above-referenced letter dated 19 January 1981 from Coopers & Lybrand states that the summary of development costs for each year from 1975 to 1979 "agrees in total by year to the audited accounts of SPP (Middle East) Limited, and is in accordance with the information contained in our audit files, which do not, however, provide a detailed analysis for each period shown in the summary." The letter further describes the audit procedures followed, indicating that a detailed analysis of these costs, prepared by employees of the company with reference to the various categories of expense, was provided to Coopers & Lybrand each year and "agreed by us to the expense accounts in the company's nominal ledger, in which all expenditure was recorded in the first instance." The letter adds that "[t]hose items which were material in relation to the total of these costs in each year were verified by us in order to ensure that the expenditure as recorded in the nominal ledger had been recorded correctly and had been authorised properly." This verification was carried out "by agreeing the selected items to the documentation supporting the expenditure, such as invoices and loan agreements and by performing tests on procedures operated by the company to ensure all payments were properly authorised" and by reviewing "minutes of the meetings of the Board of Directors."

4. Whereas, for its part the Respondent has stated in its Annex F-49 that the investigation of these expenses "sheds doubt over the components of

the unjustifiable developing costs which were not charged to ETDC. This investigation requires the appropriate and clear details with their supporting legal documents in relation to the nature and components of these costs." In this connection, the Respondent formally requested that the Tribunal order "une expertise pour vérifier la réalité de ces coûts et les destinataires réels des paiements intervenus."

5. Whereas, the Respondent has submitted as Annex F-72 a report by Peat, Marwick, Mitchell and Co. dated 14 August 1981, which states that "[i]t is not possible . . . to be satisfied that the costs incurred either up to 18 June 1978, or subsequently, relate to the Pyramids Project" and that "we do not understand why [these costs] were not directly recovered from ETDC."

6. Whereas, the Tribunal did not receive sufficiently clear and precise information and figures concerning the development costs, nor the necessary indications as to the nature and supporting documents of the expenditures involved, to be in a position to determine all of the related legal consequences.

For these reasons, the Tribunal decides the following:

a. The Claimants shall submit to the Tribunal and to the Respondent, within one month, a document indicating the nature, date and amount of the above-referenced development costs, including the names of the recipients of payments in excess of U.S. \$20,000 and a confirmation that these sums were legitimately and actually expended for the project and were directly connected with it. The document shall also contain an explanation of why these costs were not charged to or were not directly recovered from ETDC.

b. The Parties, within one month, shall submit to the Tribunal and to each other an itemized list of the legal and accounting fees relating to the present proceedings, indicating their amount, the respective dates and the phase of the proceedings to which those fees and expenses relate.

c. After receipt of the documents referred to in paragraphs a and b above, the Parties shall have one month within which to submit their comments thereon to the Tribunal."

38. On March 15, 1991, the time limit for the Claimants' submission of the information requested by the Tribunal in its procedural order of February 13, 1991 was extended to April 21, 1991. On March 25, 1991, the time limit for the Respondent's submission of the information requested in Paragraph 6(b) of the procedural order was extended to April 21, 1991, and the time limit for its submission of the information requested in Paragraph 6(c) was extended to June 21, 1991.

39. On April 22, 1991, the Centre received the Respondent's response to Paragraph 6(b) of the procedural order and on April 23, 1991 the Centre re-

ceived the Claimants' response to Paragraphs 6(a) and (b). The Centre received the Respondent's comments on the Claimants' response to the procedural order on June 26, 1991.

40. On July 9, 1991, the Claimants filed a response to the Respondent's comments of June 26, 1991, and on September 18, 1991, the Respondent filed a response to the Claimants' response. Although this final exchange of communications had not been requested by the Tribunal, the materials submitted by the Parties were nevertheless considered by the Tribunal.

41. The Tribunal convened its final deliberation on the merits in Paris on February 17, 1992. On February 18, 1992, the Tribunal issued a procedural order declaring the proceedings closed.

## II. THE FACTS

42. On September 23, 1974, a contract entitled "Heads of Agreement" was entered into by the Respondent (represented by the Minister of Tourism), the Egyptian General Organization for Tourism and Hotels ("EGOTH") and SPP, a company engaged in the development of tourist and resort facilities. EGOTH was at the time a public sector enterprise under the control of the Minister of Tourism, organized under Egyptian Law No. 60 of 1971.

43. The Heads of Agreement by its terms was entered into in accordance with certain Egyptian laws, including Law No. 43 of 1974 Concerning the Investment of Arab and Foreign Funds and the Free Zones. In the Heads of Agreement, EGOTH and SPP undertook to incorporate an Egyptian joint venture company to develop tourist complexes at the Pyramids area near Cairo and at Ras El Hekma on the Mediterranean coast. These projects were to be developed according to detailed "master plans" which were to be prepared by SPP and approved by EGOTH. The Ministry of Tourism agreed to secure the title to property and the possession of land necessary for the development of the proposed projects. The Ministry and EGOTH undertook to transfer the right of usufruct for such property to the joint venture company as part of the capital investment. They also undertook to assist in obtaining all necessary local approval for the execution of the projects in accordance with the master plans. SPP, for its part, agreed to obtain the necessary financing for the projects and to provide or arrange for all technical expertise required for the design, construction, management and marketing of the projects.

44. The Preamble of the Heads of Agreement, which was expressly made part of the Agreement by Article 1, provided:

"Whereas the Ministry of Tourism approved granting both 2nd and 3rd party [i.e., EGOH and SPP] the right to develop the areas as shown in the attached maps in the Pyramid's area and Ras El Hekma Zone.

This agreement is issued in accordance with laws No. 1 for the year 1973 relating to Hotels, Instalations and Tourism, and law No. 2 for the year 1973 relating to the supervision by the Ministry of Tourism on touristic sites and the development of such areas, and law 43 for the year 1974 relating to Arab and foreign funds invested in the A.R.E. with particular reference to government guarantees long term tax holidays, exemptions from import custom duties, etc."

45. Article 2 of the Heads of Agreement provided:

"Both 2nd and 3rd parties undertake to incorporate promptly an Egyptian joint venture company of which 40 percent would be subscribed by E.G.O.T.H. and 60 percent by S.P.P. (For the Pyramid area) and 30 percent by E.G.O.T.H. and 70 percent by S.P.P. (For Ras El Hekma)."

and Article 4 provided:

"FIRST party will secure the title of property and possession of land and both First and second party undertake to transfer the right of usufruct to the joint company as its part of the capital investment. Both M.T. [i.e., Ministry of Tourism] and E.G.O.T.H. undertake to transfer such right to the joint company immediately upon incorporation, any balance being transferred not later than 90 days thereafter."

46. On December 12, 1974, a contract entitled "Agreement for the Development of Two International Tourist Projects in Egypt" ("the December Agreement") was concluded between EGOH and SPP. The Preamble of the December Agreement referred to the Heads of Agreement, saying that:

"Following execution of the Heads of Agreement dated 23rd September, 1974, . . . and subsequent negotiations between the above parties, the following are agreed . . ."

Article 1 of the December Agreement provided for the formation of a joint venture company—the Egyptian Tourist Development Company ("ETDC")—to develop tourist complexes at the Pyramids and Ras El Hekma sites:

"A joint venture (stock) company with registered shares will be incorporated in Egypt for a duration of fifty years renewable, named the "Egyptian Tourist Development Company" (hereinafter referred to as "ETDC") which shall be responsible for the development and operation of the projects. The nominal capital shall be US\$2,000,000 (two million United States dollars) increasing to US\$10,000,000 (ten million United States dollars) at the end of the fifth year. The capital shall be subscribed 60 (sixty) per cent by SPP and 40 (forty) per cent by EGOH. On the fiftieth anniversary of the incorporation of ETDC, EGOH shall be entitled to an additional share at no cost in the capital of ETDC as will increase the EGOH shareholding to 50 (fifty) per cent of the total capital

of the company. The participation of EGOH in the capital of ETDC shall be represented by the rights of usufruct referred to in Articles 5 and 6 hereinafter. These rights are hereby agreed to be equal to the share of EGOH in the capital of ETDC namely 40 (forty) per cent at the incorporation of ETDC and through its duration and 50 (fifty) per cent beginning at the fiftieth anniversary of its incorporation."

47. SPP agreed in Article 3 of the December Agreement to arrange for the financing of the projects:

"SPP will be responsible for the arranging of US\$20,000,000 (twenty million United States dollars) finance on terms and conditions prevailing on the international market to be invested in the projects in the first four years from the date of approval of the Master Plans as referred to in Article 4 hereinafter, and will ensure over and above that all necessary additional finance required for both projects shall be provided by means of short and long term capital, both in free and local currency."

48. Article 4 provided that the development and management of the projects would be undertaken by ETDC

"within the general limits described in the maps attached to the Heads of Agreement, and in general accord with the Confidential Report, and as detailed in the Master Plans to be prepared. Each Master Plan shall recognise the appropriate regional plan and shall specify the various zones for the different types of development and shall include the location and description as well as the stages and priorities of all tourist facilities . . . For the Pyramids area there will be defined within the Master Plan area, the project site area of not less than 10,000 (ten thousand) feddans (approximately 10,000 acres) to which EGOH will receive title and ETDC the right of usufruct as provided in Articles 5 and 6 hereinafter and within which 5,000 (five thousand) feddans (approximately 5,000 acres) will be developed. The remainder will be parkland and other recreational facilities available for public use within the Master Plan."

49. With respect to the rights of usufruct that were to represent EGOH's capital contribution to the joint venture, Article 5 of the December Agreement stipulated that EGOH would

"use its best efforts to secure all the necessary Government approvals to enable ETDC the immediate possession of the land in both sites, and to ensure the transfer of the rights of usufruct to ETDC for its duration . . ."

and Article 6 provided:

"EGOH will pass irrevocably the right of usufruct to ETDC for its duration immediately EGOH receives title. ETDC shall be free to assign its right of usufruct and to rent, lease, manage, promote or assign any site, construction, recreational, residential or commercial facilities in both local and foreign markets, provided that they are developed and utilized in accordance with approved plans, but excluding the monument areas and those which are designated for public use within the project sites."

50. The December Agreement also provided in Article 17 that SPP would incorporate a holding company to own its shareholding in the joint venture:

"It is understood that SPP will be incorporating a holding company to own its shareholding in ETDC and it is agreed that SPP shall have the right to assign its rights, privileges, duties and obligations under this Agreement to this company in which SPP will have a controlling, but not necessarily majority, interest and in which it controls and directs management, provided the company satisfies EGOTH."

Such an assignment was subsequently made to SPP(ME), a wholly-owned subsidiary of SPP formed in 1974 to undertake the execution of the projects at the Pyramids and Ras El Hekma sites.

51. Article 20 of the December Agreement provided that any dispute relating to that agreement would be submitted to ICC arbitration, and Article 21 stated that the December Agreement had been made in accordance with various laws of the ARE, including Law No. 43 of 1974.

52. On the final page of the December Agreement, following the signatures of the representatives of EGOTH and SPP, there appeared the typewritten statement, "Approved, agreed and ratified by the Minister of Tourism, His Excellency, Mr. Ibrahim Naguib, on the Twelfth day of December 1974." Next to this statement the signature of the Minister and an official stamp were affixed.

53. On the same date that the December Agreement was signed, the representatives of EGOTH and SPP also signed a "statement" which provided:

"It is understood between contracting parties (EGOTH) and (S.P.P.) in concern of the agreement signed on the 12th of December 1974, that obligations which lie on EGOTH are subject to the approval of the competent governmental authorities and that the feasibility study proves the profitability of the projects."

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54. By a letter dated April 12, 1975, the General Organization for Investment of Arab Capital and Tax-Free Areas ("the GIA") notified SPP that the GIA's Board of Directors, by Decree No. 30/16-75, had approved the application for the establishment of a joint venture between EGOTH and SPP for the development of the tourist areas at the Pyramids and Ras El Hekma sites. The approval provided that the beneficial rights would accrue to the joint venture for a period of 50 years and then would revert to the State. This period was subsequently extended by the GIA to 99 years.

55. On May 22, 1975, the President of Egypt issued Decree No. 475 of 1975 which provided:

"The lands lying on each of the plateau of the pyramids and Ras-El-Hekma and whose features and dimensions are determined on the map and in the attached memorandum are assigned for the touristic utilization and the General Egyptian establishment for Tourism and Hotels itself or through one of its contributing companies will reconstruct and utilize these two areas."

56. On October 19, 1975, EGOTH as sole owner of the sites specified in Presidential Decree No. 475 transferred its right of usufruct for the sites "irrevocably" and "without restriction of any kind" to ETDC for the life of the joint venture.

57. On November 23, 1975, EGOTH and SPP(ME) signed a contract entitled "Preliminary Agreement of Incorporation" which provided for the incorporation of ETDC in conformity with Law No. 1 of 1973 Concerning Tourist Establishments and Law No. 43 of 1974. The incorporation of ETDC was subsequently authorized by Ministerial Decree No. 212 of 1975, issued by the Ministry of Economy and Economic Cooperation on December 4, 1975. This decree stated in its preamble that it was issued in conformity with *inter alia* "the [GIA] Board of Directors' Resolution No. 50/15/1975 at the session of 20th July, 1975; and the memorandum of the Deputy Chairman of the General Authority for Arab Investment dated 1st December, 1975."

58. By a letter dated April 1, 1976, the Chairman of EGOTH notified the Chairman of ETDC of the "formal approval of the MT [Ministry of Tourism] and EGOTH of the Pyramids Oasis Project as a whole . . . ."

59. On October 19, 1976, the Minister of Tourism wrote to the Chairman of ETDC, stating:

"I am writing to confirm my formal approval of the development and construction of your project pursuant to all terms of Law No. 2 of 1973.

This approval entitles you to proceed with your programme without the necessity of further reference to this Ministry."

60. On June 1, 1977, the Ministry of Tourism issued Decree No. 96 of 1977. Article 1 of this decree provided:

"The Ministry of Tourism approves the master planning for the tourist Pyramids Plateau Area, as well as the detailed planning of the first phase regarding the implementation of villages nos 1, 3 and 21 of the project of exploiting the tourist Giza Pyramids Plateau . . . ."

61. Construction began at the Pyramids site in July of 1977. Roads were laid, water and sewage trunk mains were installed, excavation for artificial lakes and a golf course was undertaken, and work on the main water reservoir was

nearly completed. Planning was completed for the Pyramids Oasis George V Hotel, as were the designs for a second hotel. In addition, ETDC sold 386 lots on which villas and multi-family accommodations were to be built, for a total of US \$10,211,000.

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62. In late 1977, the Pyramids Oasis Project began to encounter political opposition in Egypt and it became the subject of a parliamentary inquiry. Opponents of the project claimed that it posed a threat to undiscovered antiquities.

63. In a decree issued on May 27, 1978, the Ministry of Information and Culture declared the land surrounding the Pyramids to be "public property (Antiquity)." This decree was issued upon the recommendation of the Egyptian Antiquities Authority, which confirmed the presence of antiquities in the western part of the Al Giza Pyramids region.

64. On May 28, 1978, the GIA withdrew its approval of the Pyramids Oasis Project by Resolution No. 1/51-78:

"As a result of the Decree of the Minister of Culture and Information dated 28/5/78, considering the Pyramids Plateau one of the monumental areas, and accordingly the nature of the land had changed to be a public domain owned by the State as public property, it is impossible legally to implement this project on this land.

The Board of Directors of the General Investment Authority decided to drop its former issued agreement No 50/19-75, dated 20th July 1975, concerning the Pyramids Plateau, for the impossibility of executing this project on the Plateau, thus, according to the decree of the Minister of Culture and Information."

65. On June 19, 1978, Presidential Decree No. 267 was issued, cancelling Presidential Decree No. 475, which had declared that the lands on the Pyramids Plateau would be used for "tourist utilization." On July 11, 1978, the Prime Minister issued a decree declaring these same lands *d'utilité publique*.

66. At the request of EGOH, ETDC was put under judicial trusteeship by a judgment of the Giza Court for Urgent Matters rendered on June 19, 1978. The court appointed trustees who were put in charge of the management of the company's assets until a general meeting of the shareholders could take place.

67. On December 7, 1978, SPP and SPP(ME) filed a request for arbitration with the ICC in Paris against the Respondent and EGOH under the arbitration clause in the December Agreement. The Respondent objected to

the jurisdiction of the ICC tribunal. In the *acte de mission*, the Respondent and EGOH stated:

"The FIRST and SECOND DEFENDANTS wish to make it clear that their submission of an ANSWER and COUNTER-CLAIM does not constitute in any way an acceptance of the initiation of this arbitration proceedings. Their refusal of the arbitration proceedings is to remain firm until the Arbitrators render their final decision on the matter of jurisdiction. In case the Arbitrators affirm their jurisdiction over the subject matter at issue, the COUNTER-CLAIM shall be comprised within the said jurisdiction."

68. The ICC tribunal, in an award rendered on February 16, 1983, held *inter alia*:

"1. That the first Defendant, the Arab Republic of Egypt, pay to the First Claimant, Southern Pacific Properties (Middle East), Limited the sum of US\$12,500,000 (twelve million five hundred thousand) together with interest thereof at the rate of 5% per annum from the date in which the request for arbitration was received by the Secretary of the ICC Court of Arbitration (i.e. 1st December 1978) until payment.

2. That the claim by both Claimants against the second Defendant, the Egyptian General Company for Tourism and Hotels, be dismissed.

3. That the counterclaim by the said second Defendant against the Claimants be dismissed."

In dismissing the claim against EGOH, the ICC tribunal added:

"Different considerations might well apply if the Government had not been a party to the December, 1974 Agreement."

69. On March 28, 1983, the Respondent appealed the ICC award to the French *Cour d'Appel*.

70. By a letter dated August 15, 1983, SPP(ME) notified the Minister of Tourism that in its view the ICC award "is binding between the parties and finally dispositive of our dispute." At the same time, SPP(ME) added that:

"recognizing that your Government has taken the position that the ICC award was rendered without a jurisdictional basis, we hereby notify you that we accept and reserve the opportunity of availing ourselves of the uncontested jurisdiction of the International Center for the Settlement of Investment Disputes, under the auspices of the World Bank, which is open to us as a result of Law no 43 of 1974, Article 8 of which provides that investment disputes may be settled by ICSID arbitration."

71. On July 12, 1984, prior to the institution of the present proceedings, the *Cour d'Appel* annulled the ICC award on the ground that the Respondent was not a party to the December Agreement and therefore was not bound by the arbitration clause contained therein.



72. On November 28, 1984, the Claimants referred the decision of the *Cour d'Appel* to the *Cour de Cassation* (*Pourvoi N° 84/17/274*), requesting that the decision be set aside. This request was rejected by the *Cour de Cassation* on January 6, 1987.

### III. THE ISSUES REMAINING TO BE DECIDED

73. As recalled in Section I of this Award, the Tribunal disposed of the jurisdictional issues in two decisions, one issued on November 27, 1985 and the other on April 14, 1988. There remain to be decided a number of issues concerning the substantive merits of the case.

#### *The Applicable Law*

74. In addressing the remaining issues, it is appropriate to begin with the question of the law that is to be applied to the Parties' dispute. Article 42(1) of the Washington Convention provides that:

"The Tribunal shall decide a dispute in accordance with such rules of law as may be agreed by the parties. In the absence of such agreement, the Tribunal shall apply the law of the Contracting State party to the dispute (including its rules on the conflict of laws) and such rules of international law as may be applicable."

75. The Respondent contends that the Parties have implicitly agreed, in accordance with the first sentence of Article 42(1), to apply Egyptian law. It points out that the Parties' agreement with respect to the choice of law need not be express, and argues that in this case the choice of Egyptian law results from the preamble of the Heads of Agreement, which refers to Egyptian Laws No. 1 and No. 2 of 1973 and Law No. 43 of 1974. Pointing out that Law No. 43 provides that "[m]atters not covered by this Law are subject to the applicable laws and regulations," the Respondent argues that, according to this provision, "aucun autre droit que le droit égyptien n'a été choisi par les parties" and "toute lacune doit être comblée par l'application du droit commun égyptien applicable."

76. According to the Respondent, the second sentence of Article 42(1) is not applicable because it operates only "[i]n the absence of such agreement . . ." Thus, the Respondent argues, the role of international law is a limited one: it cannot be applied directly, but only indirectly through those rules and principles incorporated in Egyptian law such as the provisions of treaties ratified by the ARE and, in particular, the 1972 UNESCO Convention for the Protection of the World Cultural and Natural Heritage.

77. The Claimants, for their part, reject the notion that the Parties should be deemed to have agreed implicitly to the exclusive application of Egyptian law. In the Claimants' view, it is not the first sentence but the second sentence of Article 42(1) which becomes operative, so that the Tribunal should apply the "law of the Contracting State party . . . and such rules of international law as may be applicable." The Claimants acknowledge that their investment in Egypt was governed primarily by Law No. 43 of 1974, but they contend that the provisions of Law No. 43 do not cover every aspect of the dispute and that there is no agreement between the Parties on the rules of law to be applied by the Tribunal. In the absence of agreement, the Claimants argue, the second sentence of Article 42 (1) must apply.

78. In the Tribunal's view, the Parties' disagreement as to the manner in which Article 42 is to be applied has very little, if any, practical significance. Both Parties agree that Law No. 43 is applicable to their dispute. Nor is there any question that the UNESCO Convention is relevant: the Claimants themselves acknowledged during the proceedings before the French *Cour d'Appel* that the Convention obligated the Respondent to abstain from acts or contracts contrary to the Convention, stating:

"que les Etats étaient susceptibles d'engager leur responsabilité internationale envers les autres Etats signataires en persistant dans des actes ou contrats devenus contraires aux règles de la Convention."

79. Moreover, a consultation filed by the Respondent states:

"que si on applique l' Article 42, al. ler., 2ème phrase, le résultat est le même, les mêmes sources du droit régissant les mêmes rapports."

80. Finally, even accepting the Respondent's view that the Parties have implicitly agreed to apply Egyptian law, such an agreement cannot entirely exclude the direct applicability of international law in certain situations. The law of the ARE, like all municipal legal systems, is not complete or exhaustive, and where a lacunae occurs it cannot be said that there is agreement as to the application of a rule of law which, *ex hypothesi*, does not exist. In such case, it must be said that there is "absence of agreement" and, consequently, the second sentence of Article 42(1) would come into play.

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81. The Respondent has contended that certain acts of Egyptian officials upon which the Claimants rely are, under Egyptian law, legally non-existent or absolutely null and void. Specifically, the Respondent has assailed the validity of Presidential Decree No. 475 of 1975 because, *inter alia*, certain areas covered by the decree overlapped land which had been designated "public utilities

(antiquities)" by an *arrêté* of the Minister of Education issued in 1955. The Respondent argues that the quality of public domain is dominant and gives its character and nature to the whole area. The Respondent contends that because the public domain is inalienable and because the establishment of a usufruct constitutes an act of alienation, it follows that such an act would be absolutely null and void. The Respondent argues further that certain decisions of high-ranking government officials are invalid because they were not taken pursuant to the procedures prescribed by Egyptian law.

82. It is possible that under Egyptian law certain acts of Egyptian officials, including even Presidential Decree No. 475, may be considered legally nonexistent or null and void or susceptible to invalidation. However, these acts were cloaked with the mantle of Governmental authority and communicated as such to foreign investors who relied on them in making their investments.

83. Whether legal under Egyptian law or not, the acts in question were the acts of Egyptian authorities, including the highest executive authority of the Government. These acts, which are now alleged to have been in violation of the Egyptian municipal legal system, created expectations protected by established principles of international law. A determination that these acts are null and void under municipal law would not resolve the ultimate question of liability for damages suffered by the victim who relied on the acts. If the municipal law does not provide a remedy, the denial of any remedy whatsoever cannot be the final answer.

84. When municipal law contains a lacunae, or international law is violated by the exclusive application of municipal law, the Tribunal is bound in accordance with Article 42 of the Washington Convention to apply directly the relevant principles and rules of international law. As explained by one of the authors of the Washington Convention, such a process

"will not involve the confirmation or denial of the validity of the host State's law, but may result in not applying it where that law, or action taken under that law, violates international law." (A. Broches, "The Convention on the Settlement of Investment Disputes Between States and Nationals of Other States," *Recueil des Cours*, vol. 136, at p. 342 (1972).)

85. The principle of international law which the Tribunal is bound to apply is that which establishes the international responsibility of States when unauthorized or *ultra vires* acts of officials have been performed by State agents under cover of their official character. If such unauthorized or *ultra vires* acts could not be ascribed to the State, all State responsibility would be rendered illusory. For this reason,

"... the practice of states has conclusively established the international responsibility for unlawful acts of state organs, even if accomplished outside

the limits of their competence and contrary to domestic law." (Sorensen (ed.), *Manual of Public International Law*, New York, 1968, at p. 548.)

#### *The Change of Site*

86. The Respondent, in its Counter-Memorial and in the oral proceedings, has dealt extensively with what it describes as a "new fact" to which it attaches great importance, namely, that the project sites shown on the maps attached to the Heads of Agreement and the "Confidential Report" referred to in the December Agreement were for the most part outside and below the Pyramids Plateau and thus were different than the site where the project was finally implemented. The Respondent points out that four sites were delineated on the map that was signed by the Minister of Tourism and SPP and attached to the Heads of Agreement. Two of these sites were completely outside the Pyramids Plateau area; a third site—the second largest—was on the southwestern side of the Plateau and was nearer to the Sixth of October City than to the Plateau center; and the fourth site, which was quite small, was on the edge of the Plateau proper. The Respondent further points out that the Heads of Agreement recited that:

"the Ministry of Tourism approved granting both 2nd and 3rd party the right to develop the areas as shown in the attached maps . . ."

and then provided:

"Each complex will be developed according to a detailed Master Plan prepared and submitted by S.P.P. and approved by E.G.O.T.H. in accordance with and shown in the attached maps."

Consequently, the Respondent contends, the project with respect to which the Claimants seek compensation is not the project that the Respondent agreed to in the Heads of Agreement. According to the Respondent,

"A quick glance at the real map attached as "Annex A" to the "Heads of Agreement", and by reference to which the obligations of the Ministry of Tourism regarding the securing of title to the land and the establishment of a right of usufruct, shows that it contains not one compact site on top of the Pyramids Plateau, the limits of which are clearly delineated on the map itself, but in fact four sites . . . It is clear that the sites indicated in the "Heads of Agreement" concluded with the M.T. [Ministry of Tourism] are quite different, in fact have very little in common, with the single site to which the Claimants climbed with their project on top of the Pyramids Plateau."

87. The Respondent adds that the same pattern of several separate sites, situated for the most part outside of the Plateau area, more or less repeats itself in the map attached to the "Confidential Report" referred to in the December Agreement. In contrast, the Respondent points out, the site shown on the map attached to the "Preliminary Agreement of Incorporation" of ETDC, signed

by EGOH and SPP on November 23, 1975, sits all in one piece on top of the Plateau. The Respondent alleges that from the start the Claimants had been pressing for, and contriving to get, a single site on top of the Plateau, while the Egyptian authorities were adamant that the project should be implemented on several sites surrounding the Plateau.

88. The Respondent argues that this alteration of the agreed location of the project violated the Heads of Agreement and encroached upon an area protected by both Egyptian law and international law. According to the Respondent, the violation of the Heads of Agreement in respect of the sites was part of a larger design to transform the project into a "housing and urban development project" and entailed the violation of other imperative laws of the ARE concerning the protection of antiquities, urban development and the right of foreigners to own land in Egypt.

89. The Claimants, for their part, recognize that the map attached to the Heads of Agreement indicated four sites identified as "General Development Areas," none of which corresponds to the eventual project site (although the eventual site overlapped in small part two of the sites shown on the map). The Claimants assert, however, that the project site ultimately settled upon was agreed to and repeatedly endorsed by the Respondent. They contend that the evidence shows that Egyptian authorities suggested the Plateau site in the first place; that the Parties then proceeded to discuss and define the site together; and that by January of 1975 (at the latest) the Respondent had established—and all Parties had agreed to—the final site and that details of the site were approved in numerous decrees and other official documents. As evidence of these contentions, the Claimants call attention to a report of April 1975 on infrastructure availability at the Pyramids site which was commissioned by SPP and which refers to extensive and recorded consultations concerning the final site with numerous Egyptian Government organizations and contains several maps outlining the Plateau site.

90. The Claimants maintain that the map mentioned in the Heads of Agreement only indicated a number of possible development areas and that the precise location of the project was under discussion both prior to and after the signing of the Heads of Agreement. In this connection, the Claimants point to Article 4 of the December Agreement, which provided:

"ETDC will undertake the development and management of both projects within the general limits described in the maps attached to the Heads of Agreement, and in general accord with the Confidential Report, and as detailed in the Master Plans to be prepared. Each Master Plan shall recognize the appropriate regional plan and shall specify the various zones for different types of development and shall include the location and description as well as the stages and priorities of all tourist facilities.

For the Pyramids area there will be defined within the Master Plan area, the project site area of not less than 10,000 (ten thousand) feddans (approximately 10,000 acres) to which EGOH will receive title and ETDC the right of usufruct as provided in Articles 5 and 6 hereinafter and within which 5,000 (five thousand) feddans (approximately 5,000 acres) will be developed. The remainder will be parkland and other recreational facilities available for public use within the Master Plan."

91. The Claimants point out that the December Agreement was "[a]pproved, agreed and ratified" by the Minister of Tourism, and that knowledge of its contents—and particularly Article 4—must therefore be imputed to the Ministry. Article 4, according to the Claimants, makes clear that none of the parties to the Heads of Agreement—the Ministry of Tourism, EGOH or SPP—considered the project site to have been finally determined by the Heads of Agreement or the maps annexed thereto.

92. In response, the Respondent argues that the words "as detailed in the Master Plan to be prepared" in Article 4 of the December Agreement meant no more than that the master plan was to give the details of the project within the general limits described in the maps attached to the Heads of Agreement and the Confidential Report, and was not intended to derogate from those limits. The Respondent also contends that the change of site occurred without the knowledge of the President of Egypt, who had authorized the project on the basis of the original maps.

93. From the evidence, it is not clear precisely when the decision was made to locate the project on the Pyramids Plateau or whether the decision was taken at the initiative of the Claimants or of the Respondent. Resolution of these questions is not necessary to a decision in this case, however. Several documents in the record demonstrate conclusively that, even if the change of site was initiated by the Claimants, Egyptian authorities at the highest levels knew of and agreed to the final selection of the site on the Pyramids Plateau.

94. The most conclusive of these documents is Presidential Decree No. 475 of May 22, 1975. This decree was preceded by a draft decree submitted by the Minister of Tourism on March 30, 1975, together with a memorandum which referred to "two touristic zones on the Plateau of the Pyramids and at Ras El Hekma." On this basis, Presidential Decree No. 475 provided in Article 1 that:

"The lands lying on each of the plateau of the pyramids and Ras-El-Hekma and whose features and dimensions are determined on the map and in the attached memorandum are assigned for the touristic utilization and the General Egyptian establishment for Tourism and Hotels itself or through

one of its contributing companies will reconstruct and utilize these two areas." (Emphasis added.)

Unfortunately, the map referred to in Presidential Decree No. 475 was not placed in evidence by either Party. Nevertheless, the record establishes unambiguously that, in implementing Decree No. 475, the Egyptian Government—acting through and represented by a number of different agencies—authorized the location of the project site on the Plateau.

95. In its Counter-Reply, the Respondent alleges that certain administrative requirements were not observed with respect to the map referred to in Presidential Decree No. 475:

"the map of the Pyramids site which was said to accompany the Presidential Decree no. 475 for the year 1975 allocating the Pyramids land to EGOH was never published in the official Gazette as the law requires . . . Nor did these maps accompany the demand submitted for the registration of the Republic Decree with the Real Estate Registration Department—as law requires—on which ETDC ultimately bases its legal right of usufruct of the land . . ."

But even if such publication and registration was required by Egyptian law, it was the responsibility of the Respondent and not of the Claimants. Moreover, these alleged defects in the administrative registration of the site do not alter the fact that Presidential Decree No. 475 referred expressly to "[t]he lands lying on . . . the plateau of the pyramids."

96. Nor can the Tribunal overlook the fact that, subsequent to the promulgation of Presidential Decree No. 475, the Egyptian authorities repeatedly approved the location of the project on the Plateau. This approval took various forms. For example, the Minister of Tourism signed the contract of November 23, 1975, between EGOH and SPP(ME), incorporating ETDC. This contract referred to maps annexed to it which located the project on the Plateau. The incorporation of ETDC as provided for in this contract was subsequently authorized by the Ministry of Economy and Economic Cooperation in Decree No. 212 of 1975.

97. In February of 1976, four separate Governmental committees—the EGOH Committee, the Pyramids Plateau Committee, the Egyptian Tourist Development Committee and the Committee for Giza Survey Department—participated in the physical demarcation of the initial 4,000 feddan portion of the 10,000 feddan site on the Plateau.

98. Finally, and most importantly, the final master plan required by the Heads of Agreement—after being submitted to and commented upon by various Governmental agencies—placed the project on the Plateau. This defin-

itive master plan was formally approved by both EGOH and the Ministry of Tourism, the two Governmental parties to the Heads of Agreement.

99. In this connection, it should be noted that, even if the parties to the Heads of Agreement had intended when they signed the Heads of Agreement on September 23, 1974 that the project be located on the sites shown on the annexed map, those parties were certainly free to agree to a different site at some subsequent time; and it is clear that on April 1, 1976, when the Ministry of Tourism approved the master plan, all of the parties to the Heads of Agreement were in agreement that the project would be located on the Pyramids Plateau and not in the areas shown on the map annexed to the Heads of Agreement.

#### *The Nature of the Project*

100. The Respondent, in its Counter-Memorial and in the oral proceedings, has argued that in reality the project was not a tourist destination project but rather an urban land and housing development project, and thus was in violation of Article 4 of Law No. 43, which provides:

"Housing projects, constructed for the purpose of investment, may be undertaken only by Arab capital; foreign capital may not undertake housing projects even in participation with Egyptian capital."

The Respondent points out that Article 3(iii) of the same law defines "projects for housing and for urban development" as:

"investment in the division of land into parcels and the construction of new buildings together with the public utilities connected therewith."

The Respondent contends that this is precisely what the Claimants did in implementing the Pyramids Oasis Project: their purpose, as revealed in internal memoranda, was to remedy "the acute shortage of quality accommodation" in Cairo and profit from "the demand for recreational and second home accommodation," providing Cairo with "its first, recreational oriented suburb." The Respondent alleges that the Claimants' prime objective was to sell vacant building lots to Egyptians for Egyptian currency in order to obtain cash for their investment. It was asserted in this respect that the Claimants did not have the right to rent or sell vacant lots.

101. The Respondent further argues that the project was "a real estate operation involving the division of land" and was therefore subject to Law No. 52 of 1940 Concerning the Division of Land for the Purpose of Building. The Respondent points out that Article 1 of Law No. 52 defines "division" as:

"every parcelling of a piece of land to a number of pieces with the purpose of offering them for sale, barter, lease or "hekr" in order to construct

building on them if one of these pieces is not connected with an existing road.”

and that Article 9 requires that:

“Approval of the division shall be established by a Decree published in the Official Gazette. The publication of the Decree entails the annexation of public roads, squares, gardens and parks to the State’s public property.”

Finally, the Respondent points to Article 10 of Law No. 52, which provides:

“Shall be forbidden the sale of the divided land, its lease or its “takhir” before the issued of Decree referred to in the previous article and before the deposit in the mortgage office of a certified copy of that decree as well as of the list of conditions referred to in Article 7.

Shall also be forbidden the construction of buildings or the execution of work on the divided land before the issuance of the said Decree.”

102. The Respondent contends that the violation of an imperative law such as Law No. 43 of 1974 or Law No. 52 of 1940 renders the violating act null and void and the whole project annulable.

103. The Claimants, on the other hand, maintain that the sale of villa lots by ETDC was an integral part of the tourist destination concept and was fundamental to the proposals that SPP made to the Egyptian Government, since the lot sales were what made the project largely self-financing. The Claimants allege that representatives of the Government were fully advised of the concept and approved it. They also point out that lot sales had been used to finance SPP’s project in Fiji, which the Respondent’s representatives visited and studied prior to approving the Pyramids Oasis Project. In this connection, the Claimants recall that the Heads of Agreement referred to the plan to develop “interlinked residential and tourist destination complexes” and provided that the joint company “will be free to rent, lease, manage or assign any site . . . in both local and foreign markets . . .”, and that the December Agreement provided that “ETDC shall be free to assign its right of usufruct and to rent, lease, manage, promote or assign any site . . . in both local and foreign markets.”

104. The Claimants also draw attention to the November 23, 1975 joint venture contract—the “Preliminary Agreement of Incorporation”—between SPP(ME) and EGOH, which provided that ETDC

“may buy, sell right of usufruct, lease, rent the desert lands in the Pyramids and Ras El-Hekma sites (on the Mediterranean Coast) for touristic purposes.”

and Article 7 of the resolution of the Board of EGOH transferring the right of usufruct to ETDC, which stated:

“ETDC will have full authority and power . . . to transfer sell or lease the right of usufruct of any part of the sites to be developed to a third party without any restriction . . . .”

105. With respect to Law No. 52 of 1940, the Claimants allege that the Egyptian Government assured ETDC that this law was not applicable. In support of this allegation, the Claimants have submitted a letter dated February 9, 1977, from the GIA to ETDC’s attorney, which stated:

“We would like to inform you that said company is not subject to Law 52/1940, concerning the subdivision of lands to be developed, whereas said subdivisions are out of the boundaries of cities and villages included among the resolution of Minister of Housing, but said subdivisions are governed by Law 2/1973, regarding tourist establishments.”

106. In the opinion of the Tribunal, the sale to Cairo residents of villa sites where dwellings for permanent use might subsequently be erected did not detract from or conflict with the “interlinked residential and tourist destination” concept. An integrated tourist complex, which included hotels, apartments and villas as well as recreational facilities, would not lose its tourist nature or become a forbidden housing development simply because Cairo residents might purchase lots for weekend or second home accommodation or even for permanent residence. Indeed, the potential market of buyers described in the master plan approved by the Egyptian authorities included:

“3. The retirement market for foreign and domestic investors.

4. The foreign and domestic residential market including first and second homes (week-end villas, etc.)”

107. The Tribunal also heard uncontroverted testimony that in other resort areas local purchasers are attracted by the potential returns that can be earned from letting their furnished villas to tourists.

108. Moreover, a number of features which further the objective of tourist development differentiated this project from most housing development projects. For example, all purchasers of lots in the Pyramids Oasis Project were obliged to build villas within a limited period in order to contribute to the establishment of tourist facilities. The contract of sale for each lot contained a declaration to the effect

“that the Development covered by the sub-division plan is being developed as an integrated tourist and residential complex and that the covenants, conditions and restrictions herein contained are part of a common plan to benefit each and every lot in the Development.”

Among the “covenants, conditions and restrictions” referred to were obligations to build within a prescribed period of time, to refrain from subdivision of the lot or the erection of temporary buildings, to obtain approval of the

seller for any building works, to erect only one private house, to observe the building height prescribed for the particular lot and to refrain from conducting any business or trade on the lot. Some of these restrictions were enacted by decree of the Ministry of Tourism.

109. The evidence also shows that the Ministry of Tourism and other Egyptian authorities such as the GIA not only knew, but agreed, that the financing of the project's infra-structure was to be obtained in large part through the sale of vacant lots. The application to the GIA for the incorporation of ETDC specified that the financing of the project would come from "the sale and rent of the utilisations' right in respect of sites" and that "the profits accruing from the project comes through the utilisation of villa sites." Details of the plan to sell building sites were set forth in three separate reports submitted to the GIA prior to its approval of the project and in the master plan approved by the Minister of Tourism.

110. Various agencies and instrumentalities of the Egyptian Government, including the Giza Committee, the Ministry of Housing and Reconstruction, the Ministry of Tourism, EGOH and the GIA, approved or participated in the project with full knowledge that it would be largely financed by the sale of building sites. There is nothing in the record which indicates that any of these agencies or instrumentalities ever questioned the legality of the lot sales. Unless one assumes that these agencies and instrumentalities knowingly acted in disregard of Egyptian law, it is apparent that none of them considered the lot sales to be illegal or to render the project a "housing" project for purposes of Egyptian law.

111. Finally, the Tribunal notes that two reports prepared by the Respondent's financial experts and placed in evidence by the Respondent appear to acknowledge that the project was in fact a tourist project. The first of these reports, prepared by Peat Marwick McLintock, stated:

"It seems clear that the first stated object of ETDC was to develop international tourism within Egypt. We are not lawyers, but our interpretation as accountants of Article 3 as a whole is that other activities specified were either to facilitate this main aim or were ancillary to it. The stated objectives do not appear to rule out the division and sale of land (see Article 3-6'. . . the sale buying and leasing of property of all kinds within the Arab Republic of Egypt.) provided that any such activity serves the overall objective of tourist development."

The second report, prepared by Hazem Hassan & Co., stated:

"The prime objective of ETDC (as stated in its statutes which was published in the official Gazette in December 4, 1975) was to develop International tourism in both the Pyramids Plateau and Ras El Hekma areas through the establishment of hotels, theatres, restaurants, amusement

parks, touristic residential areas, touristic villages, clubs, cafes and other touristic establishments, using the most modern methods in tourism development."

112. In light of the foregoing, the Tribunal cannot accept the contention that the Pyramids Oasis Project was in reality a housing project, the implementation of which would have violated the various imperative laws of the ARE that have been invoked by the Respondent.

#### *The Financial and Technical Capacity of the Claimants*

113. The Respondent contends that SPP misrepresented its financial capacity and its tourism expertise when it proposed the Pyramids Oasis Project to the Egyptian Government and that the Claimants in fact lacked the ability to complete the project. In support of these contentions the Respondent has produced reports by financial experts which conclude, *inter alia*, that during the period 1972-1977 SPP's net assets per share and cover for its interest declined; that SPP had experienced certain financial difficulties with its operations in Fiji and Australia; and that ETDC apparently would have required other forms of finance to facilitate development of the Pyramids Oasis Project, including loan finance and revenues from lot sales.

114. The Claimants, for their part, maintain that SPP's experience and history, and that of its principals, were a matter of public record and were thoroughly investigated by Egyptian authorities prior to approval of the project. They point out that the Respondent even sent representatives to Fiji to study SPP's operation there. They further note that the allegations concerning SPP's financial and technical capacity were raised in February of 1978 in the People's Assembly where they were firmly rebutted by the Government.

115. With respect to the alleged financial difficulties in Fiji and Australia, the Claimants maintain that these were of a transitory character, that the economic crisis precipitated by the oil embargo in November of 1973 had a damaging effect on international tourism worldwide, and that SPP's situation improved subsequently to the point where its South Pacific hotel operation was sold in 1981 to a third party for US \$120,500,000.

116. The Tribunal will first note that the reports of financial experts relied upon by the Respondent do not conclude that the Claimants would have been unable to complete the Pyramids Oasis Project; rather, the reports state that SPP had encountered certain financial difficulties and conclude—consistent with what the Claimants have argued—that financing of the project was dependent on lot sales.

117. More importantly, the evidence shows that SPP had obtained at the required times the funds necessary to finance the Pyramids Oasis Project

according to the agreements that had been concluded and the method of financing that had been envisaged. Under the December Agreement, SPP was to "arrange for" US \$20,000,000 in financing over the first four years and "ensure" that all additional financing for both the Pyramids Oasis and Ras El Hekma Projects (total costs for both projects were estimated to be US \$400,000,000) would be provided by short and long term loans. SPP arranged the US \$20,000,000 of financing through a US \$12,000,000 share issue to Triad Holding Corporation S.A. and sales of SPP(ME) shares to two members of the Saudi Arabian royal family totalling US \$8,750,000.

118. Pursuant to the joint venture agreement of November 23, 1975 between EGOH and SPP(ME), the latter was to make capital contributions to ETDC as follows:

<i>Year</i>	<i>Amount</i>
1	\$510,000
2	\$400,000
3	\$400,000
4	\$400,000
5	\$330,000

The first three payments were made on or before the due date. The project was cancelled before the fourth payment was due.

119. Under the loan agreement of April 15, 1976, SPP(ME) granted ETDC a loan facility of up to US \$15,000,000. At the time the project was cancelled, SPP(ME) had advanced ETDC US \$1,650,000, plus interest, under the loan agreement.

120. The Claimants engaged various consultants to undertake the design and planning of the project. In June of 1977, a contract was awarded for the initial civil works and construction began on the site the following month. This construction involved roads, sewage systems, water reservoir facilities, artificial lakes and a golf course. In addition, the design work for two hotels had been completed. At the time of cancellation, ETDC had spent over US \$9,500,000 on development costs.

121. The evidence shows that the subsequent difficulties encountered by ETDC in obtaining financing for the hotels were due in large part to the failure of the Egyptian authorities to provide certain infrastructure services and to obtain customs clearance for materials and equipment imported for the project. The Heads of Agreement provided that the Ministry of Tourism would

"take appropriate measures to ensure the provision of basic infrastructure by Government to the boundaries of the sites."

The December Agreement provided that EGOH would

"use its best efforts to ensure that basic suitable infrastructure is provided to the boundaries of the respective areas at no cost to SPP or ETDC, such infrastructure to comprise roads, water supply, power supply, telephone facilities and ancillary public utilities, all of which shall be sufficient for the adequate development of each area."

and that EGOH would

"assist in acquiring permits for obtaining materials and supplies necessary for the projects."

During the months preceding the cancellation of the project, SPP(ME) wrote to EGOH and the Ministry of Tourism repeatedly, stating that the failure of the Government to provide infrastructure to the project's boundary and to clear equipment and materials through customs was jeopardizing the further financing of the project.

122. It is also apparent from the evidence that opposition to the project in Egypt and the resulting uncertainties about its future further contributed to the reluctance of foreign investors to participate in joint ventures for the construction and operation of the hotels.

123. As to the Claimants' financial means, the record shows that the Parties understood and accepted that most of the costs to be incurred for the project would be "self-financed," that is, financed with revenues generated by the project itself. Thus, the infrastructure was to be financed by lot sales, as had been done in the Fiji operation. The self-financing aspect of the project was explained by the Minister of Tourism and the Minister of Economy and Economic Cooperation in statements to the People's Assembly, as follows:

"The finance of the project is based originally on the concept of self-financing to every step, considering that the project is enormous and needs a large amount of financing, and can not be based on the principle of owned capital of the project, otherwise it will need an enormous capital which is not possible for any company to provide. For this reason the finance will follow gradually the implemented portions of the project which its revenue will be re-invested to implement the following stages."

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124. It is also evident that the Claimants had substantial experience and expertise in the tourism business prior to becoming involved in the Pyramids Oasis Project. At the hearings held in The Hague on July 10-11, 1985, Mr. Peter Munk, Chairman and Chief Executive Officer of SPP, stated that SPP was founded in 1960 for the purpose of developing tourist resorts; that SPP developed only tourist resorts and facilities; that it was the largest hotel owner in

Australia, Fiji and New Guinea; that it operated in seven countries and employed over 5,000 people; and that its major shareholders included the P&O Steamship Company and Jardine Matheson.

125. Moreover, the Egyptian Government itself confirmed SPP's experience in the tourist resort business before entering into the December Agreement. In a letter published in *Al-Akhabar* on September 4, 1977, the Minister of Tourism stated:

"we like to make clear that the General Egyptian Company entered into the contract with S.P.P. only after enquiring about the said company through our Embassy in London and our consulate in Hong Kong and through the relevant security authorities and banks. The company submitted documentary evidence of its capabilities and competence before the Egyptian Company decided to enter into contract. It is important to say that this company is a holding company and has other subsidiaries. Some of the shareholders are companies with international reputations such as the P. V.[sic] O. and the Hotels Company."

And in a written answer to the People's Assembly, the Minister of Tourism stated that the delegation of Egyptian officials which travelled to Fiji "for the purpose of visiting the project which SPP had erected there and to examine its standards of planning, construction, management, marketing and profits," had "certified that the Company has a high degree of expertise, excellent capabilities and the full ability to perform the project."

126. In light of the foregoing, the Tribunal must reject the contention that the Claimants lacked the requisite expertise and experience to properly implement the Pyramids Oasis Project.

#### *The Allegation of Irregular Contacts and Connections*

127. The Respondent's pleadings contain repeated allusions to irregular contacts and business connections on the part of the Claimants. The Respondent also alleges that certain individuals upon leaving Government service were employed by the Claimants. Finally, it is alleged that the Claimants bypassed normal Government channels of communication and went "right to the top." On these grounds, the Respondent requests the Tribunal to declare that:

"les demandes de SPP et SPP(ME) sont irrecevables et en tout cas mal fondées en raison des faits de corruption que révèlent les comportements de SPP et SPP(ME)."

128. Nowhere, however, is there any specific allegation of unlawful conduct on the part of the Claimants which could conceivably vitiate the relevant agreements or excuse non-performance of the Respondent's obligations under those agreements. The Respondent, at the end of its Counter-Reply, in effect admits the lack of concrete evidence in this respect when it states:

"Indeed nothing we have said in our Counter-Memorial or Counter-Reply should be construed as an accusation, or allegation of misconduct regarding any particular Egyptian Official referred [to] . . ."

The particular persons whom the Respondent has exempted from any allegation of misconduct are the very same persons who established the initial contacts with the Claimants, who invited the Claimants to visit Egypt for the first time, and who—as high ranking authorities in the Government—were called upon to make important decisions with respect to the project.

129. When the Pyramids Oasis Project was under consideration in the People's Assembly, the Vice Speaker, Dr. Gamal El Oteify, put a number of questions to the Minister of Tourism concerning "the agreement concluded with the foreign company concerning the tourist exploitation of the Pyramids Plateau and the Ras el Hekma site." Among these was the following:

"Was there any intermediary involved in the conclusion of this agreement?"

The Minister answered in writing as follows:

"The Note presented to the Supreme Committee for Economic and Political Planning in its session dated April 27, 1975, is attached herewith. This certifies that there were no intermediaries in this agreement."

130. The Respondent has questioned the English translation of the Minister's answer, asserting that instead of "This certifies that there were no intermediaries in this agreement," the Arabic original should be translated as "It appears from this that there was no intermediation in (for) this agreement." It is not necessary, however, for the Tribunal to resolve this question of translation. Even if the Respondent's translation is accepted, the answer, emanating from the Minister of Tourism and addressed to the People's Assembly, is sufficient to show that the Egyptian authorities at the time were satisfied that no intermediaries had been involved in the making of the agreement.

131. The record also shows that, before entering into any commitments with the Claimants, the Egyptian authorities made a number of inquiries through their embassies in Australia and Hong Kong and "received many letters from international offices which contain many details about this company." It must be concluded that those references satisfied the authorities, since they continued negotiating with the Claimants.

132. Thus, the allegations concerning irregular contacts and connections are not supported by the evidence in the record and are based on suppositions, guilt by association and what the Respondent describes as "*commencement de preuve*." On such grounds, it is simply not possible to reach the findings of fact and conclusions requested by the Respondent.



*The Status of SPP and SPP(ME) Under Law No. 43*

133. The Respondent has raised an objection of admissibility against the claims in this case on the ground

"1) Que SPP (ME) ne justifie pas que son Projet ait été régulièrement approuvé par le "Board of Directors" de l'Autorité Générale des Investissements (GIA) conformément à l'article 1 de la loi 43/74 et aux articles 33 et suivants du Règlement 91/1975 portant application de cette loi.

2) Qu' en conséquence, le décret du 4 décembre 1975 du Ministère de l' Economie ne peut pas valoir approbation régulière ni du Projet de SPP (ME), ni de l' incorporation d' ETDC dans le cadre de la loi 43/74."

134. By these submissions the Respondent has raised an objection which in its view goes to the very essence of the case: that SPP(ME) does not have the status of an investor under Law No. 43 because the GIA was never asked to consider SPP(ME) as the entity that would make the investment in the Pyramids Oasis Project, and never agreed to extend or transfer to SPP(ME) the authorization which was granted to the parent company, SPP. The Respondent points out that Decree No. 91 of 1975, which contains the regulations for the establishment of new projects under Law No. 43, requires that information concerning the investor be furnished to the GIA. According to the Respondent, the information provided to the GIA in connection with the Pyramids Oasis Project concerned only SPP, not SPP(ME), and the GIA never authorized or approved the substitution of SPP(ME) for SPP as the investor that was to implement the Pyramids Oasis Project under Law No. 43. For these reasons the Respondent contends that SPP(ME) was not an "approved investor" under Egyptian law and consequently cannot invoke any rights or privileges derived from Law No. 43.

135. The Claimants acknowledge that the transfer of rights from SPP to SPP(ME) was never expressly "authorized" as such in a GIA document. They maintain, however, that the GIA did in fact approve the substitution of SPP(ME) for SPP as the investor who was to implement the Pyramids Oasis Project under Law No. 43. The Claimants point out that Decree No. 212 of 1975, issued by the Ministry of Economy and Economic Cooperation, authorized the incorporation of a joint venture between SPP(ME) and EGOTH "[i]n conformity with . . . [t]he [GIA] Board of Directors' Resolution No. 50/19/1975 at the session of 20th July, 1975; and the memorandum of the Deputy Chairman of the General Authority for Arab Investment dated 1st December 1975."

136. The Claimants also point out that it was SPP(ME) who in fact made the investment and implemented the authorized joint venture under Law No. 43, and that it was SPP(ME) who supplied the capital contributions and loans

in accordance with the foreign investment regulations. The Claimants' emphasize that the Respondent accepted SPP(ME)'s performance and that it was SPP(ME)'s rights under the contract and as a shareholder in ETDC that were directly affected by the cancellation of the project. Finally, the Claimants recall that Article 17 of the December Agreement provided that:

"It is understood that SPP will be incorporating a holding company to own its shareholding in ETDC and it is agreed that SPP shall have the right to assign its rights, privileges, duties and obligations under this Agreement to this company in which SPP will have a controlling, but not necessarily majority, interest and in which it controls and directs management, provided the company satisfies EGOTH."

137. The gist of the Respondent's argument is that, for an investment to be protected by Law No. 43, there must be an express and specific decision of the GIA authorizing the company concerned to make the investment, and SPP(ME) cannot produce such an authorization. The Respondent contends that the silence of the GIA with respect to the transfer of rights from SPP to SPP(ME) cannot be deemed a sufficient authorization since the GIA must make an express decision in each case after examining the financial capacity of the party who is to actually make the investment.

138. To decide this issue, it is necessary to examine Decree No. 212 and the circumstances surrounding its promulgation. This decree authorized the incorporation of ETDC as a joint venture between EGOTH and SPP(ME), and consequently recognized SPP(ME) as the foreign investor in the project.

139. As the Respondent points out, Decree No. 212 was issued by the Ministry of Economy and Economic Cooperation, not by the GIA. However, the GIA played a decisive part in the promulgation of Decree No. 212. As noted above, the recitals in the preamble of this decree include a statement that it was issued "In conformity with . . . the memorandum of the Deputy Chairman of the General Authority for Arab Investment dated 1st December, 1975." The full text of this memorandum was requested by the Tribunal during the final hearings in Paris and was produced by the Respondent on November 27, 1990. It is true, as the Respondent has observed, that the first page of this memorandum refers to the creation of joint venture with SPP, without mentioning SPP(ME). It is also true that the memorandum refers to a GIA approval dated July 20, 1975, which did not include SPP(ME). However, on the second page of the memorandum, the Deputy Chairman of the GIA stated:

"Conformément à la loi n° 43 de 1974, l'acte préliminaire et le statut ont été révisés et approuvés par l'Organisme public de l'investissement.

En date du 29/11/1975 n° 11, les deux associés ont homologué les signatures au bureau d'enregistrement des activités d'investissement créé au siège de l'Organisme, et ont présenté la preuve du dépôt à la Banque

nationale Egyptienne, du quart du capital en numéraires souscrit pour la première phase.”

There can be no doubt that the corporate documents which, according to the memorandum, were revised and approved by the GIA were those incorporating ETDC, i.e., the Preliminary Agreement of Incorporation (“*l’acte préliminaire*”) between EGOH and SPP(ME), and ETDC’s articles of incorporation and by-laws. Thus, the substitution of SPP(ME) for SPP was not only known to, but also approved by, the GIA.

140. This conclusion is confirmed by the express reference to the two joint venture partners (“*les deux associés*”) who—according to the memorandum—on November 20, 1975 deposited their authorized signatures at the GIA offices and submitted proof that SPP(ME) had deposited its capital contribution with the National Bank of Egypt.

141. The memorandum also shows that Decree No. 212 was actually drafted at the GIA and then submitted to the Minister of Economy and Economic Cooperation for his signature. It is legitimate to infer from this document that the GIA not only knew of the transfer of rights from SPP to SPP(ME), but also reviewed and approved such transfer, which included the rights resulting from Law No. 43 of 1974.

142. Finally, if anything more were needed to establish the status of SPP(ME) as an “approved investor” under Law No. 43, the statement of the Deputy Chairman of the GIA that the Preliminary Agreement of Incorporation between SPP(ME) and EGOH of November 23, 1975, as well as ETDC’s articles of incorporation and by-laws, had been revised and approved by the GIA is, in the Tribunal’s view, conclusive.

143. The Respondent argues that the regulations implementing Law No. 43 do not envisage the GIA granting formal approval of an investor by means of a memorandum, and that Decree No. 212, if so interpreted, might be considered null and void. There are, however, no apparent irregularities in this instrument. The memorandum was signed by the Deputy Chairman of the GIA Board because the Minister, who presided over the Board, could not sign a decision addressed to himself. For this reason, the GIA’s decision was communicated by the Deputy Chairman of the GIA in the form of a memorandum addressed to the Minister.

144. Thus, the evidence shows that the GIA knew that it was SPP(ME) who was in fact making the investment and performing the investor’s other obligations under the relevant agreements, and that the GIA, acting pursuant to Law No. 43, approved the joint venture between SPP(ME) and EGOH that

was formed to implement the project. In these circumstances, SPP(ME) must be deemed an investor entitled to the protections of Law No. 43.

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145. At the hearings, the Claimants took the position that if SPP(ME)’s status as a foreign investor could not be recognized under Egyptian law, then SPP would advance the claim in its own name. This position was based on the fact that the parent company, SPP, joined the present proceedings as a second claimant at the request of the Respondent. It announced its voluntary intervention in the hearings held in The Hague on July 10–11, 1985. This intervention was formally agreed to by the Respondent, whose Counsel subscribed a declaration reading:

“Cette intervention est notée et acceptée par la RAE sous les mêmes réserves quant à l’incompétence du CIRDI que celles invoquées à l’égard de SPP (Middle East) Ltd.”

146. In its decision of November 27, 1985, the Tribunal took notice that:

“On July 23, 1985, the Parties advised the Centre that Southern Pacific Properties Limited (hereinafter called “SPP” or “the Claimant”), the parent Company of SPP(ME) and also a Hong Kong Corporation, had been joined as a claimant in the proceedings, subject to Egypt’s reservation of jurisdictional defenses.”

147. The Respondent’s reservation referred only to the preliminary objections then raised by the Respondent concerning the competence of the Centre. These preliminary objections were dismissed by the Tribunal in its decisions of November 27, 1985 and April 24, 1988.

148. The objection now raised is a different one, and thus is not covered by the reservation. It does not concern jurisdiction but refers instead to the admissibility of the request on a ground pertaining to the merits. The Respondent has contested the argument concerning the validity of SPP’s claims, observing that:

“Que SPP n’a présenté dans ses mémoires écrits aucune demande pour son compte; que les demandes de paiement à son profit présentées verbalement et subsidiairement au cours des audiences des 3/11 septembre 1990, sont irrecevables comme étant tardives et non conformes aux dispositions du Règlement de Procédure d’Arbitrage du CIRDI; qu’au surplus, elles n’ont été assorties d’aucune justification.”

This objection concerns the applicability of Rule 40 of the Centre’s Arbitration Rules, which provides in paragraph 2 that:

"An incidental or additional claim shall be presented not later than in the reply . . . unless the Tribunal, upon justification by the party presenting the ancillary claim and upon considering any objection of the other party, authorizes the presentation of the claim at a later stage in the proceeding."

149. The Tribunal cannot accept the Respondent's contention that a claim by SPP at this point in the proceedings would contravene Rule 40. What is involved here is neither an "incidental" nor an "additional" claim: SPP was voluntarily joined as a claimant in the case at the Respondent's request. As a claimant, SPP must be presumed to be claiming something, and there is nothing in the record which suggests that SPP has ever claimed anything different than what SPP(ME) claims. Rather, SPP(ME) and SPP have claimed jointly against the Respondent ever since SPP was joined in the proceedings.

#### *The UNESCO Convention*

150. The Respondent maintains that the entry into force on December 17, 1975 of the UNESCO Convention for the Protection of the World Cultural and Natural Heritage made it obligatory, on the international plane, to cancel the Pyramids Oasis Project. In this context, the Respondent relies primarily on Articles 4 and 5 of the Convention. Article 4 provides:

"Each State Party to this Convention recognizes that the duty of ensuring the identification, protection, conservation, presentation and transmission to future generations of the cultural and natural heritage referred to in Articles 1 and 2 and situated on its territory, belongs primarily to that State. It will do all it can to this end, to the utmost of its own resources and, where appropriate, with any international assistance and co-operation, in particular, financial, artistic, scientific and technical, which it may be able to obtain."

and Article 5(d) provides:

"To ensure that effective and active measures are taken for the protection, conservation and presentation of the cultural and natural heritage situated on its territory, each State Party to this Convention shall endeavour, in so far as possible, and as appropriate for each country: . . . to take the appropriate legal, scientific, technical, administrative and financial measures necessary for the identification, protection, conservation, presentation and rehabilitation of this heritage . . ."

151. The Convention established a body called the "World Heritage Committee" to register the property to be protected under the Convention. Article 11 of the Convention provides for such registration as follows:

"Every State Party to this Convention shall, in so far as possible, submit to the World Heritage Committee an inventory of property forming part of the cultural and natural heritage, situated in its territory and suitable for inclusion in the list provided for in paragraph 2 of this Article . . ."

152. Professor Kahn, in a consultation submitted by the Respondent, explained the system of the Convention in the following terms:

"La procédure est divisée en deux phases: tout d'abord une phase qui est à l'initiative de l'Etat de situation qui consiste en une demande d'inscription sur la liste du Patrimoine Mondial des Monuments ou des sites qui répondent aux conditions posées par la Convention; puis une phase d'examen et éventuellement d'inscription par le Comité du Patrimoine Mondial. Cette procédure préserve la souveraineté des Etats (initiative) et évite les inscriptions des biens intéressants mais non irremplaçables et non uniques grâce au contrôle international."

153. For their part, the Claimants maintain that the Respondent's expropriatory acts were not based on the UNESCO Convention and that none of the Convention's provisions required termination of the project. They point out that the Respondent ratified the Convention on February 7, 1974 and thus was aware of its terms when it authorized the Pyramids Oasis Project more than a year later. The Claimants add that the Convention entered into force on December 17, 1975 and final approval of the master plan occurred in 1976. The Claimants contend that even if antiquities existed on the Plateau, nothing in the Convention required the cancellation of the project, and that measures short of cancellation could have been taken in conformity with the Convention to protect such antiquities. They argue further that the Respondent did not rely on the Convention when it cancelled the project, and that the Respondent has only invoked the Convention as a *post hoc* rationalization for an act of expropriation which in fact had nothing to do with the Convention. In this connection, the Claimants observe that it was only on February 26, 1979—some nine months after the project was cancelled—that the Respondent nominated "the pyramid fields from Giza to Dahshur" for inclusion in the World Heritage list under Article 11 of the UNESCO Convention.

154. In the Tribunal's view, the UNESCO Convention by itself does not justify the measures taken by the Respondent to cancel the project, nor does it exclude the Claimants' right to compensation. According to the system of the Convention, as acknowledged by the Respondent, "*le classement est finalement le fait des autorités internationales de l'Unesco (Comité)*." Thus, the choice of sites to be protected is not imposed externally, but results instead from the State's own voluntary nomination. Consequently, the date on which the Convention entered into force with respect to the Respondent is not the date on which the Respondent became obligated by the Convention to protect and conserve antiquities on the Pyramids Plateau. It was only in 1979, after the Respondent nominated "the pyramid fields" and the World Heritage Committee accepted that nomination, that the relevant international obligations emanating from the Convention became binding on the Respondent. Consequently, it was only

from the date on which the Respondent's nomination of the "pyramid fields" was accepted for inclusion in the inventory of property to be protected in the UNESCO Convention in 1979 that a hypothetical continuation of the Claimants' activities interfering with antiquities in the area could be considered as unlawful from the international point of view.

*The Existence of Antiquities in the Area*

155. The Respondent has established to the Tribunal's satisfaction that antiquities exist in the project area. This was confirmed by a number of documents that were placed in evidence by the Respondent. The most conclusive of these is a memorandum prepared by the President of the Egyptian Antiquities Authority in May of 1978 which stated:

"The follow-up by the Egyptian Antiquities Authority to the works which were carried out has resulted in the following:

Firstly The presence of Antiquities was confirmed in the Western side of Al Giza Pyramids region which represents the Eastern part of the construction operations carried out. As a result the Egyptian Antiquity Authority has demanded from both the Ministry of Tourism and the Survey Authority to consider this part Public Property (Antiquity) in accordance of the Antiquities Protection Law N° 215 of the year 1951.

Secondly The scientific evidence mentions the probability of Antiquities present in this important Antiquities region in measuring of what were found in other regions."

This memorandum was submitted to the Ministry of Information and Culture, together with the recommendation that a decree be issued declaring certain lands in the vicinity of the project site to be "public property (Antiquity)." The Ministry issued such a decree—Decree No. 90 of 1978—on May 27, 1978, the day before the Pyramids Oasis Project was cancelled.

156. In any event, it is not disputed that in 1979 the World Heritage Committee accepted the Respondent's nomination of "the pyramid fields" for inclusion in the inventory of property to be protected by the UNESCO Convention. The Respondent determined—as it was entitled to do under the Convention—that the Pyramids Oasis Project was not compatible with its obligations under the Convention to protect and conserve antiquities in the areas registered with the World Heritage Committee. Admittedly, the registration of these areas occurred somewhat belatedly in the context of the present dispute. However, other of the Respondent's acts which were contemporaneous with the cancellation of the project indicate the genuineness of the Respondent's concern for the antiquities at the project site and the legitimacy of the registration of that site under the UNESCO Convention. The most important

of these acts was Decree No. 90 of 1978, discussed above (paragraph 157). This decree, which declared lands on the project site to be "public property (Antiquity)," was issued pursuant to Law No. 215 of 1951 for the Protection of Monuments and Antiquities, which, as explained more fully below (paragraph 161), authorizes expropriation when necessary to protect antiquities.

157. The Tribunal's determination that the Claimants' activities on the Pyramids Plateau would have become internationally unlawful in 1979, but not before that date, has significant consequences in other respects which are discussed below (paragraphs 192–93).

*The Lawfulness of the Measures Taken by the Respondent to Cancel the Project*

158. Clearly, as a matter of international law, the Respondent was entitled to cancel a tourist development project situated on its own territory for the purpose of protecting antiquities. This prerogative is an unquestionable attribute of sovereignty. The decision to cancel the project constituted a lawful exercise of the right of eminent domain. The right was exercised for a public purpose, namely, the preservation and protection of antiquities in the area. Nor have the Claimants challenged the Respondent's right to cancel the project. Rather, they claim that the cancellation amounted to an expropriation of their investment for which they are entitled to compensation under both Egyptian law and international law.

159. The rules of Egyptian law and international law governing the exercise of the right of eminent domain impose an obligation to indemnify parties whose legitimate rights are affected by such exercise. Article 34 of the Egyptian Constitution provides:

"Private ownership shall be safeguarded and may not be put under sequestration except in the cases specified in the law and with a judicial decision. It may not be expropriated except for a public purpose and against a fair compensation in accordance with the law. The right of inheritance is guaranteed in it."

The obligation to pay fair compensation in the event of expropriation applies equally where antiquities are involved. Thus, Article 11 of Law No. 215 of 1951 for the Protection of Monuments and Antiquities provides:

"In the case of accidental discovery of an Antiquity by an individual or an entity, the competent department has the duty to take the measures necessary for its protection and this as of the date of declaration of the Discovery; within two months thereafter it is incumbent on said department either to remove the Antiquity found on private property (and) (or else) to take the necessary measures of expropriation of the site of the object discovered, or to keep it in situ subject to the requirements of registration pursuant to the present law.

Compensation for expropriated land shall not take into account the value of the Antiquities.”

*The Legal Nature of the Measures Taken by the Respondent*

160. The Respondent argues on various grounds that there was no compensable taking of the Claimants' property. The Respondent contends that the cancellation of the project was not a “nationalization” or “confiscation” prohibited by Law No. 43 of 1974. The Respondent argues further that under Egyptian law expropriation does not apply to contractual and other incorporeal rights, but only to real property rights. Thus, according to the Respondent, while the real property rights of EGOH and ETDC may have been expropriated, those interests of the Claimants that were affected by the cancellation of the Pyramids Oasis Project were not the kind of interest that is susceptible of expropriation under Egyptian law. The Respondent further contends that, while the contractual rights of the Claimants may have been diminished in their value, they were not expropriated. Moreover, the Respondent adds, the Ras El Hekma Project was never cancelled and the Claimants were offered a substitute site for that on the Plateau, close to the Sixth of October City. This substitute site, according to the Respondent, offered views and other features similar to those of the Plateau area. Finally, the Respondent argues that an offer of compensation in the amount of US \$1,500,000 was made in order that the Claimants might pursue alternative projects, and it was only because of SPP(ME)'s arbitrary refusal to pursue such alternatives that the project was ultimately abandoned and no compensation was paid.

161. The Claimants, for their part, contend that the Respondent's arguments ignore economic reality. They maintain that the cancellation of the Pyramids Oasis Project and the publicity engendered thereby created a climate of opinion which made it impossible for the Claimants to raise additional funds in international financial markets and to undertake further investments.

162. The evidence shows that, following cancellation of the project, the Prime Minister stated that the Claimants would be compensated for their losses, but no adequate offer of compensation was ever made. The alleged offer of US \$1,500,000 did not involve a cash payment. Rather, the offer was to credit ETDC with an investment of US \$1,500,000 in a new project in which EGOH would have a majority interest. Of this credit, only 60 percent or US \$900,000 would have accrued to the Claimants. This amount must be compared with the cash losses suffered by the Claimants as a result of the project's termination. Even if one considers only the Claimants' undisputed loans and capital contributions to ETDC—some US \$3,368,000—the offer of a US \$900,000 credit, which was conditioned on the Claimants' willingness to

proceed as a minority shareholder with an entirely new and different project, did not, in Tribunal's view, constitute fair compensation for what was taken.

163. As to the argument that the cancellation of the project did not involve a nationalization or confiscation, it is the Respondent's contention that there was no nationalization because there was no transfer of the Claimants' rights or of the project to the State, and there was no confiscation because there was not a total deprivation of SPP's rights accompanied by an absence of compensation. The Tribunal cannot accept this contention. As the Tribunal observed in its decision of November 27, 1985:

“it is quite clear that expropriation, the legitimacy of which is not being contested, if not accompanied by fair compensation, amounts to a confiscation, which is prohibited by Law No. 43.” (para. 69.)

164. Nor can the Tribunal accept the argument that the term “expropriation” applies only to *jus in rem*. The Respondent's cancellation of the project had the effect of taking certain important rights and interests of the Claimants. What was expropriated was not the land nor the right of usufruct, but the rights that SPP(ME), as a shareholder of ETDC, derived from EGOH'S right of usufruct, which had been “irrevocably” transferred to ETDC by the State. Clearly, those rights and interests were of a contractual rather than *in rem* nature. However, there is considerable authority for the proposition that contractual rights are entitled to the protection of international law and that the taking of such rights involves an obligation to make compensation therefore.

165. Moreover, it has been long been recognized that contractual rights may be indirectly expropriated. In the judgment of the Permanent Court of International Justice concerning *Certain German Interests in Polish Upper Silesia*, the Court ruled that, by taking possession of a factory, Poland had also “expropriated the contractual rights” of the operating company. (*P.C.I.J., Series A, No. 7, 1926, at p. 44.*)

166. Decisions of international claims tribunals have been to the same effect. Thus, in the *Amoco Int'l Finance Corp v Iran* case (15 *Iran-US CTR*, p. 89), the Iran-US Claims Tribunal said:

“Expropriation, which can be defined as a compulsory transfer of property rights, may extend to any right which can be the object of a commercial transaction . . . .” (para. 108.)

167. And in the *Phillips Petroleum Co Iran v Iran* case (21 *Iran-US CTR*, p. 79) the Iran-US Claims Tribunal held that expropriation gives rise to liability for compensation

“whether the expropriation is formal or de facto and whether the property is tangible, such as real estate or a factory, or intangible, such as the contractual rights involved in the present Case.” (para. 76.)

168. It follows that the duty to compensate in the event of expropriation cannot be evaded by contending that municipal regulations give a narrow meaning to the term "expropriation" or apply the concept only to certain kinds of property.

169. As to the argument that the Ras El Hekma Project was not included in the cancellation, this contention is not realistic. The *affectio societatis*, which is the essential basis of any joint venture, had disappeared in the relations between EGOH and SPP(ME) as a result of the measures taken by the Respondent with respect to the Pyramids Oasis Project. In particular, the withdrawal of EGOH's contribution to the joint venture with respect to the Plateau, the blocking by the Central Bank of ETDC accounts, the placing of ETDC in judicial receivership at the request of EGOH, and the sequestration of ETDC's assets rendered impossible and impracticable the continuation of a joint venture between EGOH and SPP(ME) with respect to Ras El Hekma.

170. In these circumstances, it is no answer to say that the Claimants could have proceeded to develop the Ras El Hekma site or a substitute site in the vicinity of the Sixth of October City. In the first place, the Ras El Hekma Project clearly was affected by the cancellation of the Pyramids Oasis Project. Among the obligations assumed by the Respondent in the Heads of Agreement was the obligation to form (through EGOH) and support the joint venture company that would develop both the Pyramids and Ras El Hekma sites. That joint venture company—ETDC—was in effect dissolved as a result of the Respondent's acts. It therefore could not have developed the Ras El Hekma site, even though the Ras El Hekma Project was never formally cancelled in the sense that the Pyramids Oasis Project was.

171. Moreover, even if ETDC had somehow been resurrected, as a matter of commercial and financial reality it is extremely doubtful that ETDC would have been able to attract the capital necessary for the Ras El Hekma project. The evidence shows that the Parties considered Ras El Hekma to be of secondary importance to the overall development plan. The Pyramids Oasis Project received most of the investment and publicity. ETDC's ability to attract capital for that project was due in large part to the enthusiastic endorsement of the project by the Egyptian Government. When that same Government subsequently cancelled the project—the primary part of the development plan envisioned by the Parties' agreements—it clearly impaired ETDC's ability to go back to the world's capital markets and raise financing for another project in Egypt.

172. Finally, as to the substitute site at the Sixth of October City, the Claimants' witnesses gave convincing testimony that the site was totally unsuitable for tourist development. In any event, it is clear that the Parties' agreements

provided for development of the Pyramids site, not a substitute site. The Claimants made a substantial investment pursuant to those agreements, and the investment was in effect expropriated as a result of the Respondent's cancellation of the Pyramids Oasis Project. Furthermore, the same commercial and financial considerations which suggest that financing could not have been raised for the Ras El Hekma site after the cancellation of the Pyramids Oasis Project apply to development at the Sixth of October City site. While the Claimants may have been under an obligation to mitigate the damages incurred as a result of the cancellation of the Pyramids Oasis Project, such an obligation is not so broad and all encompassing as to require the Claimants to accept an unsuitable alternative site that was never contemplated by the Parties' agreement.

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173. As to any residuary rights with respect to Ras El Hekma in favour of the Claimants as shareholders in ETDC, the Claimants advised the Tribunal in a communication dated July 9, 1991 that

"they seek in these proceedings indemnification for the totality of SPP(ME)'s investment in ETDC which includes its entire shareholding interest in ETDC. Upon the award of such indemnification by the arbitral tribunal, and the actual payment of such award by the ARE, Respondent would be entitled to a release from any further investment claims (including if requested a release or transfer of shareholdings in ETDC). . . ."

For its part, the Respondent, in a communication dated September 20, 1991, commenting on the Claimants' communication of July 9, 1991 stated:

"Très subsidiairement, la RAE rappelle que, si par impossible le Tribunal accueillait en tout ou partie les demandes d'indemnisation des demandereses ou de l'une d'entre elles, il lui plairait constater la renonciation (release) par SPP et/ou SPP (ME), exprimée dans la lettre du 9 juillet 1991, à tous leurs droits découlant des contrats relatifs au projet égyptien, et spécialement aux droits d'actionnaires dans ETDC."

In light of this exchange, the Tribunal has decided that, upon payment of the compensation fixed in this Award, the Respondent shall be released from any further investment claims concerning the Egyptian project as a whole and the Claimants' shareholding in ETDC shall be transferred to the Respondent.

*The Mutability of Administrative Contracts*

174. The Respondent argues that the Claimants were required to accept the Sixth of October City site as a modification of the contract because the contract under Egyptian law belonged to the special category of contracts known as "administrative contracts." The Respondent adds that it was in the

exercise of the powers concerning "the mutability of administrative contracts in response to the requirements of public service" that it decided to allocate to ETDC the usufruct rights over an area of six thousand feddans of land in and around the Sixth of October City, in compensation for the usufruct rights which had been granted to ETDC on the Pyramids Plateau. The Respondent contends that it was the Claimants' refusal to accept this modification of the contract that made them responsible for the total failure of the project.

175. The Claimants answer to this argument is that the alternative site proposed by the Respondent was entirely unsuitable for a tourist destination project, and that they were therefore justified in refusing to proceed with a project on the alternative site.

176. In the *Aminoil v Kuwait* case, the tribunal referred to the doctrine of administrative contracts "as it was originally developed in French law and subsequently in other legal systems such as those of Egypt and Kuwait." (*Lloyds Arb. Rep.*, 1988, at p. 195.) The French doctrine of administrative law concerning "*la mutabilité des contrats administratifs*" authorizes the public administration to introduce unilateral modifications to an administrative contract or concession or even put an end to it provided that certain conditions are fulfilled. The first such condition is that the modification be made in the public interest and concern what is called in France a "*service public*;" the second condition is that the modification be accompanied by adequate compensation designed to preserve what is described as "*l'équilibre financier du contrat*."

177. The conditions upon which the State may modify or terminate an administrative contract were described by the tribunal in the *Aminoil* case as follows:

"(i) The public authority can require a variation in the extent of the other party's liabilities (services, payments) under the contract. This must not however go so far as to distort (unbalance) the contract; and the State can never modify the financial clauses of the contract—nor, in particular, disturb the general equilibrium of the rights and obligations of the parties that constitute what is sometimes known as the contract's "financial equation". . . .

(ii) The public authority may proceed to a more radical step in regard to the contract, namely to put an end to it when essential necessities concerning the functioning of the state (operation of public services) are involved. . . ." (op.cit., at pp. 195-96.)

178. The change of the project's site from the Pyramids Plateau to the vicinity of the Sixth of October City would have involved much more than a mere variation of the Claimants' obligations under the contract. As already explained, it would have fundamentally changed the Parties' bargain and the underlying financial assumptions. The Respondent's argument that the Claimants

were required to accept an alternative site as a modification of the Parties' contract must therefore be rejected.

#### *The Quantum of Compensation*

179. The Tribunal having determined that the cancellation of the project was compensable, there remains the question of the measure of compensation. The Claimants have put forward three alternative claims for compensation. First, they claim the following amounts ("the primary claim") as the value of their investment in ETDC at the time the project was cancelled:

- (1) the value of the investment in ETDC computed at US \$41,000,000, or such other sum as the Tribunal may award, on the basis of (i) the DCF methodology and/or (ii) the share sales to the Saudi Princes; and
- (2) the amount of the loan to ETDC, amounting to US \$1,650,000; and
- (3) post-cancellation costs for 1978 and 1979, amounting to US \$623,000; and
- (4) post-cancellation, legal, audit and arbitration costs from 1980 to 1990, amounting to US \$5,108,000;

together with interest to August 31, 1990

- (a) on the value of the investment ((1) herein) at 12.6 percent compounded annually, amounting (on a value of US \$41,000,000) to US \$125,000,000; and
- (b) on (3) herein at 12.6 percent compounded annually, amounting to US \$1,874,000; and
- (c) on the loan to ETDC ((2) herein) at the contractual rate, amounting to US \$6,931,000,

plus further interest to the date of the Award.

180. Alternatively and subsidiarily, the Claimants submit that they should be awarded the following compensation ("the alternative claim") for the value of their investment in ETDC at the time the project was cancelled:

- (1) the amount of the loans to ETDC, amounting to US \$1,650,000; and
- (2) further monies lent at no interest to ETDC, amounting to US \$408,000; and
- (3) the capital invested, amounting to US \$1,310,000; and
- (4) development costs pre-cancellation, amounting to US \$2,254,000; and
- (5) post-cancellation costs for 1978 and 1979, amounting to US \$623,000; and
- (6) post-cancellation legal, audit and arbitration costs from 1980 to 1990, amounting to US \$5,108,000; and
- (7) such additional amount as shall be fixed by the Tribunal to compensate for the loss of the chance or opportunity of making a commercial success of the project;

together with interest to August 31, 1990

- a. on the loan to ETDC ((1) herein) at the contractual rate, amounting to US \$6,931,000; and
- b. on (3) herein at 12.6 percent, compounded annually, amounting to US \$4,303,000; and
- c. on (4) herein at 12.6 percent, compounded annually, amounting to US \$7,404,000; and
- d. on (5) herein at 12.6 percent, compounded annually, amounting to US \$1,874,000,

plus further interest to the date of the Award.

181. As a further alternative and subsidiary claim, the Claimants claim only their out-of-pocket expenses ("the further subsidiary claim"). This further subsidiary claim is identical to their alternative claim except that it does not request compensation for the loss of the opportunity to make a commercial success of the project.

182. The Claimants have acknowledged that they do not challenge the Respondent's right to cancel the project. In the Reply they state that:

"SPP(ME) from the outset sought not to challenge the ARE's acts as wrongful or void, but sought compensation rather than physical restoration of its rights . . . ."

While the Claimants maintain that they are entitled to compensation for the "repudiation and taking" of their contract rights, they do not claim damages for breach of contract. Rather, they characterize their claim as follows:

"the claim here by SPP(ME) is not against the ARE for damages for breach of contract. It is for compensation on account of the losses occasioned to it by the ARE's exercise of its sovereign powers, which destroyed its property rights (including its contract rights)."

183. Thus, the Claimants are seeking "compensation" for a lawful expropriation, and not "reparation" for an injury caused by an illegal act such as a breach of contract. The cardinal point to be borne in mind, then, in determining the appropriate compensation is that, while the contracts could no longer be performed, the Claimants are entitled to receive fair compensation for what was expropriated rather than damages for breach of contract.

(i) *The DCF Approach*

184. The Claimants contend that the measure of compensation for the taking of an ongoing enterprise should be equal to the value of the enterprise at the time of taking, and that such value depends on the revenues that the enterprise would have generated had the taking not occurred. In quantifying this value, the Claimants rely primarily on the so-called "discounted cash flow" ("DCF") method. This method is intended to determine the present value of the future earnings expected to be generated by an investment. In applying the

DCF method, the Claimants have first estimated the net revenues that would have been earned over the initial eighteen-year period of development, and then discounted that revenue flow to a present value, which, according to the Claimants, represents the value of SPP(ME)'s rights as of May 28, 1978—the date when the project was cancelled.

185. To project revenues into the future, the Claimants use the actual lot sales made during the project's lifetime. On this basis, they estimate that the project would have generated total net profits after tax of US \$312,200,000 over the first eighteen years. Using a 20 percent discount rate, the Claimants then discount the net profits figure to a present value of US \$80,100,000, which, the Claimants say, is the present value of the projected total net profits after tax for the first eighteen years of the project. This figure is then adjusted downward to US \$68,500,000 to reflect ETDC's other recorded assets and liabilities. Since SPP(ME)'s share of ETDC was 60 percent, the Claimants claim 60 percent of US \$68,500,000 or US \$41,000,000 as the value of SPP(ME)'s equity in ETDC at the time that the project was terminated.

186. The Respondent contests the applicability of the DCF method on the grounds that it leads to speculative results and takes no account of the real value of the expropriated assets. In particular, the Respondent contends that in the present case the project was not sufficiently developed to yield the data necessary for a meaningful DCF analysis.

187. The Respondent has also submitted an expert opinion to the effect that the DCF method of valuation is unsuitable in this case because of the inherent uncertainties of the project and the fragility of a calculation which depends on forecasting cash flows almost twenty years into the future on the basis of revenues generated over a period of little more than a year. The Respondent has also cited the earlier ICC award in this case, where the tribunal refused to apply the DCF method on the ground that when the project was cancelled "the great majority of the work had still to be done." Finally, the Respondent argues that the DCF method would lead to unjust enrichment of the Claimants.

188. In the Tribunal's view, the DCF method is not appropriate for determining the fair compensation in this case because the project was not in existence for a sufficient period of time to generate the data necessary for a meaningful DCF calculation. At the time the project was cancelled, only 386 lots—or about 6 percent of the total—had been sold. All of the other lot sales underlying the revenue projections in the Claimants' DCF calculations are hypothetical. The project was in its infancy and there is very little history on which to base projected revenues.



189. In these circumstances, the application of the DCF method would, in the Tribunal's view, result in awarding "possible but contingent and undeterminate damage which, in accordance with the jurisprudence of arbitral tribunals, cannot be taken into account." (*Chorzow Factory case, Series A, No. 17, 1928, at p. 51*). As the tribunal in the *Amoco* case observed:

"One of the best settled rules of the law on international responsibility of States is that no reparation for speculative or uncertain damage can be awarded." (*op. cit.*, para. 238.)

190. Quite apart from the inadequacy of the underlying data, there is a second reason why the Claimants' DCF approach must be rejected in the present case: the Claimants' DCF approach would in effect award *lucrum cessans* through the year 1995 on the assumption that lot sales would have continued through that year. Yet lot sales in the areas registered with the World Heritage Committee under the UNESCO Convention would have been illegal under both international law and Egyptian law after 1979, when the registration was made. Obviously, the allowance of *lucrum cessans* may only involve those profits which are legitimate. As A. de Laubadère has stated:

"le *lucrum cessans* correspond au "*bénéfice légitime*" que le co-contractant pouvait normalement escompter." (*Traité des Contrats Administratifs, T.II, Paris, 1984, at pp. 556 and 1327.*) (Emphasis added.)

191. Thus, even if the Tribunal were disposed to accept the validity of the Claimants' DCF calculations, it could only award *lucrum cessans* until 1979, when the obligations resulting from the UNESCO Convention with respect to the Pyramids Plateau became binding on the Respondent. From that date forward, the Claimants' activities on the Pyramids Plateau would have been in conflict with the Convention and therefore in violation of international law, and any profits that might have resulted from such activities are consequently non-compensable.

(ii) *The Share transactions*

192. To confirm the value indicated by their DCF calculations, the Claimants rely on certain transactions in SPP(ME) shares. These transactions include: (1) the sale in 1976 of 12,500 shares (25 percent of SPP(ME)) to two members of the Saudi Arabian royal family at US \$700 a share; (2) an offer by a third member of the Saudi Arabian royal family to purchase 7,500 shares at US \$850 a share; and (3) the repurchase by SPP(ME) of certain of its shares at prices ranging from US \$598 per share to US \$630 per share.

193. With respect to the sales at US \$700 per share, the Claimants' expert pointed out that if one extrapolates the US \$700 per share value over the entire 50,000 outstanding shares, the overall value for SPP(ME) at the time of the share transactions was US \$35,000,000. The audited financial statements for

SPP(ME) at the relevant time showed that, apart from SPP(ME)'s 60 percent share of ETDC, its other assets and liabilities had a net value of a negative US \$3,100,000. If the overall value of SPP(ME) was US \$35,000,000 (as indicated by the purchase of 25 percent of SPP(ME)), it follows that SPP(ME)'s 60 percent interest in ETDC had an imputed value of US \$38,100,000. The Claimants' expert conducted similar analyses on the basis of the US \$850 per share offer and the repurchase of shares by SPP(ME). These analyses indicated values for SPP(ME)'s 60 percent share of ETDC ranging from US \$33,000,000 to US \$42,500,000.

194. The Claimants argue that these imputed values are, if anything, conservative because (1) the transactions occurred in 1976 when the project was not nearly as far along as it was in 1978 when it was cancelled; (2) the transactions involved minority shareholdings; and (3) certain of the transactions involved non-voting shares.

195. The Claimants' expert testified that the two purchasers of the SPP(ME) shares had undertaken substantial "due diligence" inquiries before making their investments and that they were advised by lawyers and economic consultants.

196. The Respondent's expert, on the other hand, testified that in his opinion the share transactions were not a valid means of estimating the value of SPP(ME)'s share in ETDC because

"The situation was that we had a major project which in 1976 was in the planning stage . . . and it seems to me that we are looking at what should properly be called venture capital. The princes were invited to put up venture capital, that is high risk capital, and to suggest that because they put up that high risk capital that represents the objective value of the enterprise at the date seems to me an exaggeration. I do not think it probable that willing purchasers at that price could have been found in those circumstances."

197. In the Tribunal's view, the purchase and sale of an asset between a willing buyer and a willing seller should, in principle, be the best indication of the value of the asset. This is certainly true in the case of a perfectly competitive market having many buyers and sellers in which there are no external controls or internal monopolistic arrangements. In the present case, however, there was a very limited number of transactions and there was no market as such for the shares that were sold. The price at which the shares were sold was privately negotiated. In these circumstances, the Tribunal does not believe that the share transactions can be used to accurately measure the value of SPP(ME)'s investment in ETDC.

(iii) *The Fair Measure of Compensation*

198. The Tribunal will turn now to the Claimant's alternative claim for compensation, which is essentially a claim for "out-of-pocket" expenses plus an amount to compensate the Claimants for what they have called "the loss of the opportunity to make a commercial success of the project." There is no question that considerable amounts of time and money were spent on negotiating, planning and implementing the project. SPP(ME) made capital contributions and loans to ETDC, the amounts of which are not disputed by the Respondent. In the Tribunal's opinion, these amounts must be reimbursed as part of the fair compensation to which the Claimants are entitled. In addition, the evidence shows that, when the project was cancelled, construction was under way and considerable marketing activity had been carried out. Most of the detailed engineering design and specifications for the first phase of the infrastructure and golf course had been completed. A construction contract had been concluded for the infrastructure, construction had begun and lot sales had commenced. To the extent that the expenses associated with this activity have been proven, the Tribunal is of the view that reimbursement of such expenses is also part of the fair compensation to which the Claimants are entitled.

199. *The Capital Contributions and Loans.* From the record it is evident that there is no dispute as to the amounts of the capital contributions and loans made by SPP(ME) to ETDC: the capital contributions, made in three installments, totalled US \$1,310,000; and the loans consisted of a US \$1,650,000 loan with interest at commercial rates and further loans bearing no interest of US \$408,000.

200. *Development Costs.* The Claimants submit that they are entitled to be reimbursed for pre-cancellation development costs of US \$2,254,000 and post-cancellation costs of US \$623,000. These costs are disputed by the Respondent. After the final hearings in Paris, the Tribunal, at its meeting in London in February of 1991, reviewed the evidence relating to development costs. It determined that the evidence should be supplemented, and accordingly on February 13th, 1991 it issued a procedural order which directed *inter alia* that the Claimants produce

"a document indicating the nature, date and amount of the above-referenced development costs, including the names of the recipients of payments in excess of US \$20,000 and a confirmation that these sums were legitimately and actually expended for the project and were directly connected with it. The document shall also contain an explanation of why these costs were not charged to or were not directly recovered from ETDC."

The procedural order also asked for the Respondent's comments on the information to be submitted by the Claimants. The Parties responded as described in paragraphs 39-40 above.

201. It cannot be disputed that development costs were incurred by the Claimants. Indeed, the expert report received from the Respondent on June 26, 1991 stated with respect to the development costs reported by the Claimants' auditors that "it is reasonable to accept that the costs were actually incurred."

202. The question that arises from the information submitted by the Parties in response to the procedural order of February 13, 1991 concerns the extent to which the development costs that were allocated to SPP(ME) and not reimbursed by ETDC should be taken into account in fixing the compensation to be awarded to the Claimants. For the most part, the items in question involve the allocation of salaries and costs incurred by executives and employees of SPP such as overhead costs, travel and entertainment expenses, and costs incurred for recruiting and relocation of personnel, consultations concerning marketing and banking, and so forth. These expenses were incurred in connection with the project and in order to implement it. If the project had materialized, these expenses would not have been chargeable to ETDC because the Claimants had agreed to provide all of the technical expertise required for the design, construction, management and marketing of the project. However, because the project was cancelled, the Claimants could not recoup these expenses with future profits, and the expenses thus became irrecoverable losses. The Tribunal finds that it is reasonable and legitimate to take these losses into account in determining the fair measure of compensation in this case.

203. Not all of the costs claimed have been properly documented, however. It was explained in an affidavit of SPP(ME)'s former Financial Director that many documents and financial records could not be found or were destroyed by reason of the very long period which has passed since the expenses were incurred. But as the report of the Respondent's expert points out,

"the origins of this claim date from 1978 and I am surprised that in the circumstances the relevant documents have not been retained. It was foreseeable that they were likely to be required in this action."

This report also points out that the information filed by the Claimants in response to the Tribunal's procedural order of February 13, 1991 identified US \$1,719,000 of the claimed costs by payee, but that the recipients of an additional US \$1,545,000 of claimed costs were not identified. In the Tribunal's view, it would not be appropriate to award development costs for which the Claimants are unable to identify the payee. Accordingly, the Tribunal has decided to award development costs only in the amount of US \$1,719,000.

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204. The Respondent also maintains that the information filed by the Claimants in response to the Tribunal's procedural order contains evidence of the Claimants' corruption. Specifically, the Respondent has drawn the Tribunal's attention to a payment of US \$16,000 made in May of 1975 to a former employee of the Egyptian Government. It is claimed that, while this individual was employed by the London agency of the Egyptian Ministry of Tourism, he provided information concerning SPP's financial and technical capacity to the Egyptian authorities who were considering the proposed project and who ultimately approved it. After leaving the Government, this individual allegedly assisted SPP in securing agreements with Egyptian authorities relating to the Pyramids Oasis Project. The Tribunal notes, however, that the same document which shows the US \$16,000 payment also shows that the total payments made by SPP to this individual after he left the Government amounted for the whole of the year 1975 to less than US \$2,000 a month, a figure which does not suggest illicit payments to third parties. Accordingly, the Tribunal cannot accept the Respondent's contention that the information submitted by the Claimants in response to the Procedural Order contains evidence of the Claimants' corruption.

205. *Legal, Audit and Arbitration Costs.* The Claimants seek reimbursement of US \$5,108,000 of "post cancellation legal, audit and arbitration costs from 1980 to 1990." They contend that all of the legal costs they have incurred in order to obtain compensation should be indemnified, including the legal costs resulting from the ICC arbitration and related court proceedings. They argue that all of the legal and related disbursements should be considered as an individual whole, since they were made necessary by the Respondent's wrongful refusal to grant fair compensation. The Claimants add, as a further consideration, that a great deal of the research and preparation involved in the ICC arbitration obviated the need to undertake the same work in the ICSID proceedings.

206. For its part, the Respondent states that the claim for indemnification of costs incurred in other proceedings is absurd from a legal point of view because it infringes the sanctity of *res judicata*, the awards and judgments in the other cases having already decided the question of costs incurred in those proceedings.

207. In a case such as the present one, where the measure of compensation is determined largely on the basis of the out-of-pocket expenses incurred by the claimant, there is little doubt that the legal costs incurred in obtaining the indemnification must be considered as part and parcel of the compensation,

in order to make whole the party who suffered the loss and had to litigate to obtain compensation. This is particularly so when, as in this case, the amount offered as compensation by the Respondent was manifestly insufficient.

208. However, only those legal and accounting fees and expenses that were incurred for work that was relevant and useful to the present ICSID proceedings are to be included in the compensation. This Tribunal cannot award costs for work which was only relevant or useful to the proceedings before the ICC tribunal, whose decision was annulled, or proceedings before national courts to defend the validity of the ICC award or obtain its enforcement.

209. In order to separate the costs that should be allocated to the present proceedings from those that should be allocated to other proceedings, the Tribunal, in its procedural order of February 13, 1991, asked the Parties to submit

"an itemized list of the legal and accounting fees relating to the present proceedings, indicating their amount, the respective dates and the phase of the proceedings to which those fees and expenses relate."

210. In response to the Tribunal's procedural order, the Claimants have submitted a detailed list of all payments made for legal, audit and arbitration costs in connection with the ICC proceedings, related court proceedings and the ICSID proceedings. This list includes the amount and the recipient of each payment. It shows that fees and expenses of US \$4,242,000 were incurred solely in connection with the ICSID proceedings, and that further fees and expenses of US \$1,701,000 were incurred in connection with the ICC arbitration and related court proceedings. However, it is evident from the information submitted by the Claimants that a substantial amount of the work product covered by the US \$1,701,000 of fees and expenses, such as the factual development of the case (including the preparation of various studies, reports and affidavits), was also utilized in the ICSID proceedings. On the basis of this information, the Tribunal estimates that approximately one-half of the US \$1,701,000 was spent on work product that was utilized directly in the ICSID proceedings.

211. In light of these considerations, the Tribunal concludes that the total costs to be reimbursed to the Claimants for legal and accounting work which has been relevant or useful to the present ICSID proceedings amounts to US \$5,092,000. Undoubtedly, this is a high figure, but it is justified by the extraordinary length and complication of the proceedings in this case.

212. *Loss of Commercial Opportunity.* The final element in the Claimants' alternative claim is:

"such additional amount as shall be fixed by the Tribunal to compensate for the loss of the chance or opportunity of making a commercial success of the project."

This element of the alternative claim is what differentiates that claim from the Claimants' further subsidiary claim, which is simply for out-of-pocket expenses. Here, it is important to note that the alternative claim—like the primary claim which was based on the DCF method and the share transactions—is intended to recover the *value of the Claimants' investment*. This was made clear during the oral proceedings, and is also explicitly stated in the Claimants' Final Conclusions and Prayer for Relief:

"The Claimants claim secondarily, as an alternative . . . *the value of its investment in ETDC* on the basis of its out-of-pocket expenses . . . on the view that the project would necessarily have realized, at the very least, the amount invested in it, and an additional amount . . . to compensate for loss of the chance or opportunity of making a commercial success of the project . . . ." (Emphasis added.)

213. In contrast, the Claimants' further subsidiary claim as articulated in their Final Conclusions and Prayer for Relief makes no mention of the value of the investment:

"The Claimants claim as a further, subsidiary alternative . . . the out-of-pocket expenses . . . together with interest . . . ."

The further subsidiary claim gives up any claim for the value of the investment and seeks only to put the Claimants back in the position they were in before they became involved with the Pyramids Oasis Project.

214. During the final hearings on the merits, the Respondent's expert testified that in his opinion, if damages were to be awarded, the measure of damages should be the value of the Claimants' investment in ETDC as of May 1978, when the Pyramids Oasis Project was cancelled. If it were the case that the Claimants' investment in the Pyramids Oasis Project had no value—or had no value greater than the Claimants' out-of-pocket expenses—then the further subsidiary claim might *ex hypothesi* be the appropriate basis for compensation. In the Tribunal's view, however, it is incontestable that the Claimants' investment had a value that exceeded their out-of-pocket expenses. The record shows that between February of 1977 and May of 1978, ETDC made sales of villa sites and multi-family sites totalling US \$10,211,000—more than twice the Claimants' out-of-pocket expenses. Moreover, construction involving roads, water and sewage systems, reservoirs, artificial lakes and a golf course had commenced and the design work for two hotels had been completed. In these circumstances, the Tribunal cannot accept that the project did not have a value in excess of the Claimants' out-of-pocket expenses.

215. It remains, then, for the Tribunal to determine the amount by which the value of the Claimants' investment in ETDC exceeded their out-of-pocket expenses—that part of the alternative claim which the Claimants have called

the "opportunity of making a commercial success of the project." This determination necessarily involves an element of subjectivism and, consequently, some uncertainty. However, it is well settled that the fact that damages cannot be assessed with certainty is no reason not to award damages when a loss has been incurred.

216. In determining the amount by which the value of the Claimants' investment in ETDC exceeded their out-of-pocket expenses, the Tribunal will take as a starting point the lot sales actually made during the short life of the project and the revenues to be imputed to those sales. As the Tribunal has already observed, the evidence shows that during the period February 1977 to May 1978, ETDC's actual sales of villa and multi-family sites amounted to US \$10,211,000. The lots involved—383 villa sites and 3 multi-family sites—represented only 6 percent of the villa sites and less than 1 percent of the multi-family sites with respect to which ETDC held rights. It is clear, therefore, that the remaining lots were a potential source of very substantial revenues.

217. The Tribunal will next consider what it took in the way of expenditures by the Claimants to generate the revenues imputed to the lot sales. The difference between these expenditures and the portion of imputed revenues corresponding to SPP(ME)'s shareholding in ETDC is, in the Tribunal's view, the minimum measure of the value to be ascribed to the opportunity to make a commercial success of the project.

218. It is not disputed that SPP(ME) made capital contributions to ETDC of US \$1,310,000, and the Tribunal has already determined that the Claimants' development costs were US \$1,719,000. In addition, loans totalling US \$2,058,000 were made to ETDC, but these loans will be disregarded for present purposes because they were intended to be reimbursed—for the most part with interest at commercial rates. The portion of the revenues imputed to the lot sales corresponding to SPP(ME)'s shareholding in ETDC was 60 percent of US \$10,211,000, or US \$6,127,000. Thus, the portion of the sales revenues corresponding to SPP(ME)'s shareholding in ETDC would have exceeded the Claimants' non-reimbursable out-of-pocket expenses by US \$3,098,000. In these circumstances, the Tribunal is of the view that the value of what the Claimants have called the "opportunity of making a commercial success of the project" was not less than US \$3,098,000. Stated differently, the value of the Claimants' investment in May of 1978 when the project was cancelled exceeded their out-of-pocket expenses by at least US \$3,098,000.

219. *Interest.* The Claimants maintain that it has long been accepted under international law that appropriate compensation carries with it interest from the date of the wrong, so as to compensate the injured party for not having had the use of the money between the date when it ought to have been paid and the

date of the payment. In support of this contention the Claimants invoke decisions of the Permanent Court of International Justice and various international arbitration and claims tribunals. The Claimants further assert that the rate of interest should be a reasonable one, based on the amount that a successful claimant would have been in a position to have earned if it had had the funds available to invest. Accordingly, it claims a rate of 12.6 percent per annum, compounded annually from May 28, 1978 to the date of the Award, observing that this is the rate of interest agreed between SPP(ME) and ETDC in the loan agreement of April 15, 1976.

220. For its part, the Respondent contends that, if compensation is to be awarded, the rate of interest requested by the Claimants, as well as the modalities for its computation, should be rejected as contrary to Egyptian law in accordance with Article 42(1) of the Washington Convention. The Respondent calls attention to Article 226 of the Civil Code of Egypt, which provides for a rate of four percent for civil debts (including administrative contracts) and five percent for commercial debts, and contends that this is a civil matter, since the Heads of Agreement, concluded by a Minister of the Government, could not be qualified as a commercial act. The Respondent also points out that Article 232 of the Civil Code forbids compound interest, or interest on interest, and provides that the interest may in no event exceed the principal amount. As to the date at which interest begins to run, the Respondent contends that under Article 226 it is the date of the initiation of proceedings in case of "liquid debts," so that if the amount is fixed by the award it is only from the date of the award that interest begins to run.

221. The Claimants, on the other hand, point out that the limitation in Egyptian law on the rate of interest applies only—according to the terms of Article 226 of the Civil Code—"when the object of an obligation is the payment of a sum of money of which the amount is known at the time when the claim is made," which, they maintain, is not the case here.

222. In light of these various considerations, the Tribunal reaches the conclusion that, subject to the exception discussed below (paragraphs 225-231), Article 42 (1) of the Washington Convention requires that interest be determined according to Egyptian law because there is no rule of international law that would fix the rate of interest or proscribe the limitations imposed by Egyptian law.

223. With respect to the rate of interest, the Tribunal is of the view that it should be five percent rather than four percent. The argument that the Heads of Agreement was not a commercial contract is not conclusive because the present claim is not an action for a breach of that contract, but rather one

seeking compensation for the expropriation of the rights of a commercial enterprise for the development of tourism.

224. The provisions of Egyptian law which prohibit compound interest and require that the interest not exceed the principal are also applicable.

225. The provisions of Egyptian law concerning interest do not apply to the loan of US \$1,650,000 from SPP(ME) to ETDC. The underlying loan agreement of April 15, 1976 by its terms is governed by English law. Clause 17 of the loan agreement provides:

"This Agreement shall be governed by and construed in all respects in accordance with the laws of England."

226. With respect to interest, the loan agreement provides in Clause 4 that:

"During the period from the first Date of Drawdown until the final Date of Payment the Borrower shall pay interest on the Borrowing."

and that:

"Interest shall be paid in dollars to the Lender in London or in such other foreign currency and in such other place as may mutually be agreed from time to time and shall be paid on the relevant Interest Date at the relevant Interest Rate for that Interest Period."

227. The term "Interest Rate" is defined as:

"such rate of interest from the first date of Drawdown until repayment of the Borrowing in respect of each period ending on an Interest Date as shall be two per centum above the three months offered quotation for the deposit in Dollars by prime banks to the Lender (as certified by the Lender) in the London Interbank Market at approximately 11.00 a.m. London time two Business Days before the Date of Drawdown or (as the case may be) before each relevant Interest Date."

228. The loan agreement also provides that the interest shall be compounded if interest payments are not made on time:

"If any interest payable hereunder is not paid by noon (London time) on the day on which the same is due then the interest so in arrears shall thenceforth itself bear interest at the relevant Interest Rate computed from the date the same became payable to the date on which it is in fact paid . . . ."

229. Thus, the loan agreement establishes a higher rate of interest than that prescribed by Egyptian law and also provides for compound interest. Moreover, the interest on this loan now amounts to US \$8,134,000 and thus exceeds the principal. However, since the loan agreement is governed by the laws of England, which allow compound interest and the accrual of interest in excess of the principal, the Egyptian limitations on interest do not apply. Under

the loan agreement, SPP(ME) had a contractual right against ETDC to interest at the rate fixed by the loan agreement when the project was cancelled and the Central Bank blocked the Claimants' funds. This contractual right was in effect expropriated. The Claimants do not ask the Tribunal to award interest on the principal amount as such, but rather to compensate them for the value of the contractual right taken. That value clearly includes the interest provided for in the loan agreement.

230. The Respondent argues that it was not a party to the loan agreement and thus is not bound by the choice of English law. But the Claimants are not asking for damages for a breach of the loan agreement; they are seeking compensation on account of an expropriation. The credit that SPP(ME) had with respect to ETDC was expropriated by the Egyptian authorities when the Central Bank of Egypt, acting on the recommendation of the People's Assembly Committee, ordered

"the blockage of funds, papers and documents of EGOH and also the blockage of the foreign partner funds and documents."

Thus, ETDC was prevented from repaying the loan and the interest that it had agreed to. Therefore, this loan is to be reimbursed to the Claimants with all of the interest stipulated in the loan agreement. This is the full and uncontestable value of the expropriated credit.

231. Finally, the five percent interest rate prescribed by Egyptian law does not apply to the loans of US \$408,000, since the Parties agreed that these loans would not bear interest.

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232. With respect to the date from which interest shall run, the Respondent has invoked Article 226 of the Civil Code of Egypt which provides:

"When the object of an obligation is the payment of the sum of money of which the amount is known at the time when the claim is made, the debtors shall be bound, in case of delay in payment, to pay to the creditor, as damages for the delay, interest at the rate of 4% in civil matters and 5% in commercial matters. Such interest shall run from the date of the claim in Court, unless the contract or commercial usage fixes another date. This article shall apply, unless otherwise provided by law."

233. In the Tribunal's opinion, the *dies a quo* established in Article 226, "the date of the claim in Court," only applies to "such interest" which is to be paid "in case of delay of payment," that is, to moratory interest or interest on the award. It does not apply to compensatory interest, that is, to interest which is part of the award. Also, Article 226 refers to "the payment of a sum of money

of which the amount is known at the time when the claim is made," i.e., a liquidated claim. The present case involves neither moratory interest nor a liquidated claim. Consequently, no provision of the Civil Code or other legislation concerning the *dies a quo* applies to compensatory interest for a yet to be determined amount of compensation arising out of an act of expropriation.

234. Given this lacunae, it is legitimate to apply the logical and normal principle usually applied in cases of expropriation, namely, that the *dies a quo* is the date on which the dispossession effectively took place, since it is from that date that the deprivation has been suffered. This principle is supported by the doctrine and the jurisprudence of international tribunals. Moreover, many constitutions and national laws concerning expropriation require that payment be made prior to or simultaneous with the dispossession, thus supporting the *dies a quo* from the date of the taking, in this case May 28, 1978. To fix the *dies a quo* from the date of filing the claim or the date of the award, as requested by the Respondent, would encourage parties who have expropriated property to refuse to pay compensation and to delay the proceedings seeking compensation.

235. As to the *dies ad quem* for the running of interest, there is no Egyptian rule that has been called to the Tribunal's attention. The prevailing jurisprudence in international arbitrations is to the effect that interest runs until the date of effective payment, and this conclusion is supported by doctrinal opinion. This conclusion also seems to result implicitly from Article 226 of the Civil Code of Egypt.

236. Consequently, as requested by the Claimants, post-award interest will commence 30 days after the date on which this Award is notified to the Respondent, and will run until the date of payment. This interest shall be at the rate of five percent per annum and shall not be compounded.

237. *Monetary Adjustment for Currency Devaluation.* The five percent rate of interest which the Tribunal has determined to be applicable in this case does not fully compensate the Claimants for the losses which they incurred as a consequence of being deprived of money owed them between the time when the project was cancelled and the date of this Award. The reason that the five percent rate does not make the Claimants whole is that, since the project was cancelled in 1978, there has been a significant devaluation of the US dollar.

238. Devaluation is a function of inflation. If the Tribunal had determined that a "commercial" rate of interest were applicable in this case, devaluation would be accounted for automatically because commercial interest rates add an adjustment for inflation to the "real" interest rate. The five percent rate which the Tribunal has determined to be applicable is not a commercial rate, however. The record shows that since June of 1978 rates for US dollar deposits quoted in the London Interbank Market averaged more than 12 percent. Since

commercial interest rates are always higher (usually by 2–3 percentage points) than the clearing banks' base rate, it is evident that the five percent rate does not compensate the Claimants for the devaluation of the US dollar that has occurred since 1978.

239. Accordingly, it is the opinion of the Tribunal that certain elements of the compensation based on the Claimants' out-of-pocket expenses should be adjusted upward to take into account the devaluation of the US dollar since 1978. This is required in order that the compensation awarded by the Tribunal give the Claimants the same purchasing power today that they would have had in 1978 with the dollars that they invested in ETDC. Such a correction is necessary if the compensation is to be fair. If it were otherwise, the Claimants would be seriously prejudiced as a consequence of the devaluation of currencies that has occurred during the period in which they have been seeking a remedy for the loss that they have sustained.

240. In making an adjustment to take account of currency devaluation, the Tribunal has followed the approach adopted by the tribunal in the *Aminoil* case, which included an eminent Egyptian jurist. There, in awarding compensation for an expropriated investment, the tribunal stated that

"the proportions assumed by world inflation must lead to appraisals that are more in line with economic realities, and the determination of an indemnification cannot be tied down to the inflexible consequences of a purely monetary designation." (op. cit., at p. 213.)

The tribunal further said that

"if it were thought necessary to arrive at the total figure of the capital invested by Aminoil in its undertaking it would be appropriate to do so without holding the dollars of 1977 to be equivalent to those of 1948." (ibid.)

241. The tribunal referred to "the general principle of the preservation of the value of money" (paragraph 169), and then stated:

"The Tribunal has not overlooked the fact that there may be different ways of assessing the levels of inflation . . . . In the compensation to be paid to Aminoil it would be natural to take account of the progress of inflation generally . . . ." (op. cit., at p. 214.)

The Tribunal then concluded:

"In order to establish what is due in 1982 account must be taken both of a reasonable rate of interest, which could be put at 7.5 per cent, and of a level of inflation which the Tribunal fixes at an overall rate of 10 per cent—that is to say a total annual increase of 17.5 per cent in the amount due, over the amount due for the preceding year." (op. cit., at p. 216.)

242. A monetary adjustment such as that utilized in the *Aminoil* award also finds support in Egyptian law. Decisions of the Egyptian *Cour de Cassation*

and doctrinal opinions were called to the attention of the Tribunal. These opinions and decisions concluded that "due regard should be given to the increase or decrease of the currency price." These decisions and authoritative opinions confirm that under Egyptian law consideration is given to changes occurring "in the price of currency in which the compensation is to be estimated." (Abdel-Rezzak Ahmed El-Sanhoury, *Sources of Obligation*, Section 649, at pp. 975–6.)

243. In order to compensate the Claimants for the devaluation of the US dollar that has occurred since the Pyramids Oasis Project was cancelled in 1978, the Tribunal has adjusted certain of the out-of-pocket expenses incurred by the Claimants. These adjustments have been made using a "deflator factor" derived from data published by the International Monetary Fund in *International Financial Statistics*. This factor is computed on the basis of the United States Consumer Price Index. For the period May 31, 1978 to December 31, 1991—the most recent date for which the data necessary to calculate the deflator factor is available—the deflator factor was 2.2074. In other words, the purchasing power of 100 U.S. dollars in May of 1978 was equivalent to the purchasing power of 220.74 U.S. dollars in December of 1991.

244. As to the elements of compensation to which the deflator factor is to be applied, the Tribunal is of the view that the invested capital of US \$1,310,000, the development costs of US \$1,719,000 and the interest-free loan of US \$408,000 should be adjusted for monetary devaluation. No adjustment is required for the loan of US \$1,650,000, since that loan carries commercial interest and thus takes account of inflation and the resulting currency devaluation. Nor, in the Tribunal's view, is adjustment of the legal, audit and arbitration expenses necessary, since the bulk of these expenses was either incurred in—or imputed to proceedings that occurred in—the last several years. Finally, no adjustment of the opportunity cost element of the compensation will be made because of the nature of that particular cost and the method by which it was determined.

#### *Mitigating Factors Invoked by the Respondent*

245. The Respondent has drawn the Tribunal's attention to certain circumstances which, it is claimed, are mitigating factors that should be taken into account in the event that any compensation is awarded in this case. First, it is alleged that there has been no enrichment of the State, whereas there has been an enrichment of the Claimants as a result of the sale of shares to the members of the Saudi Arabian royal family.

246. It may be true that the Respondent has not benefited financially from the cancellation of the project. However, the Respondent has obtained

certain non-material benefits through the preservation of an area constituting a world cultural heritage, thus becoming entitled to the advantages—including the possibility of outside financial assistance—deriving from the UNESCO Convention.

247. Moreover, although unjust enrichment has on infrequent occasion been used by international tribunals as a basis for awarding compensation, it is generally accepted that the measure of compensation should reflect the claimant's loss rather than the defendant's gain. The question of whether the Respondent was enriched by the cancellation of the Pyramids Oasis Project is not, in the Tribunal's view, relevant to the amount of compensation to be awarded in the present case.

248. As to the alleged enrichment of the Claimants as a result of the share transactions, the Tribunal first notes that it disregarded these transactions in fixing the amount of compensation. If the Tribunal had used the share sales to measure the value of SPP(ME)'s investment in ETDC, the resulting compensation would have been considerably more than that which the Tribunal has determined to be appropriate.

249. Furthermore, the record shows that the proceeds from the share transactions were intended to finance the Pyramids Oasis Project. If some of those proceeds were not ultimately invested in the project, this was presumably due to the Respondent's cancellation of the project rather than to any act attributable to the Claimants.

250. The next factor invoked by the Respondent to mitigate the amount of compensation in the present case is the fact that the reclassification of the land on the Pyramids Plateau was a lawful act. This factor, however, has already been taken into consideration in the Tribunal's decision not to award compensation based on profits that might have accrued to the Claimants after the date on which areas on the Plateau were registered with the World Heritage Committee.

251. Next, the Respondent contends that the project was located in an area where the Claimants should have known there was a risk that antiquities would be discovered. Again, this is a factor that is already reflected in the method used by the Tribunal to value the Claimants' loss, and particularly in the Tribunal's decision and not to base compensation on profits that might have been earned after the Plateau areas were registered with UNESCO.

252. The Respondent also argues that the Claimants' rejection of the Sixth of October City site should be taken into account in fixing the amount of compensation to be awarded. The Tribunal cannot accept this argument. As explained above (paragraph 172), the Claimants' rejection of the substitute site

was entirely justified and is therefore irrelevant to the amount of compensation to be awarded the Claimants.

253. Finally, the Respondent maintains that certain dangerous events which occurred in Egypt after 1978, adversely affecting tourism there, should be taken into account in fixing the amount of compensation. These events are also irrelevant, because the Tribunal has excluded any profits which might have been earned after 1978 from the compensation that it has determined to be appropriate.

#### *The Counter-Claim*

254. The Respondent has formally requested the Tribunal to:

“Dire et juger que SPP, et subsidiairement SPP (ME) sont responsables à l'égard de la R.A.E. de la non-réalisation des projets, et qu'elles devront payer une somme forfaitaire de 30 millions de USD à titre de réparation du préjudice, incluant les frais de procédure.”

255. In support of the Counter-Claim, the Respondent invokes certain faults alleged to be attributable to the Claimants, namely:

- i) the transformation of the project into a housing project;
- ii) the absence of touristic elements (hotels, commercial centers and villages) in the project;
- iii) the Claimants' abandonment of the Ras El Hekma Project;
- iv) the financial deficiencies of the Claimants; and
- v) above all, the Claimants' refusal to cooperate, and particularly to consider the solution of an alternative site.

256. It results from what the Tribunal has already said that none of these alleged faults was committed and none of them was imputed to the Claimants by the Egyptian authorities as a ground for the cancellation or in any other form before May 28, 1978. It follows that the Counter-Claim is to be dismissed.

#### IV. THE OPERATIVE PART (*DISPOSITIF*)

257. For these reasons,

THE TRIBUNAL, by a majority,

AWARDS to Southern Pacific Properties (Middle East) Limited and Southern Pacific Properties Limited, jointly,

THE SUM OF US \$27,661,000, consisting of the following:

1. The amount of US \$9,784,000, comprised of the US \$1,650,000 loan by SPP(ME) to ETDC, plus interest at the rate and on the terms specified in the loan agreement;



2. The amount of US \$901,000, comprised of the US \$408,000 loans at no interest, plus an adjustment for monetary devaluation using a deflator factor of 2.2074;
3. The amount of US \$3,799,000, comprised of the US \$1,310,000 of capital invested by the Claimants, plus (i) an adjustment for monetary devaluation using a deflator factor of 2.2074, and (ii) simple interest at the rate of five percent per annum from May 28, 1978 to the date of this Award on the amount of US \$1,310,000;
4. The amount of US \$4,986,000, comprised of US \$1,719,000 of development costs, plus (i) an adjustment for monetary devaluation using a deflator factor of 2.2074, and (ii) simple interest at the rate of five percent per annum from May 28, 1978 to the date of this Award on the amount of US \$1,719,000;
5. The amount of US \$5,093,000, for legal, audit and arbitration costs attributable to these proceedings; and
6. The amount of US \$3,098,000, which the Tribunal has determined to be the amount by which the value of the Claimants' investment in ETDC exceeded their non-reimbursable out-of-pocket expenses at the time the project was cancelled.

*Post-Award Interest*

The amount of US \$27,661,000 shall earn simple interest of five percent per annum, beginning 30 days after the date on which this Award is notified to the Respondent, until the date of payment.

*Decisions on Jurisdiction*

The Tribunal's Decision on Preliminary Objections to Jurisdiction of November 27, 1985, and its Decision on Preliminary Objections to Jurisdiction of April 14, 1988, are incorporated in this Award by reference.

*The Counter-Claim*

The Counter-Claim by the Respondent against the Claimants is dismissed.

*Release of Claims*

Upon payment of the present Award, the Respondent shall be released from any further investment claims in relation to the Pyramids Oasis Project and the Claimants' shareholding in ETDC shall be considered as released and transferred to the Respondent.

\_\_\_\_\_  
/s/  
Eduardo Jiménez de Aréchaga

\_\_\_\_\_  
Mohamed Amin El Mahdi

\_\_\_\_\_  
/s/

Robert F. Pietrowski, Jr.

[Date of dispatch to the parties: May 20, 1992]

**REPORTS OF INTERNATIONAL  
ARBITRAL AWARDS**

**RECUEIL DES SENTENCES  
ARBITRALES**

**Shufeldt claim (Guatemala, USA)**

24 July 1930

VOLUME II pp. 1079-1102



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**XXVIII.**

**SHUFELDT CLAIM <sup>1</sup>.**

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**PARTIES: Guatemala, U.S.A.**

**SPECIAL AGREEMENT: November 2, 1929.**

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**ARBITRATOR: Sir Herbert Sisnett (U.K.).**

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**AWARD: Belize, British Honduras, July 24, 1930.**

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Rules of evidence.—Contract between Executive and an individual.—  
Estoppel.—Legal personality of a partnership.—International and municipal  
law.—Damages for breach of contract.—Direct loss.—Loss of profit.—  
Moral damage.

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<sup>1</sup> For bibliography, index and tables, see Volume III.



### Special Agreement.

EXCHANGE OF NOTES BETWEEN THE UNITED STATES AND GUATEMALA  
PROVIDING FOR ARBITRATION OF THE CLAIM.

*The American Minister in Guatemala (Arthur H. Geissler) to the Guatemalan Minister for Foreign Affairs (Eduardo Aguirre Velásquez).*

GUATEMALA, November 2, 1929.

MR. MINISTER: Referring to previous correspondence between the Legation and the Guatemalan Foreign Office concerning the claim of P. W. Shufeldt against the Government of Guatemala, which claim has been espoused by the Government of the United States, it is agreed by the two Governments that this question shall be submitted to Sir Herbert Sisnett, Chief Justice of British Honduras, as Arbitrator. The question to be submitted to the Arbitrator is as follows:

1. Has P. W. Shufeldt, a citizen of the United States, as cessionary of the rights of Víctor M. Morales I. and Francisco Nájera Andrade, the right to claim a pecuniary indemnification for damages and injuries which may have been caused to him by the promulgation of the Legislative Decree of the Assembly of Guatemala No. 1544, by which it disapproved the contract of February 4, 1922, for the extraction of a minimum of 75,000 quintales of chicle, in a defined area in the Department of the Petén, the cession of Nájera Andrade and Morales in favor of Shufeldt having been made by contract of February 11, 1924 [1922] ?
2. In case the Arbitrator declare that Shufeldt does have the right to having an indemnification paid to him by the Government of Guatemala, what sum should the Government of Guatemala in justice pay to the Government of the United States for the account of Shufeldt?

It is proposed that the following procedure shall govern the presentation and adjudication of the case by the Tribunal, and the payment of the award, if any:

1. The Tribunal shall sit at Belize, residence of the Arbitrator.
2. Each Government shall appoint one or more representatives who shall have the authority necessary to appear before the Arbitrator and to represent it.
3. The first day of February 1930 is fixed as the day on which the representatives of the parties shall present their credentials to the Arbitrator either in person or through their respective consular officers. If they be in good and due form, the Arbitrator shall declare the proceedings open.
4. The representatives of the parties shall submit to the Arbitrator a written statement which shall comprise their respective points of view in the relation of the facts, the statements of the juridic point upon which their cause is based and all the proofs which they may wish to present as basis for their claims. They may be set forth in English or in Spanish.

The term, within which the statement of their cause must be presented by the parties, is that of thirty days counted from the time when the Arbitrator declares the proceedings open.

5. Each party shall deliver to the other party a textual copy of its statements, allegations and proofs when the originals thereof are submitted to the Arbitrator.

6. Within sixty days counted from the day on which the last of the parties presented the statement of its cause, in conformity with article 4, each party shall have the right to present a written reply to the allegations of the other party. A copy of that reply shall be delivered to the other at the time of being presented to the Arbitrator.

7. Within thirty days following the termination of the sixty days' period mentioned in article 6, the parties may present oral or written arguments to the Arbitrator, summarizing the proofs and arguments produced in the statements, but no additional evidence shall be presented except at the request of the Arbitrator.

8. Each Government shall have the right to exhibit all documents pertaining to the subject-matter of the arbitration, and the original documents or copies certified by a notary or public officials, whatever may be their character, and to request the production of such documents by the other party.

9. The Arbitrator shall have authority to establish such rules of procedure as he may deem opportune and conducive to the success of the arbitral proceeding, always provided that they do not contradict the bases laid down in the protocol of arbitration.

10. The Tribunal shall keep a record of its proceedings. The two Governments shall assign to the Tribunal such amanuenses, interpreters and employees as may be necessary. The Tribunal is authorized to administer oaths to witnesses and to take evidence on oath.

11. The decision of the Tribunal shall be given within a period of sixty days following the termination of the thirty days' period mentioned in article 7. The decision, when made, shall be forthwith communicated to the Governments at Guatemala and Washington. It shall be accepted as final and binding upon the two Governments.

12. Each Government shall pay its own expenses and one half of the common expenses of the arbitration.

13. The amount granted by the award, if any, shall be payable in gold coin of the United States at the Department of State, Washington, within one year after the rendition of the decision by the Tribunal, with interest at six per centum per annum, beginning to run one month after the rendition of the decision.

14. The honorarium and emoluments of the Arbitrator shall be as agreed upon in previous correspondence.

I avail myself [etc.].

ARTHUR H. GEISSLER

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## DECISION OF THE ARBITRATOR, JULY 24, 1930.

The questions submitted by the protocol of arbitration, dated 2nd November 1929 (and referred to in the record as marked 1), for the decision of the Arbitrator are—

1. Has P. W. Shufeldt, a citizen of the United States, as cessionary of the rights of Víctor M. Morales I. and Francisco Nájera Andrade, the *right* to claim a pecuniary indemnification for damages and injuries which may have been caused to him by the promulgation of the Legislative Decree of the Assembly of Guatemala No. 1544, by which it disapproved the contract of February 4, 1922, for the extraction of a minimum of seventy-five thousand quintales of chicle in a defined area in the Department of Petén. the cession of Nájera [Andrade] and Morales in favor of Shufeldt having been made by contract of 11th February 1922?

2. In case the Arbitrator declare that Shufeldt does have the right to have an indemnification paid to him by the Government of Guatemala, what sum should the Government of Guatemala in justice pay to the Government of the United States for the account of Shufeldt?

Two questions only have been referred for arbitration, and I shall endeavor to confine myself to them only and the points raised by the United States Government and the Guatemala Government bearing on these questions.

Where any point raised is not dealt with, it must be taken that I did not consider it necessary or material or of sufficient importance.

I fully appreciate the honor which has been done me by the United States and Guatemala Governments in appointing me Arbitrator in this case, and I have given all the evidence put before me and all the points raised my most careful consideration with the hope of arriving at a just, fair and impartial decision.

I do not propose to review all the cases quoted but will give my decision on any point in accordance with what I consider to be the law based on recognized authority.

On the question of evidence over which there was some argument, I may point out that in considering the cases quoted on both sides it is clear that international courts are by no means as strict as municipal courts and can not be bound by municipal rules in the receipt and admission of evidence. The evidential value of any evidence produced is for the international tribunal to decide under all the circumstances of the case.

The evidence acted upon in this case conforms with paragraph 8 of the protocol of arbitration and is such as brings moral conviction to my mind.

The foundation of this claim is the contract dated the 4th February 1922 made between David Pivaral B. as Secretary of Agriculture in the name of and in representation of the Government of the Republic of Guatemala and Messrs. Francisco Nájera A. and Víctor M. Morales I.

The provisions of this contract are shortly and where material as follows:

1. Permission was granted to Nájera and Morales to extract chicle in a section of the public lands situate in the Department of Petén in Guatemala.

2. The period of the concession was ten years from the date it was signed, which period could be extended for five years more by mutual agreement.

11. The employees, station masters, chicle inspectors designated by Nájera and Morales by agreement with the authorities of the Department shall have the character of auxiliary authorities for the purpose of preventing and prosecuting fraudulent exploitation and for maintaining order in the contracted zone and prosecuting offenders.

12. Exemption from military service &c.

13. Nájera and Morales obligate themselves to maintain in good condition the natural products of the zone as are not in a condition to be exploited and that they shall effect the extraction of resin in such a manner that it shall not harm or destroy the life of the trees.

14. This chicle negotiation is subjected to the supervision of the respective authorities and to the laws and fiscal by-laws now in force.

15. At expiration of contract or any extension of same, the construction and improvements constructed in the area contracted, such as dwellings, warehouses, roads, telegraph, telephone and railroad lines, railroads, tramways, artesian wells, or any other constructions whatever will pass over to the benefit or possession of the Government.

16. It is expressly agreed between both contracting parties that on entering the fifth year that the contract is in force, they will proceed to make an inventory of all the improvements, constructions, implements, working material &c., which the company may have introduced into the area for the business undertaken and that this inventory will serve as a basis for the delivery of the improvements specified in preceding paragraph upon the expiration of the contract or extension of same. This inventory may be repeated or amplified as many times as the Government may deem advisable.

17. It is also agreed upon that in case of any question arising from failure of fulfilment or misinterpretation of any of the clauses of this contract the subject will not be taken by any means to the courts of justice nor shall the case be referred to diplomatic channels but that any question which may arise will be submitted to two arbitrators, appointed one by each party, and in case of disagreement between both arbitrators they will appoint a third arbitrator whose action or finding on the subject will be deemed final or just without appeal.

18. The Government may dispose of the sum of five thousand dollars deposited as guarantee of this contract as per clause 9 (a) which amount in case of revocation or cancellation of the contract can not be claimed or refunded to them. This five thousand dollars American gold shall be repaid by export duties which correspond to the last lots upon which duties should be paid to the customs.

19. This contract only grants the right to Nájera and Morales to extract and export the chicle from this area and the uses and services which have been mentioned, but the Government expressly reserves to itself the right of absolute dominion and possession of the section or area mentioned; therefore the above-mentioned gentlemen can not withhold its delivery upon expiration of the contract or extension of the same, or upon declaration of the cancellation of the rights under the contract for the reasons specified in same.

This contract was approved of by the President of the Republic of Guatemala on the same day it was signed, and the contract with the President's



3. Nájera and Morales bound themselves to extract and export a minimum quantity of seventy-five thousand quintales of chicle during the ten-year term of contract.

4. Nájera and Morales bound themselves to export one thousand quintales of chicle as a minimum during the first year contract in force, five thousand in the second year and eight thousand five hundred in the next following years.

5. Five dollars American gold was to be paid to Guatemala Government for every quintal of chicle exported—a quintal to be considered as 46 kilos net. This payment was to include the extraction and export duties, the municipal taxes and whatever taxes may be imposed in the future.

6. Payments to be made to the Government, to be made to National Treasury at Guatemala City or any other place designated by the Government of Guatemala.

7. One year from date of signing contract Nájera and Morales obligated themselves to form a company under existing laws of Guatemala, the same period being allowed for beginning the works of the installation of the business.

8. The rights granted to Nájera and Morales by the Government of Guatemala under contract were—

- (a) To introduce free of import duty machinery, implements and tools needed for the extraction and export of chicle.
- (b) To make free use of the natural resources of contracted zone, &c.
- (c) To use rivers, lakes &c., for conveyance of their products.
- (d) To introduce laborers and employees of other nationalities except negro and yellow races.
- (e) To make plantations of grain within the area ceded for exploitation, but in such case to pay Government of Guatemala two thousand dollars annually and in advance as rental duties for the area contracted.

9. Nájera and Morales bind themselves—

- (a) To deposit in National Treasury five thousand dollars American gold within fifteen days from the date contract approved as guarantee of the obligations assumed.
- (b) To prevent fraudulent exploitation of forests within area.
- (c) Within five years to demark and clean limits of area.
- (d) To give preference of employment to Guatemalan citizens.
- (e) To render monthly statement to authorities &c.

10. The rights ceded by this contract will be cancelled:

- (a) For failure to deposit at the proper time the five thousand dollars, which deposit Nájera and Morales bind themselves to make in accordance with clause 9 paragraph (a) of contract.
- (b) For failure to extract and fabricate the annual amounts of chicle referred to in clause 3.
- (c) For infraction of the privileges granted to introduce implements &c., exempted from duties.

approval was published in *El Guatemalteco*, the official newspaper of the Government of Guatemala, in its issue of the 18th February 1922 (see annex 2 of United States Case).

On the 11th February 1922 the five thousand dollars American gold was paid into National Treasury as provided for in paragraph 9 (a) of the contract and a receipt given therefor signed by the National Treasurer, E. Hernandez, and sealed with the seal of the National Treasury (see annex[es] 1 A and 1 B of United States Case).

On the 1st March 1922 in the Acting President's message to the National Legislative Assembly at the opening of its ordinary sessions, it is stated that "the respective Secretaries of State will give you a detailed account in their [printed] 'memorial,s]' which they will present to you of each and every account of the work which has been accomplished by their respective offices during the year just passed" (see annex 8, United States Case).

In *El Guatemalteco* of the 15 April 1922 (annex 11 of United States Case) in the report of the proceedings of the National Assembly of 14th March 1922 it appears that the Minister of Agriculture presented, with accompanying documents, a report or memorial of the work verified by that Department during the past fiscal year. This report and accompanying documents were referred to the National Assembly's Commission on Agriculture, who in reporting thereon submitted the following resolution:

The Legislative Assembly is now informed of the work consigned in the memorial rendered by the Secretary of State in the despatch of agriculture for the year 1922.

On the 25th April 1922 the report of the Commission of Agriculture was approved (see annex 12, United States Case).

This memorial is required to be submitted to the National Assembly by article 75 of Constitution of Guatemala and must in the absence of proof to the contrary be presumed to have contained copies of all the contracts made, including the one in question, or some reference to them.

The Legislative session closed on 29th May 1922, and in June was printed and published at the National Printing Office of the Republic a document purporting to be "the memorial of the Minister of Agriculture presented to the National Legislative Assembly at its ordinary session of 1922" and bearing in print the official seal or stamp of Guatemala. This forms annex 10 of the United States Case and is put in by them as the memorial of the Minister of Agriculture, and this document contains a copy of the contract and other mention thereof.

The Guatemala Government contend that this document is not the memorial of the Minister of Agriculture and that the memorial contained no mention of the contract and that the contract was never submitted to the Legislative Assembly, but would appear to have been deliberately and wilfully withheld from them.

This would seem to be a charge against the then Government of Guatemala, but I do not see how it can discredit Shufeldt, unless he was in league with the Guatemala Government against his own interests and then one would be as bad as the other. I place no value on this statement.

The Guatemala Government put in a photostat copy of a typewritten document (exhibit 25) which they contend is the memorial of the Minister of Agriculture and which contains no mention of the contract. They also put in as exhibit 27 a similar document to annex 10 of United States Case, apparently to show that as it had not been printed till June it could not have

been the "printed memorial" which the United States Government stated was laid before the Legislature which closed in May. The United States Government did state in their Case that the printed memorial was laid before the Legislature, but this was clearly a mistake as will be seen later; the memorial must have been laid in type and printed after. No further use was made of this exhibit 27 by the Guatemala Government.

This document (exhibit 25) is word for word the same as the first and signed portion of annex 10, but without the accompanying documents contained in annex 10. On a perusal of this exhibit 25 it is quite clear that it is not the whole memorial, in fact exhibit 25 would seem to be only the Minister of Agriculture's report on the memorial of his Department for he says on page 9 of exhibit 25 (translation):

The memorial of the General Board accompanying *this report*, will give you an idea of what that important office has done towards the development of their program.

It is clear therefore that there were other documents submitted with the report and together forming what is called the memorial, and this is borne out by references in this report (exhibit 25) to other parts of memorial which are not included in exhibit 25 but are in annex 10 of the United States Case and exhibit 27 of the Guatemala Government Reply; e.g., on page 17 of the translation of exhibit 25 the Minister of Agriculture says: "If these matters do not appear to you as deserving of your attention, I beg to request your glancing at the initiative exposed at the end of this memorial (appendix A)." Appendix A is included in annex 10 and exhibit 27. Again on page 20 of exhibit 25 he says: "The statistical tables shown in another part of this memorial are a part and give an idea of the work done by that important dependency of the Ministry."

On page 21 of the translation of exhibit 25 he states: "In order to bring that idea into practice, I have dared to formulate a complementary project to our immigration law of 1909, which, marked with the letter B, in the appendix to this memorial" (contained in United States annex 10, p. 175, and in Guatemala exhibit 27).

On page 22 he says: "These ideas receive a more ample development in the initiative I permit myself to submit in the appendix of the memorial marked with the letter C, which deals with the repopulation of the forest [*of forests*] and to which I request your benevolent attention" (United States annex 10, p. 182, and Guatemala exhibit 27).

All these references are found in the printed copy of the memorial (United States annex 10 and Guatemala exhibit 27) but not in Guatemala exhibit 25 which the Guatemala Government claim to be the memorial.

The Guatemala Government in further support of their contention that the contract was not submitted to Assembly and [that] no mention was made of the contract in the memorial, contend that the report (exhibit 29 of the Guatemala Government) of the Agricultural Commission of the Assembly on the memorial does not mention the contract. This report however does mention certain contracts which they say are *not* included in the memorial. Had the contract of the 4th February 1922 not been included it must be presumed that it would have been mentioned. As a matter of fact the contract is given in full with the President's approval just as published in *El Guatemalteco* at pages 145-49 of annex 10 and is also mentioned in the list of Executive orders (*acuerdos*) on page 167 as having been approved; that the Commission considered this list is clear from the following passage

therein at bottom of page 3 of the translation of the report: "Of the lecture of the resolutions passed during the year, we make a résumé &c."

In further support of this contention the Government of Guatemala submitted a certificate from Raf. Castellanos A. and Ramón Calderón, Secretaries of the Legislative Assembly of Guatemala, dated 18th February 1930 to the effect that in the *text* of the memorial presented by the Ministry of Agriculture in the year 1922 to the Legislative Assembly, relative to the work undertaken by said Ministry from March 15, 1921, to March 15, 1922, no mention was made to the contract celebrated on February 4th 1922 between Ministry of Agriculture and Messrs. Francisco Nájera Andrade and Víctor M. Morales I.

What is the exact meaning of the word *text* in this certificate I am not prepared to say. In view of the fact that the Guatemala Government contend that the report portion of the memorial is the memorial, it may mean text of the report part of the memorial only or the text of the part other than the report or the whole memorial. It is too indefinite for me to act on in any case, particularly in face of evidence before recited and other evidence which I have not cited.

In the face of the facts already related, exhibit 25 of the Guatemala Government is certainly not the whole memorial, and those facts and others to be mentioned later lead me irresistibly to the conclusion that the contract was submitted to the Legislative Assembly in the memorial and that that body were fully cognizant thereof, and I so find.

I will now consider the question of the legality of the contract, apart from the question of its submission to the Legislative Assembly.

Where a contract has been made by the Executive and duly reported to the Assembly and approved—and where a document is laid before the Assembly in accordance with the law and no objection taken, it must be taken to be approved—it is difficult to see what more is wanted to make it legal, and the fact of my having found that the contract was submitted to the Legislative Assembly settles most of the grounds of illegality urged by the Guatemala Government, and it is not really necessary for me to discuss further the legality of the contract. I will however discuss the points on which the Guatemala Government contend the contract is illegal, and they are eight in number, as given in their Case (p. 16).

- (a) The Minister for Agriculture had no authority to make same.
- (b) The President had no authority to approve of the same.

I will deal with these two together.

In support of these contentions the Guatemala Government tender a certificate from Raf. Castellanos A. and Ramón Calderón, Secretaries of the Legislative Assembly of Guatemala, to the effect that in the month of February 1922 the Executive Power was not authorized by the Assembly to celebrate contracts as prescribed in paragraph 6th of Article 54 of the Constitution, which gives among the attributes of the Assembly the power to authorize the Executive to make contracts, and to approve or disapprove of contracts made under such authority, and in exhibit 6 of the Guatemala Case Mr. J. A. Mandujano, a Guatemalan lawyer, gives it as his opinion that the Government was not authorized by Congress to enter into any contract under the provisions of article 54, paragraph 6.

The American Government, however, refer me to article 650 of chapter 6 of title XIII of the Fiscal Code of Guatemala, which is to the following effect: "The authorization to exploit national forests will be conceded by

means of contracts which will be celebrated with the Executive or by leases which will be celebrated with the Jefe Político."

As to this the Guatemala Government contend that the contract is one of lease and therefore not within article 650. This would imply that if the contract is one of exploitation and not of lease article 650 would apply. The question of lease will be dealt with later.

The United States Government also submitted that under Decree No. 12 of the Legislature dated the 20th December 1921 the Executive Power was authorized to make such contract.

This decree is published in *El Guatemalteco* vol. C, no. 83 of the 24th December 1921 and is as follows:

ARTICLE 1. The Executive Power is amply empowered to enact all dispositions in respect to regulating the economic condition of the State.

ARTICLE 2. Executive Power shall report to the Assembly during its ordinary sessions of 1922 such acts as he may dictate.

The Guatemala Government contend that this does not empower the Executive to make contracts, and in support of this rely on the opinion of J. A. Mandujano and Marcial Salas, Guatemalan lawyers, to this effect: "The Legislative Decree No. 12, second series of December 20 [th], 1921, did not confer powers to the Executive to celebrate contracts; said faculties can only be granted by the Assembly under a clear and categorical form." The Guatemala Government in their Reply, section 81, say: "In order to further show that Decree No. 12 . . . does not grant any power to the Executive to execute contracts, the Republic [of Guatemala] exhibits Decrees 1199, 1312, and 1500 made subsequently thereto, by which it will be seen that the Legislative Assembly granted the Executive the power to execute contracts specifically. A comparison of these last-mentioned decrees with the former (annex 7) will be conclusive in this point."

These three Decrees 1199, 1312, and 1500 (exhibits 43, 44, and 45 of Guatemala) were passed by the Assembly on the 27th May 1922, 5th May 1924, and 3rd May 1927 all after the contract had been made, and could not in justice be allowed to affect acts done and rights acquired under a previous decree of the Assembly. I can see no grounds for doubting that the Executive had the power to contract. The President must have known whether he had the power to contract or not, and the publication of the contract is certainly not in accord with his trying to get away with something he was not legally entitled to.

(c) The period of duration thereof was contrary to the law of the Republic of Guatemala.

(d) The lease or rental of the territory in question without previous public auction was contrary to [the] law [of the Republic of Guatemala].

In support of these contentions the Guatemala Government refers to the opinion of Mr. J. A. Mandujano, a Guatemalan lawyer (exhibit 6, sec. 11), who says: "In consequence of articles 1439, 1440, 1443, 1444, 1447, 1459 of the Fiscal Code and 1645 and 1668 of the Civil Code, no property belonging to the Republic can be sold or rented if the sales are not submitted to public auction, and even in those cases the maximum period of rental can not exceed 5 years."

The contract in question is not one of sale or rental of Guatemalan property and this is clear from a perusal thereof particularly section 19; it merely gives the right to extract chicle, with certain privileges in connection there-

with among which is the one to make plantings of grain which if exercised was to be paid for by annual payments. This privilege in my opinion can not change the whole character of the contract from a concession to extract chicle to that of a lease of the land, this would be a case of the lesser containing the greater; nor can the use of the terms "tenant", "lease", "lessee", &c., in documents or papers unconnected with the contract as referred to in certain parts of the case.

The protocol refers to Shufeldt as cessionary and I can not but presume that the Governments who signed the protocol carefully weighed the significance of the terms they used.

(e) The duties payable thereunder were less than those required to be collected by the said law.

The contract having been approved by the Assembly, any variations in the rate of duty then in existence would be made good even if the Executive had no previous authority to make such change. It is not therefore necessary for me to comment further on the matter, but the Guatemala Government in support of their contention do not refer me to the law on the subject but submit (1) the opinion of Mr. J. A. Mandujano, as follows: "According to the customs-house tariff which is a law of Guatemala the exportation of each quintal of chicle is impose [*sic*] a tax of \$7.00 American gold be it the product of public or private lands. These exportation duties were in force on the 4th February 1922 and only Congress has power, as per article 54 of the Constitution to modify or abrogate them", and (2) a certificate from F. Fuentes Dias, Under Secretary of State in the Department of Finance and Public Credit, to the effect that the export duty on chicle in February 1922 was seven dollars per quintal. Supposing however that these two statements be correct from a general point of view, they do not show that the tax may not be altered under certain special circumstances.

Article 54 of the Constitution, referred to in Mr. Mandujano's opinion, provides in section 12 for the giving by the Legislative Assembly to the Executive extraordinary power when demanded by necessity or the interest of the State; and in the *El Guatemalteco* of the 17th January 1922 it is reported that at the eighteenth session of the Assembly on 2nd January 1922 as follows: "After being read, the report of the Combined Committee on Legislation and Finance was put to a discussion for once only and that point of the resolution which read as follows was approved:"

By virtue of the decree issued by the Assembly during the present extraordinary session under date of the 20th of last month (Decree No. 12, Second Series) the Executive is fully empowered to legislate upon fiscal matters included in the economic adjustment and in consequence the Department of the Treasury and Public Credit may enact whatever tax law it may deem adequate, or modify the one now in force (Decree 1153) as it sees fit and to enact any other laws on the economic order which in its judgment may promote the well-known interests of the State.

It would seem therefore that the Executive had full powers to reduce the tax as was done in the contract, if considered advisable.

In this connection I will mention that in a bulletin issued by the Director General of Customs purporting to be printed at the Government Printing Office and bearing the official stamp or seal of the Department, put in



by the United States as annex B to their Reply, I see that "Chicle pays 7 cents American gold per lb. (order of October 31, 1914) and pays by contract 5 cents American Gold per pound (vol. 101 nos. 30, 31 & 56 of *El Guatemalteco*)". (The Guatemala Government objects to this annex as not being "certified, not official and incomplete"—but make use of it as evidence for themselves: p. 5 of their Final Argument.) I can not avoid the conclusion that the Executive had the power to do what they did. I may point out that in a volume of the laws of Guatemala entitled "Recompilation of the Laws of the Republic of Guatemala 1921-22", published at the Government Printing Office in 1927 and bearing the official stamp or arms, I find copy of a contract made between the Minister of Forests, on instructions of the President, with the Chicle Development Company for the extraction of chicle approved by the President on the 2nd February 1922. In this contract the duty payable on chicle is five dollars per quintal. The contract in this case is also contained in this same volume. This would point to the fact that the contract was deemed and treated as legal up to the time of this publication.

(f) The authority to import free of duty purported to be given under clause 8 of the said agreement was contrary to the said law.

In view of the powers of the Executive as shown above it is hardly necessary to discuss this point.

(g) The authority to constitute the employees of P. W. Shufeldt & Company to be government officials purported to be given in clause 11 of the said agreement is contrary to law.

Clause 11 of the contract as I read it can not be held to confer authority on the concessionaires to constitute their employees government officials, it only provides that the employees by agreement with the authorities shall have the character of auxiliary authorities. The government authorities must sanction the assumption of any such character and there is no general power given to concessionaires to sanction the assumption of such character without the approval of the authorities. The Guatemala Government refer me to the opinion of Mr. J. A. Mandujano (exhibit 6, translation) who says: "The appointment of any person having official authority corresponds to the Government of the Republic, but the authority to effect these appointments can not be delegated or bestowed on any person", but why or on what authority he does not say.

(h) The said agreement was not submitted for nor received the approval of the National Assembly.

This point has already been dealt with.

I will now deal with events subsequent to the making of the contract and giving rise to Shufeldt's interest in the contract and to the present proceedings.

On the 11th February 1922 or about seven days after the making of the contract the concessionaires assigned all their rights and obligations without reservation whatever to Shufeldt on the following terms: (1) Shufeldt to pay on the day of assignment five thousand dollars American gold and continue to pay during life of contract five thousand yearly on same date "of this instrument being drawn" and in addition three dollars American gold for each hundredweight of chicle extracted; (2) Shufeldt

to make all payments the concessionaires are under the contract bound to pay to the Government (United States annex to Case, No. 3).

On 1st July 1922 Nájera and Morales notified the Minister of Agriculture of the transfer to Shufeldt and asked that Shufeldt be considered as concessionaire under contract and that the authorities in Petén be so informed.

On the 7th July 1922 Shufeldt also reported the transfer and made a similar request, and on the 10th July the Minister of Agriculture instructed that Shufeldt be so recognized.

On 25th April 1922 Deputy Franco in a motion in the National Assembly proposed the following decree—

#### CONSIDERING

that the constitutive law of the Republic empowers the Executive to grant concessions for a term of 10 years to those introducing or establishing new industries in the Republic; that without character of novelty some persons under pretended contracts with the Government have succeeded in obtaining true monopolies for the exploitation of well-known industries in the country and that with it not only are the collective rights hurt, but it violates the dispositions in article 20 of the Constitution of the Republic.

#### THEREFORE

the National Legislative Assembly decrees:

ARTICLE 1. Under no circumstances or whatsoever pretence nor in any form may concessions be granted for the introduction or exploitation of industries already known in the country.

ARTICLE 2. The concessions granted prior to the decree are declared null with no value or effect and in fact lapsed even though in its granting the form employed was that of a contract.

This motion was referred to the Commission of Legislation and Constitutional Points who reported against it saying as to article 2, that the decree "would establish a disposition of retroactive effects contrary to the general principles of right" and on the 17th April 1923 Mr. Franco's motion was rejected.

During the debate on this motion it was proposed that a special study be made of all the contracts made during the year, but this was rejected. The present contract was clearly one of the contracts made during the constitutional year in which the motion was made, it had been published in the gazette before the motion was made and also purported to have been laid before the Assembly in the usual way, in the Minister of Agriculture's memorial. If therefore further evidence of approval of the contract was needed here we have it. In negating the resolution we also have approval or sanction of the monopoly which it is contended the contract created, and which was one of the grounds of disapproval stated in the proposed decree submitted by the Commission on Agriculture to the Legislative Assembly in their report which led to passing of the decree disapproving of contract on the 22nd May 1928—but not mentioned in the decree as eventually passed.

On the 16th January 1923 in accordance with the provisions of section 7 of the contract Shufeldt and one Don Clodoveo Berges entered into



partnership for the purpose of exploiting and exporting chicle from Department of Petén in complete conformity with the requirements of the contract, on the following terms, so far as material to this case:

1. The name of the firm will be P. W. Shufeldt & Co. and the partner Shufeldt shall have exclusive use of it, (2) society to exist ten years, Mr. Berges to have right to withdraw from the company at any time, in which case he shall have the right to collect his capital with six per cent, (3) the partner Shufeldt contributes as capital the concession of which he is grantee, (4) the partner Berges will contribute the sum of twenty-five thousand dollars American gold and is obligated to put the same sum in the funds of the company as soon as the business demands it, (5) the partner Berges has no right to share in profits until his contribution is made, (6) in case the sum of twenty-five thousand dollars gold as contribution of partner Berges is not handed over within thirty days after a demand made in writing this deed of partnership will be non-existent.

Mr. Berges never paid up the twenty-five thousand dollars and died in 1924 having no claim whatever on the partnership. On 29th March 1928 Shufeldt entered into partnership with David Davidson on similar terms to previous partnership, except that Shufeldt contributed as capital the right of exploiting and extracting chicle but will remain the only owner of the concession. In the articles of incorporation is recited the death of Berges without his having contributed his twenty-five thousand dollars. Davidson has never contributed his twenty-five thousand dollars, and he therefore has no claim or interest whatsoever in the partnership or concession (annex 11 to United States Reply). The question raised on this partnership will be dealt with later.

On 24th April 1923 a petition by the Peteneros was presented to the Legislative Assembly, asking for a revision of the contracts with the Chicle Development Co., with Nájera and Morales, and with Attorney Leonardo Lara and stating that the Nájera and Morales contract had been transferred to Shufeldt. This petition was referred to the Agriculture Commission, and the Minister of Agriculture forwarded to the Legislative Assembly certified copies of those contracts on the 30th April 1923, about one year after the signing of the contract in question (see exhibit 7 of Guatemala Government). This petition, judging from exhibit 7, is still with the Commission on Agriculture—but here is further evidence of the contract being brought to the notice of the Legislature. From these facts the Legislature knew of the contract in April 1923, and did nothing for about five years. It was no doubt difficult to do anything in face of their previous action, but it was up to the Legislative Assembly to move, and do their duty (if any), and on what grounds it is stated that influence was brought to bear on the Commission on behalf of parties interested I fail to see.

Certainly Shufeldt would not seem to have tried to use any influence with Assembly as he wrote to the President on the subject of this petition and the President replied assuring him that he need have no fear that the procedure of the aforementioned persons (the petitioners) will injure the legitimately acquired rights. Being thus assured by the Head of the Government why should Shufeldt try to influence the Commission? Had Shufeldt addressed the Assembly as the Guatemala Government in section 35 of their Answer seem to think he ought to have, there might have been more reason for thinking he was trying to influence the Assembly.

The contract continued in force up to the 22nd May 1928, when Decree No. 1544 was passed by the Legislative Assembly disapproving the contract. During all these six years Shufeldt had been carrying out his contract, expending money on it and paying what the contract called for to the Government. Relying on the good faith of the Government he expended large sums in providing the necessary appliances, roads &c., for facilitating and expediting the extraction and export of chicle in the hope of recouping his expenditure by the time the contract expired (see annex 14 A of United States Case, p. 189).

During these six years the Government—and in speaking of the Government I mean the Executive who must be presumed to be acting in accordance with law and whose acts, those dealing with the Government are justified in treating as acts of the Government—recognized and treated the contract as a legal contract, as for instance—

(1) The Government received the five dollars a quintal on all the chicle exported and gave receipts therefor, and the two thousand dollars a year in respect of plantings in the area.

(2) On 28th February 1928 the President wrote to Shufeldt about *ceding* "part of the land which you have contracted" (see annex No. 28, United States Case).

(3) On the 2nd May 1927 the Minister of Agriculture wrote to Shufeldt, acknowledging receipt of "a copy of the detailed report of the improvements made by you in the zone of Petén, which you are working as grantee in accordance with the respective contract". This inventory is required by section 16 of the contract.

The Guatemala Government, in section 37 of their Answer, point out that this inventory was overdue and had to be asked for. This may be so, but the Guatemala Government accepted the inventory without protest and took no action; and it was certainly not a ground on which the contract was cancelled, and whatever cause of complaint there may have been was waived.

In view of my finding that the contract was laid before the Legislature and approved by them, it is not necessary for me to deal with the second point raised by the United States Case, viz., that the Guatemala Government having recognized the validity of the contract for six years and received all the benefits to which they were entitled under the contract and allowed Shufeldt to go on spending money on the concession, is precluded from denying its validity, even if the approval of the Legislature had not been given to it.

I may however state on this point that in all the circumstances I have related and the whole case submitted to me, I have no doubt that this contention of the United States is sound and in keeping with the principles of international law and I so find.

I will now pass on to a consideration of the decree which put an end to the contract, and the points raised in connection therewith.

It is not necessary for me to go into what led up to the enactment of the decree, or the influencing causes, suffice it to say that as shown in the decree itself it was not due to any action of Shufeldt's. On 22nd May 1928 the Legislative Assembly of Guatemala passed Decree No. 1544 which is as follows:

The Legislative Assembly of the Republic of Guatemala consider that the contract celebrated on the 4th February 1922, by the Secretary of State in charge of the Ministry of Agriculture and Messrs. Francisco Nájera Andrade and Víctor M. Morales I. by virtue of which these latter are given *permission* for the *extraction of chicle* in a zone of the public lands situate in the Department of Petén and defined in that said contract, is harmful to the national interests, in violation of dispositions and prohibitions defined under the laws of the Republic and especially those contained in articles 653, 1458, 1459 of the Fiscal Code, and that it is within legislative attributions to approve or disapprove contracts of the nature of that in question—

Therefore, be it decreed:

**ONLY ARTICLE:** The contract in question is disapproved. The Executive should take such measures and emit such dispositions as the case demands, to the effect that the zone of public lands be returned to the power of the State. Passed to the Executive for publication and compliance.

This decree was approved of by the President and published in the *El Guatemalteco* of 7th July 1928. This brought the contract summarily to an end, thus depriving Shufeldt of all his rights under the contract.

The grounds on which the decree is based are three:

- (1) harmful to national interests,
- (2) in violation of dispositions and prohibitions defined under the laws of the Republic and especially those contained in articles 653, 1458, 1459 of the Fiscal Code,
- (3) that it is within legislative attributes to approve or disapprove of such contracts.

As to (1) and (3), it is perfectly competent for the Government of Guatemala to enact any decree they like and for any reasons they see fit, and such reasons are no concern of this Tribunal. But this Tribunal is only concerned where such a decree, passed even on the best of grounds, works injustice to an alien subject, in which case the Government ought to make compensation for the injury inflicted and can not invoke any municipal law to justify their refusal to do so.

As to (2), the provisions of the Fiscal Code referred to relate solely to leases of national forests and leases of national real property. Article 653 is found in title 6 of the Fiscal Code in the same title and chapter that article 650 referred to before is found, and on a consideration of the two articles under same title and chapter I come to the conclusion that article 653 refers to leases by the Jefe Político and not to contracts celebrated by the Executive for the exploitation of national forests as provided by article 650. Articles 1458 and 1459 deal with the alienation of national property.

It is significant that the grounds of disapproval are inherent in the contract and not due to any breach of the contract. According to the Guatemala Government the contract was null and void *ab initio* and never had any existence, to set up a breach of the contract is to admit a legal contract. I will however consider the points raised.

The Guatemala Government in section 34 of their Case contend that this decree establishes the fact that the contract was null and void *ab initio*. I can not agree with this contention, but as I have already found

that the contract was a valid contract made by the Executive and approved by the Legislature, it is not necessary therefore to discuss this point.

In sections 38 and 39 of their Case the Guatemala Government contend that the contract provides for its own automatic cancellation, in the event of the minimum quantity of chicle specified not being exported and that such minimum was not exported in 1924 and 1925. In section 3 of their contentions at the end of their Case, they contend that the said agreement of the 4th February 1922 was abrogated, cancelled and avoided under the terms thereof, by reason of the grantee's failing to comply therewith "as set out in paragraphs 39 and 40 hereof".

There is however no provision in the contract for automatic cancellation, the contract says "will be cancelled" and contemplates a declaration of cancellation before actual cancellation, as section 19 of the contract says that the Government expressly reserves to itself the right of absolute dominion and possession of the section or area mentioned, therefore the concessionaires can not "withhold its delivery upon expiration of the contract or extension of same, or upon declaration of the cancellation of the rights under the contract for the reasons specified".

If there was a contravention of the agreement as alleged, it is clear from the evidence that the Government took no steps to cancel the contract and did not refer the matter to arbitration under the terms of section 17 of the contract, and that the Government continued to recognize the validity of the contract and receive the benefits accruing to it thereunder up to the time of the passing of the decree—a matter of about three years after the alleged breach—thereby in my opinion waiving such breach (if any).

But was there a contravention? The chicle business year runs from about July one year to July next year, and from annex 64 of United States Case and the receipts of the Guatemala Government referred to therein, which I have inspected, there was less chicle extracted in seasons 1923-24, 1925-26, 1926-27 and 1927-28 than called for by section four of the contract, but in the seasons 1922-23 and 1924-25 enough was extracted to cover all deficiencies in the other years and leave a balance over and above the proportionate part for six years of the seventy-five thousand quintales required for the whole period (ten years) of the contract.

Again, section 3 of the contract provides for the extraction and export of a minimum of seventy-five thousand quintales of chicle during the ten years of the contract, while section 4 gives the quantities to be exported each year, but section 10 states that on a failure to comply with section 3, not section 4, the contract will be cancelled. Section 3 has been more than complied with and section 4 would seem to be subsidiary and merely directory to section 3.

In any case the Guatemala Government can not set up this alleged breach as the cause of the cancellation in face of the provisions of the decree.

The Guatemala Government also contend that the contract was "abrogated, cancelled and avoided" by the using of machetes for bleeding the trees instead of a scratcher contrary to law and fiscal regulations, and support this by an affidavit of one Franco J. Perez (exhibit 14) who states that he was employed at Plancha de Piedra in 1925, 1926 and that during that period chicle was bled in the zone in question by the use of machetes.

The contract makes no provisions for the use of machetes, but provides, section 13, that the resin shall be extracted in "such a manner that it

will not harm or destroy the life of the trees" and also that (section 14) "this chicle negotiation is subjected to the supervision of the respective authorities and to the laws and fiscal by-laws now in force". If therefore the law had been broken in this way the authorities could have proceeded under the law; but the Government never having taken any steps to put a stop to this practice which they must have known existed either under the law or by arbitration under the contract, and never having declared the contract cancelled therefor, and having recognized the contract all through, and thus making themselves *particeps criminis* in such breach (if any) of the law, can not now in my opinion avail themselves of this contention.

I may also point out that the use of the machete is not a ground given in the decree for the disapproval of the contract, nor is there any evidence of the trees having been in any way damaged or destroyed by such use.

Having found that the contract was a valid contract and that there was no breach thereof by Shufeldt, the question arises did Shufeldt acquire any rights of property under the contract.

There can not be any doubt that property rights are created under and by virtue of a contract, and the Guatemala Government admit this in section 103 of their Answer as follows: "The Republic of Guatemala does not deny that the grantee or assignee of a legal and binding contract acquires property rights subject to the terms and conditions of the [such] contract." There is therefore no need to discuss this question further. Shufeldt did, in view of my findings, possess the rights of property given to him under the contract.

The Guatemala Government however contended (in their Reply, sections 105-107) that notwithstanding that Shufeldt may have acquired rights under the contract in the first instance, yet by forming the company required to be formed under the contract (section 7), and assigning to such company all his rights under the contract, he has divested himself of all his rights and vested them in the company Shufeldt & Company, and that Shufeldt "has no rights under the contract which he could either enforce by action in courts of law or by invoking the aid of the United States as an American citizen".

There was considerable argument on both sides as to whether a partnership was a juridical entity in Guatemalan law and whether the Shufeldt-Berges or the Shufeldt-Davidson partnership was in existence at the date of the decree depriving Shufeldt of the concession, but in the view I take it is not necessary for me to consider those questions. The Guatemala Government contend that the Shufeldt-Berges partnership was in existence, and the United States that the Shufeldt-Davidson partnership was in existence, but it makes no difference which was in existence, or whether any partnership was in existence, as it is not the rights of the partnership that are in question but the personal interest of Shufeldt in the partnership. Had Shufeldt not formed a partnership, the terms of the contract to that effect would not have been carried out, but this could not affect the present question; the Guatemala Government did not take any action in the matter, the contract was being carried out, no injury was done to the Guatemala Government, and if the reason for the provision as to the formation of a company in the contract was what is suggested in section 105 of the Guatemala Government's Reply, viz., to prevent the possibility of the grantee's rights under the said contract falling into the "hands of an alien with the subsequent risk of international claim such as the one that

has actually arisen in this present case", then the Guatemala Government was trying to do what it could not do in the eyes of international law. International law will not be bound by municipal law or by anything but natural justice, and will look behind the legal person to the real interests involved.

The Guatemala Government, by way of showing that Clodoveo Berges had an interest in the partnership, states in sections 26 and 27 of their Reply that Francisco Nájera assigned to Berges for the sum of ten thousand dollars his right to receive under the contract one hundred and fifty dollars per quintal for chicle exported and that there was due to Berges fifty-nine thousand seven hundred and fifty-six dollars and ninety-nine cents on this account, and that this more than covered the twenty-five thousand dollars capital to be brought into the partnership by Berges. This assignment is given as exhibit 31 of the Guatemala Government's Reply, and it is dated the 12th October 1923. On that same day, however, and in the presence of the same parties, Berges assigned to Shufeldt the same rights assigned to him by Nájera for the sum of ten thousand dollars (see annex 50, p. 358, of the United States Case), and I have seen a certified copy of such assignment of the 12th October 1923 furnished me by the United States consul at my request.

I am perfectly satisfied that Berges had no pecuniary interest in the partnership either before or after his death, nor had Davidson at the date of the decree, and that all the rights conferred under the contract to the concessionaires were vested in Shufeldt and he was the only sufferer by the decree terminating the concession and in effect confiscating all his rights and interests therein.

Any other view with regard to this question of partnership would be contrary to the provisions of the protocol of arbitration, which submits this question: "Has P. W. Shufeldt . . . the right to claim pecuniary indemnification . . .?" What does the word "right" in this question mean? It can only mean an equitable right of which international law takes cognizance. It can not mean legal right enforceable only in keeping with Guatemalan law, for if that was so this case never would have been referred to an international tribunal which does not administer municipal law.

If this point raised by the Guatemala Government was sound why should they have consented to arbitration? They referred to arbitration not the rights of Shufeldt & Co. but those of Shufeldt and this notwithstanding the provision in the contract requiring the formation of a partnership, put therein for the purpose of preventing such an arbitration. No international tribunals will allow municipal legal fictions of this sort to prevent them doing strict justice.

The Guatemala Government contend further that the decree of the 22nd May 1928 was the constitutional act of a sovereign State exercised by the National Assembly in due form according to the Constitution of the Republic and that such decree has the form and power of law and is not subject to review by any judicial authority. This may be quite true from a national point of view but not from an international point of view, for "it is a settled principle of international law that a sovereign can not be permitted to set up one of his own municipal laws as a bar to a claim by a sovereign for a wrong done to the latter's subject".

Having dealt with all the points of any importance urged for and against the right of Shufeldt to claim pecuniary indemnification I come to the conclusion and find that he has such a right.



I will now consider the question of damages and will, to begin with, quote the words of the Arbitrator in the claim of *R. H. May vs. Guatemala and Guatemala vs. May*, reported in *Foreign Relations of the United States*, 1900 (p. 673): "I can not pretend to lay down the law concerning damages in clearer words than those of the advocate of the Guatemala Government who uses the following language in the counter-claim: 'The law of Guatemala says Don Jorge Munoz (to which the claimant is subject in this case) establishes, like those of all civilized nations of the earth, that contracts produce reciprocal rights and obligations between the contracting parties; that whoever concludes a contract is bound not only to fulfil it but also to recoup or compensate (the other party) for damages and prejudice which result directly or indirectly from the nonfulfilment or infringement by default or fraud of the party concerned and that such compensation includes both damage suffered and profits lost: *damnum emergens et lucrum cessans*.'"

The *damnum emergens* is always recoverable, but the *lucrum cessans* must be the direct fruit of the contract and not too remote or speculative.

I will deal with the profits lost first and it seems to me that this is essentially a case where such profits are the direct fruit of the contract and may reasonably be supposed to have been in the contemplation of both parties as the probable result of a breach of it.

The contract at the date of its cancellation or abrogation had been in existence for six years, and the extraction and exportation of chicle was carried on as a going business which was producing substantial profits, and there is nothing to show that these profits would not have continued to the expiration of the contract. The amount of profits earned during this period is shown by the extract from Shufeldt's books, duly certified by his bookkeeper Mr. Julio Urquiola to be one hundred and fifty-six thousand four hundred and eighty-seven dollars and forty-seven cents (\$156,487.47) but deducting four thousand dollars interest on mortgage on Ixlu—Mr. Shufeldt's own property—which I can not hold as properly included, the sum becomes \$152,487.47 which gives a yearly profit of \$25,415 for the six years, and this multiplied by four gives the profits at say \$101,660 which Shufeldt would be entitled to for the four remaining years of the contract. The United States Government in their case claimed \$400,000 as prospective profits, and it was urged by the United States Government that the improved means of transportation carried out by Shufeldt and the fact that he was free from his contract with Wrigley & Co. and could get a better price for his chicle, should be considered in fixing the amount of profit; but taking into consideration Mr. Shufeldt's memorial to the President of the Republic, dated the 30th May 1928 (annex 39 to United States Case), in which he gives details of cost of a quintal of chicle and price obtained showing an "apparent" (?) profit of \$5.00 from which must be paid bagging, freight from Plancha de Piedra to Belize, overhead, interest on money and losses inherent to all business, and states that the profit is very questionable; and also that the largest profits made during the six years were made in the season 1924-25 before the effects of improved transportation had been experienced, I can not see my way to extend the amount of the profits beyond those based on the profits actually obtained during the period of six years.

Dealing with the *damnum emergens* the Guatemala [United States?] Government make certain claims—twenty-one in number—which I will consider in the order in which they are given in the United States Case:

1. Deposit in the Guatemalan National Treasury, under section 9 (a) of the contract, which was in accordance with section 18 of the contract to "be repaid by export duties which correspond to the last lots upon which duties should be paid to the customs". The abrogation of the contract prevented Mr. Shufeldt from exporting these last lots of chicle, therefore Mr. Shufeldt who acquired all the concessionaire rights under the contract is entitled to the refund of this amount—\$5,000.00.

2. Laborers' accounts due on account of advances, \$612.92. Most of these are old accounts the nonpayment of which can not be ascribed to the cancellation of the contract. I allow one hundred and thirty-seven dollars and fifty cents (\$137.50).

3. Chicleros' accounts due on account of advances, \$7,600.91. These are also old accounts the nonpayment of which can not be put down to the cancellation of the contract. I allow one thousand three hundred and nine dollars and ninety-six cents (\$1309.96).

4. Contractors' accounts due on account of advances, \$5,391.59. This amount I allow.

5. Current accounts due, \$5,539.98 less \$3,747.66 paid, leaving \$1,792.23, which I allow.

6. Employees' accounts due on account of advances, \$584.59. I allow this amount.

The amounts set out in numbers 2, 3, 4, 5, and 6 could reasonably have been expected to have been repaid, had the contract continued in existence to the end of its period, the canceling of the contract renders it impossible that they or any portion of them will now be paid. I think these items ought to be allowed.

7. Cost of Finca Ixlu and improvements \$28,790.37. The property was bought by Shufeldt as his own private property and still is his own private property. He states however that it was bought purely for the purposes of his concession and is now no use to him. I can not see my way to allowing this item.

8. Cost of mules and horses on hand, \$9,976.50.

9. Cost of work cattle (oxen), \$619.10.

10. Cost of tools and equipment, \$7,978.70.

11. Cost of boats and equipment, \$4,742.90.

12. Cost of office furniture, equipment &c., \$3,009.10.

13. Cost of general merchandise, \$8,593.24.

All these items, 8, 9, 10, 11, 12, and 13 of expenditure were incurred on the strength of the contract lasting ten years at least, and now they are useless; it must be remembered that the concession covered a very wide area and many offices and large number of employees. There was recovered a sum of \$4,430.00 on sale of equipment making the total amount of items 8, 9, 10, 11, 12, and 13, \$30,489.54, which I allow.

14. Cost of insurance premiums paid, \$13,510.00, less surrender value \$6,700.00 equalling \$6,810.00. This was an insurance on Shufeldt's own life for the purpose of liquidating, in the case of his death, any liabilities arising from his business, which were not covered by other assets. This item I can not allow.

15. Care of live stock, July 4th 1928 to 31st March 1929, \$2,013.24.

16. General expenses 4th July to March 31, 1929, \$17,058.28.

17. Cash expenditures Belize, March 31, 1929, to 31st December 1929 \$4,512.81.



18. Cash expenditures Belize, March 31 1929 to November 6 1929, \$1,377.02.

These are all expenses incurred in consequence of the cancellation of the contract, in closing down the business. They are not impugned in themselves by the Guatemala Government but are stated to be included in damages given in the case of *Shufeldt vs. Wrigley* decided in March 1928. There is however no sufficient evidence to satisfy me on that point and I therefore allow them \$24,961.35.

19. Loss of salary and living expenses March 31 1929 to date of award, \$8,261.20.

This Mr. Shufeldt is certainly entitled to as part of his damages, for the prospective profits allowed are calculated on a net basis and do not include his salary or living expenses.

20. Additional commitments. March 31 1929 to date of award, \$25,968.42.

This item is objected to by the Guatemala Government to the extent of \$20,000.00, which is included to satisfy any judgment that Nájera and Morales may recover against Shufeldt in respect of the annual sum agreed to be paid by Shufeldt to them for the purchase of the concession, on the ground of its remoteness. This objection I uphold and allow only \$5,968.42.

21. Rental of pit-pan wharf in Belize, \$660.00, less rental received for boats \$323.00, leaving \$337.00. This wharf was necessary in connection with the business and the rent due after the cancellation of the contract forms a proper claim. I allow \$337.00.

The United States Government also claim the sum of \$50,000.00 in respect of loss of time, injury to credit, and grave anxiety of mind on account of the cancellation of the contract. Taking all the circumstances into consideration, that Shufeldt was suddenly thrown out of business and the time and expense incurred in endeavoring to come to a settlement with the Government of Guatemala and then in trying to get the United States Government to espouse his cause, I think it just and not excessive to allow \$35,000.00 on this head.

Interest is also claimed by the United States Government. Shufeldt has been deprived of the use of his property—the income on his investment—for two years. This income or property I have assessed at \$25,415.00 per annum, and I think he is entitled in justice to compensation for the loss of such use. I therefore award an amount equal to six per cent on such income for two years, that is \$4,575.100.

The United States Government also claims an award in respect of legal services obtained by Shufeldt in Guatemala and Washington, first in his endeavors to prevent the cancellation of the contract, second, in his efforts to come to a settlement with Guatemala and third, in preparation of this case for presentation before the Arbitrator.

I can not allow legal expenses on the first ground, being expenses incurred before the cancellation of the contract, nor can I allow them on the third, as the protocol of arbitration provides in article 12 that each Government shall pay its own expenses and half the common expenses of the arbitration.

As to the second ground, the expenses in this connection are included in the \$35,000.00 awarded as general damages.

In answer therefore to the two questions submitted by the protocol of arbitration, I find :

1. That P. W. Shufeldt has the right to claim pecuniary indemnification from the Government of Guatemala, and
2. That the Government of Guatemala should in justice pay to the Government of the United States \$225,468.38 for the account of P. W. Shufeldt.

In conclusion I desire to express my appreciation of the very full and able manner in which the Representatives of both Governments placed their cases before me, and for their courtesy and consideration on all occasions that they appeared before me.

H. K. M. SISNETT,  
*Chief Justice of British Honduras,*  
*Arbitrator.*

[SEAL.]

CHIEF JUSTICE'S CHAMBERS,  
BELIZE, BRITISH HONDURAS,  
24th July 1930.



# Antoine Biloune, Marine Drive Complex Ltd. v Ghana Investments Centre, the Government of Ghana, Awards, 27 October 1989

These awards have been made public in court proceedings in the United States District Court for the District of Columbia, Case No. 90-2109.

## Facts

This dispute arises out of the business activities in Ghana of the claimants, Antoine Biloune and Marine Drive Complex Ltd. (MDCL). MDCL is a Ghanaian corporation in which Mr. Biloune is the principal shareholder, and Mr. Michigan the minority shareholder.

On 5 November 1985, MDCL and Ghana Tourist Development Company (GTDC) concluded a Lease Agreement (GTDC Lease Agreement). The GTDC Lease Agreement provided for a ten-year lease to MDCL of a 2.95 acre parcel of land and a restaurant complex, with a five-year renewal option, at a rate of 30,000 cedis per month. Under the GTDC Lease Agreement, MDCL was to renovate and manage the restaurant. The claimants alleged that prior even to the conclusion of the formal lease, GTDC issued a letter of intent, granting MDCL permission to enter the premises and begin renovation work.

At some point of time, the nature of the parties' relationship was modified. The claimants asserted that in place of the lease/operation contract, the parties to the lease negotiated the terms of a joint venture. MDCL's share of the venture was to be fixed at 49%, GTDC's at 51%; and MDCL was designated manager of the venture.

In early 1986, MDCL commissioned a feasibility study for the expansion of the facilities by the firm of Lambrise Industrial and Commercial Management. This study was completed in April 1986. It contemplated an expansion of the original scope of the project from simply renovating the existing restaurant to the construction of an extensive new 4-star hotel resort complex.

In April 1986, MDCL applied to Ghana Investment Centre (GIC) to obtain for the expanded project certain benefits available to joint ventures between foreign and Ghanaian partners under the Ghana Investments Code of 1985. MDCL submitted the April 1986 Lambrise study as part of the application process. On 16 July 1986, GIC reported favorably on the project and approved the investment. An arrangement, including the requested investment concessions, was realized in the GIC Agreement of 18 November 1986. The agreement contained the following arbitration clause:

"Where any dispute arises between the foreign investor and the Government in respect of the enterprise, all efforts shall be made through mutual discussions to reach an amicable settlement.

Any dispute between the foreign investor and the Government in respect of an approved enterprise which is not amicably settled through mutual discussions may be submitted to arbitration;

in accordance with the rules of procedure for arbitration of the United Nations Commission on International Trade Law..." [page "12"](#)

Moreover Art. 22 provided:

"Subject to the provisions of the Code:

no enterprise approved under the Code shall be expropriated by the Government.

no person who owns, whether wholly or in part, the

## Jurisdiction

- › Austria
- › Syria
- › Ghana

## Organization

- › Ad - Hoc

## Organization

- › United Nations Commission on International Trade Law

## Arbitrators/Judges

- › Judge Stephen M. Schwebel, Chairman
- › Prof. Don Wallace Jr.
- › Monroe Leigh Esq.

## Case date

- › 27 October 1989

## Parties

- › Claimant, Antoine Biloune
- › Claimant, Marine Drive Complex Ltd.
- › Respondent, Ghana Investments Centre
- › Respondent, the Government of Ghana

## Topics

- › Investment Arbitration

## Key words

- › prerequisite of efforts at amicable settlement
- › no jurisdiction over claim for denial of justice or violation of human rights
- › jurisdiction over party not party to agreement
- › addition of respondent to arbitral proceedings
- › validity of agreement
- › constructive expropriation of assets by government
- › reconsideration of award under UNCITRAL Rules
- › evidential weight of contemporaneous books and records
- › calculation of foreign

capital of an enterprise approved under the Code shall be compelled by law to cede his interest in the capital to any other person.”

At the outset of the project MDCL hired an architectural firm and an engineer to oversee the planned operations to the facilities. The same firm was retained to prepare plans and get Accra city planning approval for construction of the additional buildings. The claimants maintain that, before the building permit was obtained, GTDC obtained the Accra City Council's assurances that approval would be forthcoming and instructed MDCL to proceed with the work without the permit. The respondents denied that any such assurances or instructions were or could be given.

On 28 August 1987, the Accra City Council (ACC) caused a Stop Work notice to be issued, as no building permit had been issued. The notice, addressed to GTDC as “Owner or Developer”, required GTDC, “on or before 4 September 1987”, to “show cause” why the construction in progress “should not be stopped & demolished”. On 3 September, the Accra City Council ordered demolition of the project, which in some measure was carried out. MDCL immediately informed GTDC of the demolition. Several letters were written by Lt. Col. Yaache of GTDC to the ACC and to P.V. Obeng, who was “Chairman of the Committee of PNDC Secretaries” - apparently effectively the Prime Minister of Ghana - and who was also Chairman of the Board of GIC. Lt. Col. Yaache noted that the “project is 51% owned by the Government and not a privately owned venture”. He requested that Mr. Obeng “take the necessary action to save the project from destruction and enable us [to] proceed with the construction works.”

On 3 September 1987, an announcement was made in the *People's Daily Graphic* that persons who had connection with MDCL were to report to the National Investigations Committee (NIC). Mr. Biloune and other named MDCL officers reported to the NIC where they were given “assets declaration forms” and ordered to fill them out within fourteen days.

On 19 October 1987, NIC referred the MDCL case to the Office of Revenue Commission. After Mr. Biloune or his accountants requested and obtained a number of extensions of the deadline to file his assets declaration form he was arrested on 11 December 1987 and held in custody for thirteen days without charge. On 15 December 1987 a deportation notice was issued, stating that Mr. Biloune's presence in Ghana “is not conducive to the public good” and Biloune had to leave Ghana the same day. On 24 December 1987 Mr. Biloune was deported from Ghana to Togo.

In the ensuing arbitration, the claimants invoked the arbitration clause of the GIC Agreement. Mr. Biloune alleged that the GIC and the Government of Ghana interfered with his investment in MDCL and that by various means, including Mr. Biloune's arrest and deportation from Ghana, the respondents effectively expropriated the assets of MDCL. Mr. Biloune claimed damages for expropriation, denial of justice and violation of human rights. The respondents denied that they expropriated or unreasonably interfered in Mr. Biloune's investment in MDCL. They asserted that Mr. Biloune's detention and deportation were for reasons unrelated to the investment and were justified under the law of Ghana. Moreover, the respondents maintained that the question of denial of justice had been mooted by their participation in the arbitration and that the claim of violation of human rights was beyond the jurisdiction of the Tribunal.

In its *Award on Jurisdiction and Liability* of 27 October 1989, the Tribunal found that it had jurisdiction and held that the Government of Ghana expropriated MDCL's assets and Mr. Biloune's interest in MDCL. In view of the provision in the GIC Agreement which bound the Government not to expropriate such interests, the Tribunal concluded that the Government of Ghana was under an obligation, under the law of Ghana and international law, to compensate Mr. Biloune.

In its *Award on Damages and Costs* of 30 June 1990, the Tribunal gave its final calculation of damages and the compensation to be paid to Mr. Biloune.

### **Excerpt**

#### ***Award on jurisdiction and liability***

##### ***I. Jurisdictional Issues***

[1] “As a preliminary matter, this arbitral Tribunal must satisfy itself

- currency investments
- ▶ historical investment value as basis for calculating damages
- ▶ currency of award
- ▶ compensation of arbitrators at ICSID rate

#### **Source**

- ▶ **Antoine Biloune, Marine Drive Complex Ltd. v Ghana Investments Centre, the Government of Ghana, Awards, 27 October 1989** These awards have been made public in court proceedings in the United States District Court for the District of Columbia, Case No. 90-2109, in Albert Jan van den Berg (ed), Yearbook Commercial Arbitration 1994 - Volume XIX, Yearbook Commercial Arbitration, Volume 19 (© Kluwer Law International; Kluwer Law International 1994) pp. 11 - 32

that it has jurisdiction to hear the dispute placed before it and that it has the power to adjudicate the rights and obligations of the parties before it. That is, the Tribunal must find that the dispute falls within a valid and binding arbitration clause.”

#### **A. Prerequisite of Efforts at Amicable Settlement**

[2] “The respondents’ initial communication to the Tribunal raised the preliminary objection that the arbitral proceedings were instituted before [page “14”](#) opportunity for reconciliation or consultation. This assertedly is in violation of the arbitration clause at Art. 15 of the GICAgreement, which requires that before arbitration is commenced, ‘all efforts shall be made through mutual discussions to reach an amicable settlement’. The Tribunal previously deferred this issue to the merits phase of the proceedings, and it is now addressed.

(....)

[3] “The Tribunal believes that the claimants have made a clear showing of their efforts to reach an amicable settlement. On more than one occasion the claimants invited negotiations with the respondents on this matter. GIC failed to make any response to those invitations. GIC and the Government were fully informed by the claimants, by the Designating Authority under the UNCITRAL Rules, Mr. Varekamp, by the Appointing Authority, Dr. Shihata, and by this Tribunal of the establishment and composition of the Tribunal. The respondents had ample opportunity to negotiate an amicable settlement. GIC did not respond to the claimants’ request for an inquiry into the situation. Nor did the respondents object to the establishment of the Tribunal until well after proceedings had begun and the claimants had already prepared and served their Statement of Claim and their evidence concerning the Claim to the respondents. Although the minutes of GIC board meetings submitted in evidence show that extensive consideration was given to the MDCL problem, including requests for its settlement or arbitration, the fact and content of those deliberations were not communicated to the claimants until the pleadings were filed in these proceedings.

[4] “In light of these findings, the Tribunal holds that the legal and contractual prerequisite to arbitration - failure of attempts at amicable settlement - was satisfied by the claimants’ efforts and the respondents’ inaction.”

#### **B. Jurisdiction over the Dispute**

[5] “The arbitration clause contained at Art. 15 of the GICAgreement is broad, providing for arbitration of ‘[a]ny dispute between the foreign investor and the Government in respect of an approved enterprise.’ The Agreement contains an explicit guarantee against expropriation by the Government. There can be no question that a claim that the Government has interfered with and expropriated the claimants’ interest in the venture with GTDC gives rise to a dispute ‘in respect of an approved enterprise’ under the Agreement.

[6] “The same cannot be concluded as to the other causes of action alleged, that is, the claim for denial of justice and the claim for violation of Mr. Biloune’s human rights. As to the first, the claimants based their claim on the initial failure of the respondents to submit to arbitration under Art. 15 of the Agreement. The Tribunal need not decide whether such a claim could [page “15”](#) form the basis of a separate claim under the arbitration clause, because that claim is moot. While the respondents did not participate in the constitution of the Tribunal, and for some time left unclear the question of their participation in the arbitration, they eventually did obtain counsel and took part fully in the proceedings, filing briefs and documentary evidence, appearing at the Hearing, and providing their share of the expenses of the Tribunal. Thus no continuing ‘dispute’ between the parties, over which the Tribunal could exercise its jurisdiction, exists as to the alleged denial of justice for failure of the respondents to participate in the arbitration.

[7] “In the final cause of action asserted, the claimants seek recovery for alleged violation by the Government of Ghana of Mr. Biloune’s human rights. The claimants assert that the Government’s allegedly arbitrary detention and expulsion of Mr. Biloune and violation of his property and contractual rights constitute an actionable human rights violation for which compensation may be required in a commercial arbitration pursuant to the GICAgreement. They assert that the Tribunal should consider this portion of the claim because this is the only forum in which redress for these alleged injuries may be sought.

[8] “Long-established customary international law requires that a State accord foreign nationals within its territory a standard of

treatment no less than that prescribed by international law. Moreover, contemporary international law recognizes that all individuals, regardless of nationality, are entitled to fundamental human rights (which, in the view of the Tribunal, include property as well as personal rights), which no government may violate. Nevertheless, it does not follow that this Tribunal is competent to pass upon every type of departure from the minimum standard to which nationals are entitled, or that this Tribunal is authorized to deal with allegations of violations of fundamental human rights.

[9] "This Tribunal's competence is limited to commercial disputes arising under a contract entered into the context of Ghana's Investment Code. As noted, the Government agreed to arbitrate only disputes 'in respect of the foreign investment. Thus, other matters - however compelling the claim or wrongful the alleged act - are outside this Tribunal's jurisdiction. Under the facts of this case it must be concluded that, while the acts alleged to violate the international human rights of Mr. Biloune may be relevant in considering the investment dispute under arbitration, this Tribunal lacks jurisdiction to address, as an independent cause of action, a claim of violation of human rights."

### ***C. Jurisdiction over the Parties***

[10] "The Tribunal must also establish that each claimant before it has a right, under the arbitration clause, to assert a claim and, likewise, that each [page "16"](#) respondent against which a claim is asserted is a person bound by and subject to the arbitration clause.

[11] "MDCL was the foreign investor that entered the Agreement with Ghana Investments Centre seeking investment concessions from GIC. Mr. Biloune was and is the majority shareholder and Chairman of MDCL. The respondents have not disputed the right of either MDCL or Mr. Biloune to appear as claimants. The Tribunal finds that MDCL is entitled to invoke arbitration under the GIC Agreement and that Mr. Biloune, as MDCL's Chairman and principal shareholder, may assert MDCL's claims. The Tribunal also finds that, in the circumstances of this case, and particularly having regard to GIC's knowledge of Mr. Biloune's role of financing and directing the project, Mr. Biloune, though not a party to the GIC Agreement, may assert his own claims arising out of his investment in MDCL. The respondents have not disputed this conclusion, which finds support in Art. 22 of the GIC Agreement. The first paragraph of that Article prohibits expropriation of an approved enterprise, and the second expressly protects a 'person who owns, whether wholly or in part, the capital' of such an enterprise.

[12] "GIC is the entity originally named as the respondent in this arbitration. As signatory to the GIC Agreement, GIC is clearly bound by it and its arbitration clause.

[13] "As noted above, the Government of Ghana was not originally named a respondent in the Statement of Claim. The claimants sought to add the Government by an amendment in their Additional Comments submitted to the Tribunal on 15 June 1989. Counsel for the respondents objected to the amendment at the beginning of the Hearing.

[14] "Under the UNCITRAL Rules, Art. 20, a claimant may amend his claim at any time, unless such factors as undue delay or prejudice suggest that such amendment is inappropriate or the amended claim would fall outside the arbitration clause. In the present case, the amendment was made in the claimants' first submission on the merits following the Statement of Claim, and in any case confirmed the obvious conclusion. From the outset of these proceedings, it was clear to all concerned that the claim was addressed in large part to alleged acts and omissions of the Government of Ghana. Indeed, several responses to the Tribunal's communications and Orders were submitted not by GIC itself (although some were) but by the Solicitor General of the Government of Ghana. Moreover, the first communication of the respondents' Washington's counsel to the Tribunal introduced counsel as representing both GIC and the Government. Given these clear indications of the Government's awareness of and participation in the proceedings prior to the claimants' amendment, no prejudice appears.

[15] "Of course, in order to be subject to the Tribunal's jurisdiction, the Government must have consented to the arbitration, either now or previously. We need not consider the possibility that the Government's [page "17"](#) participation in the proceedings might constitute consent, despite counsel's later objection to the Government's inclusion as a party. This is because the Agreement with GIC, an agency of the Government of Ghana, clearly binds the



Government; indeed, the Agreement speaks explicitly of disputes between the investor 'and the Government', and the expropriation clause expressly prohibits expropriation 'by the Government'. Thus the relevant clauses both engage the Government of Ghana, and contemplate claims against it.

[16] "The claimants also sought to add GTDC as a respondent. They refer in addition to the acts of a number of entities, such as the ACC and its subdivisions, alleged to be controlled by or part of the Government. The parties differed as to whether, under the current governing law of Ghana, such entities are legally and factually independent of the Government, or whether they should instead be considered as subdivisions or agents of the Government. The Tribunal decides that it need not determine whether these entities, because of their alleged relationship to the Government, could be considered party to the arbitration. No relief is sought against these entities and they need not be parties to this arbitration for their acts to be relevant and considered by this Tribunal in determining the obligations of those entities which are parties to the arbitration."

#### **D. Validity of the GIC Agreement**

[17] "The final jurisdictional issue is whether the GIC Agreement, which contains the operative arbitration clause, remains in effect and is binding on the parties. The respondents have asserted that the GIC Agreement should be held inapplicable because MDCL and Mr. Biloune do not qualify as foreign investors as required by the GIC Agreement. They allege that GIC approved the Marine Drive venture for investment concessions on the basis of a 60%-40% shareholding between Mr. Biloune and Mr. Michigan in MDCL. According to the respondents, the fact that over 99% of the financing for the venture was in fact provided by Mr. Biloune constituted a misrepresentation which, under Art. 20 of the GIC Agreement, permits GIC to cancel its approval.

[18] "The respondents argue in addition that because MDCL obtained GIC approval as a foreign/Ghanaian joint venture, it was required to make a minimum \$60,000 foreign currency investment in MDCL, in cash or in capital goods. They point out further that if MDCL had sought approval as a venture wholly owned by Mr. Biloune, as a foreign national he would have been required to invest \$100,000. The respondents assert that the foreign currency investment advanced by the claimants as satisfying this requirement - largely a shipment of building materials needed for the construction work worth £47,000 - was too little to satisfy the minimum required for an enterprise [page "18"](#) wholly owned by a foreign investor. The respondents argue in the alternative that the investment was not registered with the appropriate governmental office, as allegedly required to prove foreign investment in any amount.

[19] "The Tribunal does not find these objections sufficient to deprive the GIC Agreement of validity. As to the alleged misrepresentation in describing the capital basis of MDCL, the Tribunal notes that the application submitted to GIC clearly states both that the shares would be split 60%-40% between Mr. Biloune and Mr. Michigan and that Mr. Biloune would provide 24.7 million cedis of MDCL's capital compared to only 150,000 cedis for Mr. Michigan. This disclosure of the proposed capital arrangements eliminates any basis for the defense of misrepresentation as now alleged. Thus, in fact such an arrangement is not normally contemplated by GIC, GIC's approval of the application must be considered a waiver of this defense and an acceptance of a modification of the norm. Moreover, it may also be relevant to note that the project at issue was carried forward by what Lt. Col. Yaache described as a partnership between GTDC (whose shares are wholly owned by the Ghanaian Government) and MDCL.

[20] "Much the same can be said about the allegation of insufficient foreign currency investment. The respondents' defense is deficient in two respects. First, it does not appear that any time limit was imposed within which full foreign currency contributions must be in place. Second, there is no indication in the record that GIC was concerned at the time that MDCL's foreign currency requirement were being implemented too slowly, or that, if it was, that the Agreement was voided as a result. On the contrary, the parties consistently acted in accordance with the terms of the GIC Agreement, treating it as in force. During the difficulties experienced by Mr. Biloune at the end of 1987, it was never suggested that the Agreement was invalid. Accordingly, the Tribunal determines that the respondents have failed to establish their contention that the GIC Agreement should be considered invalid. This does not mean that issues as to the amounts actually invested in, and paid out by, the enterprise, may not be relevant to the ultimate determinations of this Tribunal.

[21] "Given the Tribunal's determination of the validity of the



GICAgreement, it need not decide whether, if the Agreement were adjudged invalid, the arbitration clause would nevertheless be separable and provide sufficient basis for this Tribunal's jurisdiction. Nor need it decide whether there is an independent basis for arbitration under Art. 20 of the Ghana Investment Code of 1985.

[22] "The respondents have also argued that the expropriation clause in the contract does not apply to a constructive expropriation such as that alleged here, but only to expropriation by act of positive law. There is no basis for such a distinction in the contract, and certainly one cannot reasonably read the Agreement - or customary international law - to permit the Government [page "19"](#) to expropriate indirectly what it has undertaken not to expropriate directly.

[23] "For all the above reasons, the Tribunal holds that it has jurisdiction to decide the claim of expropriation as here presented."

## **II. Applicable Law**

[24] "The rights and obligations of the parties to the GICAgreement are governed by the provisions of that Agreement. Art. 24 of the Agreement requires the Tribunal to 'constru[e]' the Agreement 'according to the laws of Ghana'. The provisions of Ghanaian law which have been brought to the Tribunal's attention do not relate to the construction of the Agreement. Neither party pleaded the particulars of the legal principles or provisions of the law of Ghana that should guide the Tribunal's decision on the main contractual issues and, in particular, it was not argued how any provision of the Agreement should be construed in accordance with the law of Ghana. Specifically, neither party brought to the attention of the Tribunal any interpretation of the GICAgreement, or of the parties' rights and obligations under the Agreement, including the prohibition of expropriation, peculiar to the law of Ghana. Moreover, there is no indication that Ghanaian law diverges on the central issue of expropriation from customary principles of international law. On the contrary, both parties explicitly treated those principles as governing the issue of expropriation."

## **III. The Tribunal's Decisions**

[25] "The fundamental outlines of the relevant events are clear. Where differences between the parties on the facts remain, the Tribunal has had recourse to the principle recorded in the UNCITRALRules that each party has the burden of proving the facts upon which it relies for its claim or defense. UNCITRALRules, Art. 24.

(...)

[26] "This Tribunal must determine whether the above facts constitute, as the claimants charge, a constructive expropriation of MDCL's assets and Mr. Biloune's interest in MDCL. The motivations for the actions and omissions of Ghanaian governmental authorities are not clear. But the Tribunal need not establish those motivations to come to a conclusion in the case. What is clear is that the conjunction of the stop work order, the demolition, the summons, the arrest, the requirement of filing assets declaration forms, and the deportation of Mr. Biloune without possibility of re-entry had the effect of causing the irreparable cessation of work on the project. Given the central role of Mr. Biloune in promoting, financing and managing MDCL, his expulsion from the country effectively prevented MDCL [page "20"](#) from further pursuing the project. In the view of the Tribunal, such prevention of MDCL from pursuing its approved project would constitute constructive expropriation of MDCL's contractual rights in the project and, accordingly, the expropriation of the value of Mr. Biloune's interest in MDCL, unless the respondents can establish by persuasive evidence sufficient for these events.

[27] "The respondents' defenses on this point are that the various events described above are independent and unrelated, and that their conjunction is coincidental. The respondents maintain that the independent and unrelated reasons for Mr. Biloune's detention and deportation essentially were that in 1985 he was found guilty of selling kerosene stoves above the price-regulated price; that he had been accused by a private Ghanaian party of involvement in a bank fraud scheme; and that the sources of his investment in MDCL had not been shown to the satisfaction of the National Investigations Commission to be in accordance with the currency regulations of Ghana.

[28] "The evidence submitted in support of these alternative explanations is not convincing for the following reasons. First, while Mr. Biloune admits that he was fined for an apparently minor price-

control infraction in respect of kerosene stoves, that case was apparently closed in 1985. The allegation of bank fraud is made only in a letter of a private individual which resulted in no indictment or other action by Ghanaian authorities. The sources of all of Mr. Biloune's investment in MDCL, on the basis of the record now before the Tribunal, are unclear. But by the same token it is not established that they were in violation of whatever may be the governing regulations of Ghana. The Tribunal therefore finds that the Government has not succeeded in establishing that there were reasons for the NIC investigation and the arrest and deportation of Mr. Biloune that were not connected to the MDCL project.

[29] "As for the failure to issue a building permit, and the partial demolition of the project (whether or not it was prompted by the lack of a building permit), the respondents have not adequately explained these actions, in view of the history of the site, the time elapsed between the application and the issuance of the stop work order, the work actually carried out by MDCL, and the claimants' justifiable reliance on GIC and GTDC as liaison with the relevant Governmental agencies. In particular, the Tribunal does not find credible that the authorities in Accra were ignorant of the existence for well over a year of construction activity on one of the most prominent sites in the city, and one which adjoins the seat of the Government of Ghana.

[30] "The Tribunal therefore holds that the Government of Ghana, by its actions and omissions culminating with Mr. Biloune's deportation, constructively expropriated MDCL's assets, and Mr. Biloune's interest therein, not later than 24 December 1987. The claimants are therefore entitled to compensation. [page "21"](#)

[31] "In view of the Tribunal's holding that the Government of Ghana expropriated MDCL's assets and Mr. Biloune's interest in MDCL, and in view of provision in the GIC Agreement which binds the Government not to expropriate such interests, the Tribunal has concluded that the Government of Ghana is under an obligation, under the law of Ghana and international law, to compensate Mr. Biloune. The Tribunal is satisfied that Mr. Biloune suffered significant damage from the expropriation.

(...)"

#### **Award on damages and costs**

### **I. The Tribunal's Decision**


#### **A. Reconsideration or Annulment of Award**

[32] "As provided in Art. 32(2) of the UNCITRAL Rules, the award on jurisdiction and liability which this Tribunal issued on 27 October 1989 was and is 'final and binding on the parties'. The UNCITRAL Rules make no provision for reconsidering an award. Arts. 35, 36 and 37 provide that within thirty days of an award a party may request 'interpretation' of an award, may request correction of clerical or typographical errors, or may request an additional award covering issues omitted from the award. The present request for reconsideration was not made pursuant to any of these articles, and (apart from the fact that the request was first made more than thirty days after the original award) none of these articles would seem to support the kind of reconsideration that has been requested.

[33] "Nevertheless, a court or Tribunal, including this international arbitral Tribunal, has an inherent power to take cognizance of credible evidence, timely placed before it, that its previous determinations were the product of false testimony, forged documents or other egregious 'fraud on the Tribunal'. See *United States on behalf of Lehigh Valley Ry. v. Germany, (Sabotage Claims)*, Mixed Claims Commission, United States and Germany, Opinions and Decisions from 1 October 1926 to 31 December 1932 (1933) at 967; *id.*, Report of the American Commissioner (30 December 1933) at 7-8; *id.*, Opinions and Decisions in the *Sabotage Claims* (15 June 1939 and 30 October 1939). Certainly if such corruption or fraud in the evidence would justify an international or a national court in voiding or refusing to enforce the award, this Tribunal also, so long as it still has jurisdiction over the dispute, can take necessary corrective action. See the Statute of the International Court of Justice, Art. 61 (permitting revision of an award upon the subsequent [page "22"](#) discovery of a new decisive fact);<sup>(1)</sup>

(...)" ICSID Convention Art. 51 (same);<sup>(2)</sup> U.S. Arbitration Act, 9 U.S.C. Sect. 10 (permitting judicial annulment of an arbitral award 'procured by corruption, fraud or undue means').

[34] “The present Tribunal would not hesitate to reconsider and modify its earlier award were it shown by credible evidence that it had been the victim of fraud and that its determinations in the previous award were the product of false testimony. However, no such evidence has been adduced. As in many complex cases, this Tribunal has been required to weigh and resolve occasional inconsistencies in the evidence of both sides in this arbitration, and to come to its best determination of the relevant facts. Nevertheless, the Tribunal is satisfied that the material facts on which it based its previous award on jurisdiction and liability, as well as the present award on damages and costs, are sufficiently explained and proved by credible evidence.

[35] “The Tribunal has thus weighed the charges of untruthfulness and exaggeration made by the respondents in their request for reconsideration. It is the opinion of the Tribunal that, while there are factual issues on which the parties differ, there is no indication that any material determination regarding the establishment and existence of the claimants’ investment or the respondents’ subsequent constructive expropriation of it was based on or the product of false testimony, fraudulent evidence, or otherwise of such a nature as to undermine the authority and finality of the previous award. Accordingly, the respondents’ request for reconsideration is denied.”  [page "23"](#)

### **B. Standards of Proof**


(....)

[36] “Under the UNCITRAL Rules, ‘Each party shall have the burden of proving the facts relied on to support his claim or defense’. This Tribunal, governed by the UNCITRAL Rules, has proceeded in accordance with this principle. The Tribunal has reviewed the accounting records submitted to it, as well as the reports analyzing those records by both the claimants’ and the respondents’ accountants. The Tribunal holds that, in general, the contemporaneous books and records of a company regularly kept in the normal course of business should be accorded substantial evidentiary weight. In the present case, it appears that a firm of Ghanaian chartered accountants, licensed to pursue their profession by the Government of Ghana, designed MDCL’s accounting system and controls and periodically performed audits. This same firm has provided its opinion to this Tribunal that the company’s books in fact accurately reflect MDCL’s financial status. MDCL’s records are thus accepted by the Tribunal as presumptively accurate, subject to proof to the contrary by the respondents.

[37] “The respondents and their accountants, also professional Ghanaian chartered accountants, have alleged certain shortcomings and irregularities in the design of MDCL’s accounting system and the companies’ bookkeeping practice. They argue that a higher verification or confirmation standard should have been used by an auditor who was fully independent of the company’s affairs, and they assert that many of the book entries could not be verified by their accountants’ recent review of the records submitted to the Tribunal.

[38] “The Tribunal is not convinced, however, that difficulties in verifying every entry in books from admittedly incomplete files necessarily render the books unreliable and fundamentally erroneous. The respondents have not demonstrated any instances of wrong recording (the few instances which they mentioned were satisfactorily explained by the claimants and their accountants). In general, it appears to the Tribunal that the backup documents submitted adequately support the book entries.”

### **C. Foreign Currency Denominated Investments**

[39] “The claimants’ calculation of the foreign currency investments in the project is based on evidence in MDCL’s accounting books of in-kind inputs in the form of building materials and certain communication and travel expenses. While the respondents question whether all of the travel expenses claimed were incurred on behalf of the project, the minutes submitted, in the Tribunal’s view, provide sufficient indication that the travel, in question was related to Mr. Biloune’s efforts to secure foreign financing for the project.  [page "24"](#) Without more, the fact that Mr. Biloune had other business interests in Europe is not sufficient to induce the Tribunal to regard the expenses as unrelated to the project. These travel and communication expenses are accepted in the amounts claimed.

[40] “The controversy over the building materials involves a dispute as to whether the materials admittedly imported from MDCL were actually sold in Ghana to other users, and whether, if so, the proceeds of such sales were diverted to the Trader Vic Company or

to Mr. Biloune himself.

[41] "The respondents have presented the statement of Mr. Michigan purporting to show that by September 1986 a substantial portion of the building materials had been sold, but the notations on the original import invoice produced in evidence of such sales do not indicate in any way when, to whom, at what cost, or even whether such alleged sales were made. The respondents also obtained from one of MDCL's administrators in Ghana (the Osei-Wiredu firm) 'waybills' showing the quantities of materials that were removed from the Marine Drive premises to warehouse in early 1988 after Mr. Biloune's expulsion. The respondents also submitted a survey of the remaining items in the Trader Vic warehouse as of February 1990 performed by the respondents' accountants, purporting to show additional reductions in inventory. None of these documents proves that any items of MDCL's inventory were sold, however.

[42] "The only direct evidence adduced purporting to prove that MDCL sold some of its construction materials is the request to MDCL from the Public Works Department for 500 gallons of white masonry paint on 26 August 1986. This is submitted together with an undated handwritten notation which is said to show payment of 1,555,000 cedis for paint as well as several other items, and PWD payment vouchers.

[43] "On the basis of these documents, the respondents allege that Mr. Biloune was selling materials imported for the project. They just allege that the materials cannot form part of Mr. Biloune's investment.

[44] "As noted above, the claimants counter that no improper diversion was made of any MDCL construction materials. They assert that at the time of the alleged sale of 500 gallons of paint in 1986, the paint imported for the project was still in customs warehouse. They provide board of directors minutes stating that in August 1987, efforts were still underway to 'secure the release of the paints' by GTDC.

[45] "They describe the sale of paint to PWD in August 1986 as an unrelated transaction of Trader Vic out of its own separate inventory. The respondents' evidence shows that the request from PWD for 500 gallons of 'white stoneface cementone Masonry Paint' was dated 26 August 1986. The claimants' evidence shows that on that same day 500 gallons of 'caring for masonry (white)' were delivered to Public Works Department from Trader Vic. They also provided shipping and import documents showing that [page "25"](#) Trader Vic had imported in October 1985 a shipment of paints, including 1785 'tins each 5 litres' of 'caring paints' for masonry. (5 litres equals, roughly, one (imperial) gallon.) Finally, the evidence includes payment vouchers showing the sale of paint as part of other goods sold by Trader Vic to PWD in August and September 1986. The amount paid to Trader Vic for the paint and 'rendatex' equals the 1,555,000 cedis amount shown on the undated list of payments submitted by the respondents.

[46] "In the light of the analysis in the preceding four paragraphs, it is reasonable to conclude that the request for masonry paint had nothing to do with MDCL (except, perhaps to the extent PWD knew of Mr. Biloune's relationship with both Trader Vic and MDCL) and that the order was filled entirely out of separate Trader Vic inventory. The Tribunal is therefore not prepared to assume that the sale was out of MDCL's inventory, rather than Trader Vic's, especially given the clear markings that the claimants state (without contradiction) limited their use to a GTDC-authorized project.

[47] "Moreover, even if it could be shown that MDCL did sell some or most of the materials it originally imported for its own project, this does not necessarily result in the deduction of the value of those materials from the total investment by Mr. Biloune. Unless the proceeds of such sales were wrongfully diverted from MDCL to third parties, the value of the goods at the time of their original importation would still constitute sums invested by Mr. Biloune in MDCL. There is no evidence of such a diversion.

[48] "If, as the claimants' accountants maintain, the remaining materials now in warehouse have deteriorated and are valueless, this loss of value does not negate the fact that the materials constituted a valuable material input when originally invested. However, it is possible that these materials or some of them still have value. Since the Tribunal has determined that all the assets of MDCL were constructively expropriated by the respondents, it follows that title to these assets passed to the respondents in December 1987. Accordingly, there is no ground for deducting the residual value, if any, of these assets from the Award.

[49] "The respondents also argue that in any case the imported

materials cannot be considered as investments because they were not registered as investments in kind. The respondents state that under Sect. 42 of the Ghana companies law,<sup>(3)</sup> all foreign goods invested in kind in Ghanaian entities [page "26"](#) require registration. Claimants deny that the companies law requires registration, but they discuss a different provision of the law.

[50] "The Tribunal is of the opinion that in the present circumstance this issue does not determine the claimants' recovery. Whether registered or not, Mr. Biloune did in fact provide the materials as an in-kind investment. There is certainly no indication that failure to register works a forfeiture, even if there were a requirement of registration. Accordingly, the Tribunal finds the value of the materials imported for the MDCL project to constitute a foreign currency investment of Mr. Biloune."

#### ***D. Cedi Denominated Investments***

[51] "As noted above, the Tribunal is satisfied that MDCL's regular accounting books adequately identify the amounts of cedi investments made by Mr. Biloune in MDCL. The respondents' objection is that the investments should have been more formally receipted and documented, and that the source of the funds is not established.

[52] "The Tribunal believes that, while more sophisticated accounting controls might have been useful, the entries in the company's cash book, which was kept current in the ordinary course of business, adequately evidence the investments by Mr. Biloune, especially since it is apparently conceded by the respondents that Mr. Biloune was the sole financier of the company.

[53] "It is true, as the respondents contend, that the source of the funds Mr. Biloune invested in MDCL is never shown with precision. The claimants assert, as they did at the Hearing, that Mr. Biloune raised the funds largely through imports of goods financed by his outside trading companies and sold for Ghanaian currency within Ghana. Whether these imports usually or always involved Mrs. Biloune's Ghanaian companies is not shown, however, and the respondents object that the transfers of earnings from these companies to Mr. Biloune are not documented.

[54] "The Tribunal accepts the explanation of the claimants that to the extent Mrs. Biloune's companies were involved, the funds were made available to Mr. Biloune informally by his wife. In any event, the Tribunal does not find it necessary to determine the ultimate source of the cedi funds invested in MDCL. The issue is whether the funds were actually invested in [page "27"](#) MDCL by Mr. Biloune, and on that issue the company's books are explicit. Thus, the Tribunal finds that Mr. Biloune invested cedis in MDCL in the amounts and on the dates shown in the company's books."

#### ***E. Application of Invested Funds to the Project***

[55] "The Tribunal is satisfied, in the absence of evidence to the contrary, that the funds invested in MDCL were used in furtherance of the project. Indeed, in most cases, the investment was made immediately as needed to cover an expenditure for project-related goods or services. The Tribunal has no reason to doubt that the sums invested by Mr. Biloune were directed toward and incorporated in the Marine Drive project."

#### ***F. Basis for Calculating Damages***

[56] "Having determined the amounts Mr. Biloune invested in the Marine Drive project, the Tribunal must now determine the basis for calculating the damages due the claimants from the respondents' constructive expropriation of that project. The claimants have proposed two alternative methods for calculating damages: historical investment value or lost profits.

[57] "The standard for compensation in cases of expropriation is restoration of the claimant to the position he would have enjoyed but for the expropriation. This principle of customary international law is stated in many recent awards on international arbitral tribunals. See, e.g., *Texaco Overseas Petroleum v. Libya* (TOPCO) (Dupuy, arb.), paras. 40-105, 17 I.L.M. 28-35 (1977);<sup>(4)</sup> *Sedco, Inc. and National Iranian Oil Co.*, Award No. ITL 59-129-3, 10 Iran-U.S. Claims Tribunal Rep. 180, 184-189 (1986), 25 I.L.M. 629, and separate opinion of Judge Brower in id.; *Amoco International Finance Corp and Islamic Republic of Iran* (Khemco), Award No. 310-56-3, 15 Iran-U.S. Claims Tribunal Rep. 189, paras 183-209 (1987), 27 I.L.M. 1320, 1391. This standard is also reflected in hundreds of bilateral



investment treaties. The respondents in this case have not challenged this principle, and indeed have explicitly 'recognize[d] that there exists a generally accepted principle of international law that prompt, adequate and effective compensation be paid in case of expropriation'.

[58] "Normally, in cases of expropriation of a going concern, the most accurate measure of the value of the expropriated property is its fair market value, which in its nature takes into account future profits. The discounted cash flow method of valuation is often used to calculate the worth of the enterprise at the time of the taking. *Starrett Housing Corp. and Islamic* [page "28"](#) *Republic of Iran*, Award No. 314-24-1, 16 Iran-U.S. Claims Tribunal Rep. 112, paras. 279-280 (1987).<sup>(5)</sup>

[59] "The claimants have made a compensation claim based on the future lost profits of MDCL. While the Tribunal accepts the validity of the principle that lost profits should be compensated it is not possible to make an award on that basis in this case. The claimants have not provided any realistic proof of the future profits of the company. The Lambrise Report purports to project profits, but the Tribunal agrees with the respondents that this report was not an economic forecast of profits, but a projection intended to encourage potential investors. Moreover, at the time of the project's suspension and effective expropriation, the project remained uncompleted and inoperative. It was generating no revenue, still less profits. Thus, with no basis on which to calculate future profits, the Tribunal is required to consider an alternative methodology.

[60] "The claimants have also requested that Mr. Biloune be awarded the historical investment value of the project. Given the nature of the project, and its early interruption by the respondents, the Tribunal has concluded that the most appropriate method for valuing the damages to be paid will be to return to Mr. Biloune the amounts he invested in MDCL, i.e., restitution.

[61] "Thus, respondents are obligated to pay Mr. Biloune the amounts shown to have been invested by him, i.e., £ Sterling 50,765.85; DM600.00; and U.S. \$8,115.66 for the foreign currency investment, and 46,790,982.85 cedis. (The claimants set forth various totals for the total cedi investments with slight variations. Since the variations were not explained, the Tribunal has selected the lowest total claimed.)

[62] "Since this Award is based on amounts actually invested by Mr. Biloune, no apportionment to allow for the interests of GTDCor Mr. Michigan is appropriate. Thus, the Tribunal need not address allocation questions and other issues that might arise if the award were based on the going concern value of MDCL or of the Marine Drive project as a whole."

### **G. Currency of the Award**

[63] "...The claimants have asserted that the principle of 'prompt, adequate and effective' compensation requires that all sums be awarded in U.S. dollars, converted from other currencies at the time of investment. The Tribunal does not wholly agree with this claim.

[64] "It certainly is right, as the respondents have acknowledged, that amounts awarded must be paid promptly in a freely convertible currency and made available to the claimants outside Ghana. The respondents have indeed [page "29"](#) undertaken to permit the conversion and transfer required:

'Once the amount of the damages [is] determined and awarded in cedis, the requirement of promptness and effectiveness would operate to ensure that the damages denominated in cedis be paid promptly, be freely convertible into foreign currencies and be transferable to claimants outside Ghana.'

[65] "The Tribunal holds that, under the applicable norms of international law, the respondents were obligated to pay the amounts awarded in freely convertible, transferable currency on the date of the expropriation. The applicable cedi-dollar rate on that date was 175.43 (IMF International Financial Statistics (March 1988)). Accordingly, on this basis, the 46,790,982.85 cedis awarded are equivalent to \$266,721.67. This latter amount, payable in dollars, shall be awarded.

[66] "The Tribunal notes that the claimants maintain that they are entitled to a larger sum of \$599,928.44 on the theory that cedis must be converted into dollars on the various dates on which cedis were invested in the project. The Tribunal cannot accept this contention. It agrees with the respondents that they did not insure foreign investors against depreciation of the cedi between the date of

investment and the date of expropriation.

[67] “The amounts invested in Pounds Sterling, Deutschmarks and U.S. dollars will be awarded in those currencies.”

## **II. Costs and Interest**

### **A. Costs**

[68] “Under the UNCITRAL Rules, Art. 38,<sup>(6)</sup> the fees and costs of the arbitration are to be separately stated in the award. The total costs of this arbitration are \$84,781.14. This figure has been calculated as follows: The [page "30"](#) arbitrators have been compensated at a rate based on the current rate applied by the International Centre for Settlement of Investment Disputes (ICSID). This rate was chosen as appropriate for a case with a modest amount at stake. It is the more appropriate in light of the designation of Mr. Ibrahim Shihata, Secretary-General of ICSID, as the appointing authority in this arbitration. On an actual hourly basis, the fee of each of the three arbitrators totals \$15,610.00. The President of the Tribunal has not found it appropriate to accept fees higher than those of the other arbitrators.

[69] “In addition, other costs of the arbitration, including out-of-pocket expenses, secretarial and office expenses, hearing expenses, and the time of the registrar total \$37,951.14

[70] “The Tribunal has assessed and received \$20,000 from each side as a deposit against the costs of arbitration. The difference between the deposit of \$20,000 already made by the respondents and the costs and fees of the arbitration is \$64,781.14. This amount is assessed against the respondents, to be paid directly to the Tribunal's registrar. Upon receipt of this payment, the Tribunal will transmit the deposit of \$20,000 advanced by the claimants to their counsel.”

### **B. Interest**

[71] “Interest is required to be awarded in order fully to compensate the victim of an expropriation for the delay in payment of the value of the expropriated property, calculated from the time of taking to the time of payment of the award. The Tribunal considers the London Interbank Offered Rate (LIBOR) to be the appropriate rate upon which to calculate interest. The average 6-month LIBOR rate between 24 December 1987 and 30 June 1990 was 8.6512%. Applying this rate over the 918 days between 24 December 1987 and 30 June 1990 to the sums awarded yields, on a simple interest basis, an additional \$59,800.16, £11,045.82 and DM130.55, which will be included in the Award.

[72] “This Award shall be paid within thirty days of the date on which this award is delivered to the respondents' counsel (Delivery Date). Any amounts of the award (including the above interest) that remain unpaid thirty days after the Delivery Date will bear interest at the current 6-month LIBOR rate until the Award is paid in full.

[page "31"](#)

[73] “The claimants have also requested counsel fees in an amount no less than \$100,000. Particularly given the respondents' request for an identical amount had they prevailed, the Tribunal deems that amount to be reasonable. The respondents shall pay such amount directly to counsel for the claimants, and that amount shall be deducted from any gross sum of counsel fees chargeable by the claimants' counsel to the claimants.”

(...) [page "32"](#)

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<sup>1</sup> Art. 61 of the Statute of the International Court of Justice reads in relevant part:

“1. An application for revision of a judgment may be made only when it is based upon the discovery of some fact of such nature as to be a decisive factor, which fact was, when the judgment was given, unknown to the Court and also to the party claiming revision, always provided that such ignorance was not due to negligence.

<sup>2</sup> Art. 51 of the 1965 (ICSID) Washington Convention on the Settlement of Investment Disputes between States and Nationals of

Other States reads in relevant part:

“(1) Either party may request revision of the award by an application in writing addressed to the Secretary-General on the ground of discovery of some fact of such a nature as decisively to affect the award, provided that when the award was rendered that fact was unknown to the Tribunal and to the applicant and that the applicant’s ignorance of that fact was not due to negligence.

(....)”

<sup>3</sup> Sect. 42 of the Ghana Companies Code (1963) reads in relevant part:

(1) “Except on a capitalization issue pursuant to subsection (1) of section 74 of this Code, shares shall not be issued otherwise than for valuable consideration paid or payable to the company and unless otherwise agreed shares shall be paid for in cash.

(2) If a company shall have agreed to accept payment for any shares otherwise than wholly in cash the company shall, within 28 days after the allotment of such shares, deliver to the Registrar for registration a contract in writing duly stamped evidencing the terms of such agreement and the true value of the consideration or, if such agreement shall not have been reduced to writing, particulars in the prescribed form of such agreement duly stamped, as if it were a written agreement.

(....)”

<sup>4</sup> Reported in Yearbook IV (1979) pp. 177-187.

<sup>5</sup> Reported in Yearbook XIII (1988) pp. 271-284.

<sup>6</sup> Art. 38 of the UNCITRAL Arbitration Rules reads:

*“Article 38*

The arbitral tribunal shall fix the costs of arbitration in its award. The term ‘costs’ includes only:

- (a) The fees of the arbitral tribunal to be stated separately as to each arbitrator and to be fixed by the tribunal itself in accordance with article 39;
- (b) The travel and other expenses incurred by the arbitrators;
- (c) The costs of expert advice and of other assistance required by the arbitral tribunal;
- (d) The travel and other expenses of witnesses to the extent such expenses are approved by the arbitral tribunal;
- (e) The costs for legal representation and assistance of the successful party if such costs were claimed during the arbitral proceedings, and only to the extent that the arbitral tribunal determines that the amount of such costs is reasonable;
- (f) Any fees and expenses of the appointing authority as well as the expenses of the Secretary-General of the Permanent Court of Arbitration at The Hague.”

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# EU LAW

Text, Cases, and Materials

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Gráinne de Búrca

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## THE ECJ

20. The Commission... contends that the Member States were empowered to adopt measures such as the Sea Fish Order 1982 by Article 6(1) of Regulation 170/83 of 25 January 1983 which authorises retroactively, as from 1 January 1983, the retention of the derogation regime defined in Article 100 of the 1972 Act of Accession for a further ten years, and which extends the coastal zones from six to twelve nautical miles. ...

21. Without embarking upon an examination of the general legality of the retroactivity of Article 6(1) of that Regulation, it is sufficient to point out that such retroactivity may not, in any event, have the effect of validating *ex post facto* national measures of a penal nature which impose penalties for an act which, in fact, was not punishable at the time at which it was committed. That would be the case where at the time of the act entailing a criminal penalty, the national measure was invalid because it was incompatible with Community law.

22. The principle that penal provisions may not have retroactive effect is one which is common to all the legal orders of the Member States and is enshrined in Article 7 of the European Convention for the Protection of Human Rights and Fundamental Freedoms as a fundamental right; it takes its place among the general principles of law whose observance is ensured by the Court of Justice.

23. Consequently the retroactivity provided for in Article 6(1) of Regulation 170/83 cannot be regarded as validating *ex post facto* national measures which imposed criminal penalties, at the time of the conduct at issue, if those measures were not valid.

Where there is a pressing Union objective and where the legitimate expectations of those concerned are duly respected, then retroactivity may, exceptionally, be accepted in a non-criminal context. This is exemplified by *Fedesa*.<sup>90</sup> The applicants argued that the Directive was in breach of the principle of non-retroactivity because it was adopted on 7 March 1988 and stipulated that it was to be implemented by 1 January 1988 at the latest. The Court drew a distinction between the retroactive effect of penal provisions and retroactive effect outside the criminal sphere. As to the former, the Court affirmed *Kent Kirk*, but held that the Directive in *Fedesa* did not impose any criminal liability as such. As to the latter, the Court ruled that the Directive did not contravene the principle of non-retroactivity. It had been adopted to replace an earlier Directive that had been annulled. The time frame of the challenged Directive was necessary to avoid a temporary legal vacuum where there would be no Community legislation to back up the Member States' existing implementing provisions. It was for this reason that the Council had maintained the date of the earlier Directive when it passed the later Directive.<sup>91</sup>

(ii) *Legal Certainty, Legitimate Expectations, and Apparent Retroactivity*

Apparent retroactivity covers the situation where legislative acts are applied to events which occurred in the past, but which have not yet been definitively concluded. The moral arguments against allowing laws to have actual retroactive effect are powerful. Cases involving apparent retroactivity are more problematic, because the administration must have the power to alter policy for the future, even though this may have implications for the conduct of private parties, which was planned on the basis

<sup>90</sup> Case C-331/88 [1990] ECR I-4023.

<sup>91</sup> The Court held that there was no infringement of the legitimate expectations, because the earlier dir was only annulled because of a procedural defect, and those affected by the national implementing legislation could not expect the Council to change its attitude on the substance of the matter in the dir during the short time between the annulment of the first dir and the notification of the second dir: *ibid* [47].

of the pre-existing legal regime.<sup>92</sup> The law in this area is complex and only an outline can be provided here. The key elements in the Court's approach are as follows.

First, the protection of legitimate expectations developed initially in relation to the revocation of administrative decisions. The general principle is that favourable decisions bind the administration,<sup>93</sup> although this principle is subject to a number of exceptions.<sup>94</sup>

Secondly, the protection of legitimate expectations also applies to representations.<sup>95</sup> The general principle is that the protection of legitimate expectations extends to any individual who is in a situation from which it is clear that, in giving precise and specific assurances,<sup>96</sup> the Union institutions caused that person to entertain justified hopes.<sup>97</sup> This depends on the nature and wording of the representation.<sup>98</sup> In *CIRFS*<sup>99</sup> the ECJ was willing to accept that the Commission was bound by the terms of its policy framework, and in *IJssel-Vliet*<sup>100</sup> it held that Commission guidelines that had been built into a Dutch aid scheme were binding upon the Dutch Government. Moreover, in *Vlaams Gewest*<sup>101</sup> the CFI held that the guidelines adopted by the Commission had to be applied in accordance with the principle of equal treatment, with the implication that like cases, as defined in the guidelines, had to be treated alike.

Thirdly, the claim will fail where the Court adjudges that the applicant's expectations were not legitimate. This will be so where: the challenged EU activity was designed to close a legal gap to prevent traders from making a speculative profit;<sup>102</sup> the expectations were not reasonable, because the contested measure should have been foreseen;<sup>103</sup> or the applicant had not met the conditions attached to a grant of funding.<sup>104</sup>

Fourthly, the mere fact that a trader is disadvantaged by a change in the law will not give cause for complaint based upon disappointment of legitimate expectations. A trader will not be held to have a legitimate expectation that an existing situation, which is capable of being altered by decisions taken by the institutions within the limits of their discretionary powers, will be maintained.<sup>105</sup> This is particularly so in the context of the CAP, where constant adjustments to meet new market circumstances

<sup>92</sup> For a valuable analysis of the justifications for protecting legitimate expectations see Schonberg (n 81) ch 1.

<sup>93</sup> Cases 7/56 and 3-7/57 *Algera v Common Assembly* [1957] ECR 39; Case T-251/00 *Lagardere SCA and Canal+ SA v Commission* [2002] ECR II-4825.

<sup>94</sup> Craig (n 4) ch 18.

<sup>95</sup> Case 54/65 *Chatillon v High Authority* [1966] ECR 185, 196; Case 81/72 *Commission v Council (Staff Salaries)* [1973] ECR 575, 584-585; Case 148/73 *Louwage v Commission* [1974] ECR 81, [12].

<sup>96</sup> Case T-72/99 *Meyer v Commission* [2000] ECR II-2521; Case T-290/97 *Mehibas Dorstseleaan BV v Commission* [2000] ECR II-15.

<sup>97</sup> Case T-489/93 *Unifruit Hellas EPE v Commission* [1994] ECR II-1201; Case T-534/93 *Grynberg and Hall v Commission* [1994] ECR II-595; Case T-456/93 *Consorzio Gruppo di Azioni Locale Murgia Messapica v Commission* [1994] ECR II-361; Case T-326/07 *Cheminova A/S v Commission* [2009] ECR II-2685, [81]; Case T-264/07 *CSL Behring GmbH v European Commission and European Medicines Agency (EMA)* [2010] ECR II-4469, [117].

<sup>98</sup> Cases C-189, 202, 205, 208 and 213/02 P *Dansk Rorindustri* (n 89) [209]-[232].

<sup>99</sup> Case C-313/90 *CIRFS v Commission* [1993] ECR I-1125, [34]-[36].

<sup>100</sup> Case C-311/94 *IJssel-Vliet Combinatie BV v Minister van Economische Zaken* [1996] ECR I-5023.

<sup>101</sup> Case T-214/95 *Vlaams Gewest v Commission* [1998] ECR II-717.

<sup>102</sup> Case 2/75 *Einfuhr- und Vorratsstelle für Getreide und Futtermittel v Firma C Mackprang* [1975] ECR 607; Case C-179/00 *Weidacher v Bundesminister für Land- und Forstwirtschaft* [2002] ECR I-501.

<sup>103</sup> Case 265/85 *Van den Bergh en Jurgens and Van Dijk Food Products v Commission* [1987] ECR 1155; Case C-350/88 *Delacre v Commission* [1990] ECR I-395; Case T-489/93 *Unifruit Hellas* (n 97); Cases T-466, 469, 473, 474 and 477/93 *O'Dwyer v Council* [1996] ECR II-2071; Cases T-142 and 283/01 *Organización de Productores de Túnidos Congelados (OPTUC) v Commission* [2004] ECR II-329; Case C-342/03 *Spain v Council* [2005] ECR I-1975, [48]; E Sharpston, 'Legitimate Expectations and Economic Reality' (1990) 15 *ELRev* 103.

<sup>104</sup> Case T-126/97 *Sonasa—Sociedade Nacional de Segurança Ld v Commission* [1999] ECR II-2793.

<sup>105</sup> Case C-110/97 *Netherlands v Council* [2001] ECR I-8763; Case C-402/98 *ATB v Ministero per le Politiche Agricole* [2000] ECR I-5501; Cases T-64-65/01 *Afrikanische Frucht-Compagnie GmbH v Commission* [2004] ECR II-521, [83]-[84]; Case C-17/03 *Vereniging voor Energie, Milieu en Water v Directeur van de Dienst uitvoering en toezicht energie* [2005] ECR I-4983, [73]-[87].



Decision No. 209

David Bigman,  
Applicant

v.

International Bank for Reconstruction and Development,  
Respondent

1. The World Bank Administrative Tribunal, composed of Robert A. Gorman, President, Francisco Orrego Vicuña and Thio Su Mien, Vice Presidents, and A. Kamal Abul-Magd, Bola A. Ajibola, Elizabeth Evatt and Jan Paulsson, Judges, has been seized of an application, received on May 12, 1998, by David Bigman against the International Bank for Reconstruction and Development. The usual exchange of pleadings took place. The case was listed on February 17, 1999.

2. This case concerns a complaint by the Applicant that the conditions under which he was recruited by the Bank on a fixed-term appointment were not honored and that, as a result, his appointment was neither regularized nor extended. Issues relating to breach of promise and breach of contract have been raised in this connection, together with allegations of arbitrariness and abuse of discretion.

3. The Applicant joined the Bank in 1994 as a Senior Economist in the Human Resources Division of the Africa Technical Department (AFTHR) on a three-year fixed-term appointment. At the time of his recruitment by the Bank, the Applicant was on a two-year contract as a Senior Economist with the International Monetary Fund (IMF), a position he had held since 1992. He was also at that time on sabbatical leave from the Hebrew University of Jerusalem. The Applicant maintains that this sabbatical leave had prevented him from accepting a regular staff appointment when he joined the IMF.

4. In order to accept the offer made by the Bank, the Applicant had to take two important steps in the pursuance of his professional career. The Applicant explained that he had first to inform the pertinent Department at the IMF that he would not seek extension or regularization of his appointment. The second, and more important, step was to take early retirement from the Hebrew University. The Applicant further explains that he took these steps and accepted the Bank's offer of employment because of the nature of the work offered by the Bank and the conditions discussed for his appointment. An examination of the circumstances of the Applicant's appointment and of the conditions that might have intervened are, therefore, crucial aspects that need to be considered by the Tribunal.

5. The Applicant was interviewed and recruited by Mr. X – a senior officer and technical specialist who served as supervisor of the Poverty Unit in AFTHR – and was assigned to Mr. X's Unit when he joined the Bank. During the process of his recruitment, he was also interviewed by the Division Chief of AFTHR and the supervisor of the Food Security Unit in that Division. The Applicant contends that during the recruitment process he was given assurances by Mr. X that his appointment would be regularized after one year if his performance was satisfactory. The Bank is of the view, however, that the Applicant only accepted an offer of a three-year fixed-term appointment and that, in accordance with the letter of appointment, such fixed-term appointment was not subject to automatic regularization or extension. The Bank further argues that Mr. X had only offered an opinion and not a promise of any kind and that, in any event, Mr. X had no managerial authority to make promises.

6. The first question that the Tribunal must address is whether there was in fact a promise made by Mr. X relating to the Applicant's appointment, and if so the nature of the promise. The record is abundantly clear that such a promise was in fact made. In an electronic message addressed to the Technical Manager of the Africa Technical Department, Institutional and Social Policy Division, regarding discussions about the Applicant's confirmation, dated September 29, 1996, Mr. X stated: "My dilemma is that I assured David almost two and a half years ago when he joined the Bank that he would be confirmed given my assumption that his work would be good." In the Report of the Appeals Committee on the Applicant's appeal, dated February 19, 1998, it was further recorded that "Mr. [X] testified that he recalls 'assuring' Appellant, based on his understanding of common practice at the Bank, that if all went well, Appellant could expect to be regularized toward the end of his contract term." In yet more unequivocal terms, Mr. X signed a written statement on September 10, 1998, confirming that

[a]s the person in charge of the Poverty Unit and responsible for recruiting for this position, I assured David that under normal conditions he would be made regular staff if his performance was satisfactory .... I expected the regularization to take place within one to two years after his entry on duty and certainly well before the end of his contract.

7. Contrary to the Respondent's assertions in its pleadings, the Bank itself acknowledged that a promise of regularization was in fact made to the Applicant, conditioned upon his satisfactory performance. In particular, the Acting Vice President for the Africa Region, in his administrative review of July 30, 1997, stated: "It is regrettable that you were promised regularization in one year. This was an unauthorized promise and this matter was clarified with you after you accepted the appointment." In the light of the above, it is well established that Mr. X made a promise to the Applicant with respect to the terms and conditions of the Applicant's appointment, beyond and in addition to what was included in the letter of appointment. Mr. X's authority to make a promise of regularization will be discussed further below.

8. The question that follows is whether such terms and conditions were decisive in the Applicant's acceptance of

employment with the Bank. Again on this point, the Tribunal finds that this was so. It is hardly conceivable that a well-established professional such as the Applicant would forego a possibility of regular employment with the IMF or take early retirement from the Hebrew University in order to accept a limited three-year fixed-term appointment with the Bank. The assurances about his regularization made a crucial difference for his acceptance of employment with the Bank. This conclusion is based not only on the Applicant's statement of events, but also on the opinion of Mr. X. Indeed, Mr. X, in his written statement of September 10, 1998, confirmed that:

I encouraged David to apply for the position in the Africa Region's Poverty Unit, which matched his qualifications and experience. I knew that David would have to make important career decisions in accepting the position in the Bank on the basis of a fixed term contract since he had a position in the IMF that could be regularized, and he was still a tenured professor at the Hebrew University. Therefore, he relied on my assurances about the nature of the position and the good prospects for regularization given sound performance.

9. The Tribunal must now turn to the question of Mr. X's authority to make a promise of the kind discussed above. In the Bank's view, Mr. X did not have such authority since he "was not a 'Senior Staff Member with management responsibilities,' a 'recruiter,' or in any other position which would authorize him to offer or promise terms of appointment or conditions of employment, as Applicant has portrayed." (Respondent's Answer at para. 56.) As was stated in the administrative review of July 30, 1997, "[t]his was an unauthorized promise...." In the Applicant's view, however, Mr. X was the officer responsible for the Poverty Unit, supervised its work and recruited for it, and was relied on by the Division Chief for this and other administrative tasks relating to the Division. Mr. X himself indicated in his statement of September 10, 1998 that he was "the person in charge of the Poverty Unit and responsible for recruiting for this position...."

10. There can be no doubt that Mr. X was the Applicant's main contact with respect to recruitment for, and discussions about, the offered position. Furthermore, it appears that Mr. X was in charge of a number of administrative aspects relating to the work of the unit concerned, a matter on which his advice was followed by the Division Chief. The Applicant, therefore, had every reason to rely on the terms discussed with Mr. X and no reason whatsoever to doubt Mr. X's authority or clearance to this effect. However, even assuming that Mr. X acted without authority or that he exceeded his competence, this does not relieve the Bank of its responsibility vis-à-vis the Applicant. It is a well-established principle of many legal systems, as well as of international law, that the act of an official who is acting within the scope of his or her actual or apparent authority will be attributable to the relevant entity. It follows that also the act of a Bank official who is acting within his or her apparent authority will be attributable to the institution, particularly if this act was relied upon in good faith. Whether the question of Mr. X's authority was explained to the Applicant and discussed with him after his acceptance of the letter of appointment, a matter which the Bank affirms and the Applicant denies, does not change the fact that the Applicant relied on the conditions offered for accepting his employment with the Bank.

11. The promise made to the Applicant was, however, expressly conditional on his performance being satisfactory. In the interim performance evaluation of January 25, 1995, the Applicant's Division Chief concluded that the Applicant "has demonstrated that he has the required technical knowledge, analytical capability to work under pressure and initiative to perform well in this Division." A similar evaluation was recorded in the Applicant's Performance Review Record (PRR) for the period of June 1994 to June 1995, that is, covering the first full year of his association with the Bank. In both evaluations, it was noted that the Applicant needed to improve his interpersonal skills with other members of the Division; in the PRR, it was also observed that the Applicant needed to adapt more readily to "the operational focus and requirements." These comments did not involve any negative criticism of the Applicant's performance and it was precisely because his "performance [had] been very good" during this first year that the Applicant's original probationary appointment was confirmed by the Management Review Team on recommendation of the manager, as was provided for under Staff Rule 4.02, paragraph 3.02(a). Such a recommendation is made if the "staff member is considered suitable for continued employment with the Bank Group," as provided under Staff Rule 4.02, paragraph 3.01(a), as then in force.

12. On the basis of the Applicant's satisfactory performance, Mr. X – who was of the opinion that the Applicant's performance had been "excellent" – recommended that the Applicant be given a regular appointment, just as he had promised during the recruitment process. It was at this point, however, that problems associated with the regularization of the Applicant's contract began to emerge.

13. In the PRR for the period of February 1995 to December 1995, it was again concluded that the Applicant's performance had been satisfactory. In this PRR, it was indicated that the Applicant brought "analytical rigor in operational and own-managed work" and that there had been "considerable improvement" in the Applicant's "interpersonal skills and in team collaboration." On this basis, the Applicant was given a full satisfactory merit increase rating of "3" for that year, a rating given to most of the staff in the Division. Notwithstanding its agreement with this evaluation, the Management Review Team decided to reserve its recommendation regarding regularization on the ground that it "could not find a rationale for early regularization." It was expressly stated by the Management Review Team that "[t]his is not a negative comment on Mr. Bigman's performance, which was satisfactory." The practical result of this decision was that the Applicant was not regularized after his various evaluations, even though his performance was satisfactory.

14. After efforts by both the Applicant and Mr. X to have the issue of regularization addressed, the Vice President for the Africa Region informed the Applicant, by memorandum of June 28, 1996, that the issue would be determined "through the regular process and procedures applicable to such cases" and that a decision would be taken at least six months before the end of his contract in June 1997.

15. The PRR for 1996 also reflected satisfactory performance by the Applicant, but the question of his teamwork effectiveness was again raised. On this basis, and having also considered the Applicant's technical work, the Management Review Team decided in March 1997 that there "was not an adequate case to regularize Mr. Bigman, nor to extend his fixed-term contract for a multi-year period." This language was changed in the final version of the Management Review Record after the Ombudsman intervened. In the final version, it was stated that the Management Review Team "had high regard for Mr. Bigman's technical skills and capacities," but that it did not see a possibility of extending the contract "since there has not been a sufficient match between the experience that Mr. Bigman offered and the operational needs of the Africa Region." A six-month extension of the contract was recommended instead. At this point it should be noted that – according to the terms of the application – a two-year extension of the Applicant's contract could have been acceptable to him as an

alternative fulfillment of the promise made. An administrative review did not change the conclusions of the Management Review Team, and the Applicant's ability to work as part of a team was invoked as a reason. Neither was relief obtained by the Applicant from the Appeals Committee, in the findings of which it was indicated that the decision not to regularize the Applicant "resulted from a shifting of the priorities in the Region, that took place during Appellant's tenure in the Bank." The various evaluations of the Applicant support the conclusion that the Applicant's performance was satisfactory throughout his term of service.

16. Some criticisms relating to the Applicant's interpersonal relations and to the need to demonstrate his effectiveness in operational work were made, but these criticisms did not change the overall evaluations. Moreover, the criticisms made were not consistent. In fact, early references to interpersonal problems were followed later by an observation that there had been "considerable" improvement in this respect. The Applicant's interpersonal skills were then again criticized and were initially listed as one of two reasons for not regularizing or extending his contract. The Applicant's technical work was mentioned as the other reason even though his evaluations were unanimous in commending his skills and experience. In fact, the final version of the Management Review Record was changed to reflect the Management Review Team's "high regard" for such skills. Concerns about the Applicant's operational work were also raised, but, again, such concerns were not important aspects of his evaluations. A change of priorities in the Africa Region and a mismatch between experience and operational needs have also been invoked, aspects that are entirely unrelated to interpersonal relations or professional skills. From these contradictions, it follows that there was no clarity at all with respect to the reasons that led to the decision not to regularize or extend the Applicant's employment. However, it is clear enough that such a decision was not related to the Applicant's performance but to new priorities in the region.

17. A professional controversy between the Applicant and the Research Department about a Special Program of Assistance for Africa appears to have had some influence on the decisions taken. Differing views were expressed about the orientation of this program and the matter was discussed with a group of the Bank's donors at a meeting held in Bern in September 1996. Criticism of the Applicant's approach was made by staff of the Research Department and concerns were expressed about the implications that this discussion could have outside the Bank. This situation was not fully addressed until after regularization had already been turned down. While the Applicant argues that his contribution was ultimately approved, the Tribunal need not address this question as it is reasonable to conclude that non-approval of his contribution would not have affected his overall performance or the evaluations of his many other tasks, which occupied more than two-thirds of his time.

18. As noted above, the Appeals Committee found that the decision not to regularize the Applicant's contract resulted from a shifting of the priorities in the Africa Region. In fact, following a reorganization of that Region in mid-1996 the Applicant was transferred to the Institutional and Social Policy (ISP) Unit, the supervisors and managers of which participated in the Management Review Team that decided against regularization or extension of his contract. The question of research capability versus operational needs was again brought to the fore during the Applicant's stay in ISP. This was indicated in the Appeals Committee Report, where it was concluded that the "Appellant's managers in the reorganized ISP unit were interested in hiring outside consultants to perform the type of work that Appellant had been doing, and they did not foresee demand for Appellant's services as a staff member."

19. This last conclusion confirms that the decision not to regularize the Applicant's contract was unrelated to his performance and responded to the change of priorities mentioned above. Not only was the Applicant's contract not regularized or extended despite his overall continuing satisfactory performance, but it is quite evident that the Applicant's interpersonal problems, teamwork performance and professional skills were not, in fact, the main reason for the final decision not to convert or extend his contract. Rather, it appears that the main reason for the decision was the shifting of priorities that took place during the third and last year of the Applicant's employment. The operational needs of the ISP Unit and the managers' preferences for hiring consultants were absent from all of the Applicant's evaluations. Until the late shifting of priorities took place, the Applicant had satisfied the condition (i.e., satisfactory performance) that had been attached to the promise of conversion of his fixed-term appointment.

20. As rightly argued by the Respondent, and as often held by the Tribunal, there is no absolute right to conversion or extension of a fixed-term appointment. (Mr. X, Decision No. 16 [1984].) But this is so in ordinary circumstances, which are not present in this case. The Applicant accepted employment with the Bank in the light of specific conditions offered to him. This offer constituted a legally valid promise as it was made by an official with at least the apparent authority to do so and is, therefore, attributable to the Bank. The Applicant relied in good faith on this promise to accept the Bank's offer of employment and passed up other opportunities outside the Bank.

21. The promise was conditional on the Applicant's satisfactory performance. His performance was not only satisfactory but commended throughout the period of his appointment, as is clearly evidenced by the record. The reasons invoked for the decision not to convert or extend the Applicant's contract were not adequately reflected in the Applicant's evaluations, nor were they meaningful in the context of such evaluations. Only a change of priorities and a different preference by the managers, unrelated to the Applicant's performance, appear to have been at the very heart of the decision taken.

22. As the Tribunal held in another case involving the question of a promise, "[t]he discretion exercised by the Respondent as to whether the Applicant met the requirements of the position must, therefore, be scrutinized by the Tribunal in order to ensure that it is not vitiated by an abuse of discretion..." (Matthew, Decision No. 103 [1991], para. 29.) While evaluations of the Applicant were in the present case fair and reasonable, such evaluations were not duly taken into account in reaching the final decision, which was based on considerations different from his performance. The process of reaching a decision was, therefore, vitiated by an abuse of discretion. This led to the breach of a legally valid promise, the conditions of which had been properly met.

23. The Tribunal must now consider the question of remedies. While normally a vitiated decision would be quashed by the Tribunal, this has not been requested by the Applicant. It follows that the Tribunal shall award compensation for the damage that the Applicant has suffered as a result of the breach of the promise made by the Respondent.

#### Decision

For the above reasons, the Tribunal unanimously decides that:

- (i) the Respondent shall pay the Applicant compensation for the breach of promise in the amount equivalent to eighteen months' net salary;
- (ii) the Respondent shall remove from the Applicant's file all the documents relating to the Management Review Record dated May 8, 1997, in the event that this has not already been done; and
- (iii) the Respondent shall pay costs to the Applicant in the amount of \$9,974.48.

Robert A. Gorman

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President

Nassib G. Ziadé

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Executive Secretary

At London, England, May 14, 1999

**The World Bank Administrative Tribunal**

1900 Pennsylvania Avenue, NW

MSC 9-009, Washington, DC 20431 USA

TEL: (202) 458-0271 FAX: (202) 522-3581 EMAIL: [Tribunal@worldbank.org](mailto:Tribunal@worldbank.org)

Staff based in country offices may reverse the telephone charges, or may provide a number where they may be reached.

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West's Annotated California Codes  
Corporations Code (Refs & Annos)  
Title 1. Corporations  
Division 1. General Corporation Law (Refs & Annos)  
Chapter 3. Directors and Management (Refs & Annos)

West's Ann.Cal.Corp.Code § 309

§ 309. Performance of duties by director; liability

[Currentness](#)

(a) A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

(b) In performing the duties of a director, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by any of the following:

(1) One or more officers or employees of the corporation whom the director believes to be reliable and competent in the matters presented.

(2) Counsel, independent accountants or other persons as to matters which the director believes to be within such person's professional or expert competence.

(3) A committee of the board upon which the director does not serve, as to matters within its designated authority, which committee the director believes to merit confidence,

so long as, in any such case, the director acts in good faith, after reasonable inquiry when the need therefor is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted.

(c) A person who performs the duties of a director in accordance with subdivisions (a) and (b) shall have no liability based upon any alleged failure to discharge the person's obligations as a director. In addition, the liability of a director for monetary damages may be eliminated or limited in a corporation's articles to the extent provided in paragraph (10) of [subdivision \(a\) of Section 204](#).

**Credits**

(Added by Stats.1975, c. 682, § 7, eff. Jan. 1, 1977. Amended by Stats.1976, c. 641, § 9.5, eff. Jan. 1, 1977; [Stats.1987, c. 1201, § 7](#); [Stats.1987, c. 1203, § 2, eff. Sept. 27, 1987](#).)



## Editors' Notes

### LEGISLATIVE COMMITTEE COMMENTS--ASSEMBLY

1975 [Corrected]

Source: ABA § 35 (proposed revision). The duties of a director are specified in [subdivision \(a\) of § 300](#). The purpose of this section is to establish a standard by which the performance of a director in the exercise of his duties shall be judged. It is intended that a person who performs his duties as a director in accordance with this standard shall have no liability by reason of being or having been a director.

(a) This subdivision provides a standard of care applicable to directors. Comments to the proposed revision of ABA § 35 indicate that it is the intent of the draftsmen of this provision, by combining the requirement of good faith within the standard of care, to incorporate “the familiar concept that, these criteria being satisfied, a director should not be liable for an honest mistake of business judgment” [Committee on Corporate Laws, Changes in the Model Business Corporation Act, 29 Bus. Lawyer 951 (1974)].

The Committee on Corporate Laws of the Section of Corporation, Banking and Business Law of the American Bar Association arrived at a number of decisions in formulating the standard of care:

(1) The reference to “ordinarily prudent person” emphasizes long traditions of the common law, in contrast to standards that might call for some undefined degree of expertise, like “ordinarily prudent business man”; the phrase is not intended to establish the preservation of assets as a priority for the corporate director, but, rather, to recognize the need for innovation as an essential of profit orientation and, in short, to focus on the basic director attributes of common sense, practical wisdom and informed judgment.

(2) The phrase “under similar circumstances” is intended both to recognize that the nature and extent of oversight will vary, depending upon such factors as the size, complexity and location of activities carried on by the particular corporation and to limit the critical assessment of a director's performance to the time of action or nonaction and thus prevent the harsher judgments which can invariably be made with the benefit of hindsight ...

(3) The phrase “in a like position” simply recognizes that the “care” under consideration is that which would be used by the “ordinarily prudent person” if he were director of the particular corporation [Committee on Corporate Laws, Changes in the Model Business Corporation Act, 29 Bus. Lawyer 954 (1974)].

While the new law adopted in general the language of ABA § 35, in subdivision (a) of Section 309 of the new law the words “including reasonable inquiry” were inserted in the phrase “with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.”

This change was made because some members of the State Bar Committee desired to make explicit what the majority of members considered to be implicit in the original language, i.e., that reasonable care under some circumstances could include a duty of inquiry. In other words, a director may not close his eyes to what is going on about him in the conduct of the corporate business and, if he is put on notice by the presence of suspicious circumstances, he may be required to make such “reasonable inquiry” as an ordinarily prudent person in his position would make under similar circumstances. There was no intention of imposing upon any director a duty to make an inquiry regardless of the circumstances, such as the duty imposed by Section 11 of the United States Securities Act of 1933 in connection with a public offering of securities, or to add a separate requirement of inquiry apart from a director's general duty of care.

Also, in subdivision (b) of this same section, the word “reasonably” was deleted in three places where it appeared in the ABA § 35 language before the word “believes.” The reason for this deletion was the concern expressed by some members of the State Bar Committee that the phrase “reasonably believes” to be competent or reliable would impose upon each director the duty in all cases of making an investigation or inquiry regarding the competence and reliability of the employees and advisers of the company. In lieu of the phrase “reasonably believes”, there was inserted in this subdivision (b) the language towards the end: “after reasonable inquiry when the need therefor is indicated by the circumstances.”

The phrase “including reasonable inquiry” in subdivision (a) was intended to mean precisely the same thing as the language substituted in subdivision (b), i.e., that the duty of inquiry only arises if the circumstances indicate the need therefor.

The standard of care does not include officers. The Committee on Corporate Laws concluded that:

... it was not appropriate in connection with a revision of Section 35 to deal with those officers who were not also directors of the corporation. Although a non-director officer may have a duty of care similar to that of a director as set forth in Section 35, his ability to rely on factual information, reports or statements may, depending upon the circumstances of the particular case, be more limited than in the case of a director in view of the greater obligation he may have to be familiar with the affairs of the corporation [Committee on Corporate Laws, Changes in the Model Business Corporation Act, 29 Bus. Lawyer 953 (1974)].

**Section 300** (also derived from the proposed revision of ABA § 35) provides that the business and affairs of the corporations shall be exercised by or under the direction of the board. In formulating a proper standard of care for a director in the performance of his duties, the Committee on Corporate Laws considered the nature of the duties of a director.

It is generally recognized that the board of directors may delegate to appropriate officers of the corporation the authority to exercise those powers not required by law to be exercised by the board itself. While such a delegation will not serve to relieve the board from its responsibilities of oversight, it is believed appropriate that the directors not be held personally responsible for actions or omissions of officers, employees or agents of the corporation so long as the directors, complying with the enunciated standard of care, have relied reasonably upon such officers, employees or agents [Committee on Corporate Laws, Changes in the Model Business Corporation Act, 29 Bus. Lawyer 952 (1974)].

(b) Under prior law, a director has the right to rely in limited situations upon certain materials [Cal. § 829]. This subdivision, due to the number and complexity of the matters considered by directors, enlarges the right of reliance to encompass all matters for which the board is responsible and broadens the range of materials upon which a director may rely. The statutory right of reliance is not intended to be exclusive.

The purpose of these provisions were the subject of comment by the Committee on Corporate Laws. A director will be entitled to rely:

... upon factual information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by (a) one or more officers or employees of the corporation whom he reasonably believes to be reliable and competent in the matters presented, (b) counsel, public accountants or other persons as to matters which he reasonably believes to be within such person's professional or expert competence, or (c) a board committee (upon which he does not serve), provided that he reasonably believes confidence therein is merited, so long as in any such case he shall be without knowledge concerning the matter in question which would cause such reliance to be unwarranted. Inherent in the good faith standard is the requirement that, in order to be entitled to rely on such reports, statements, opinions and other matters, the director must have read, or been present at the meeting at which is orally presented, the report or statement in question and must not have any pertinent knowledge which would cause him to conclude that he should not rely thereon [Committee on Corporate Laws, Changes in the Model Business Corporation Act, 29 Bus. Lawyer *supra* 954 (1974)].

The provision permitting reliance upon a committee of the board is intended to permit reliance upon the work product of a board committee resulting from a more detailed investigation undertaken by that committee and which forms the basis for action by the board [Committee on Corporate Laws, Changes in the Model Business Corporation Act, 29 Bus. Lawyer 955 (1974)]. Additionally, the provisions contemplate reliance upon a committee where only a supervisory responsibility is exercised (e.g. a corporate audit committee with respect to its role of oversight concerning accounting and audit functions) [Committee Corporate Laws, Changes in the Model Business Corporation Act, 29 Bus. Lawyer 955 (1974)].

See the discussion above regarding the changes made in this subdivision from the language in ABA § 35 to make crystal clear that no duty of inquiry comparable to that contained in Section 11 of the United States Securities Act of 1933 was intended to be imposed upon directors in judging the competence and reliability of the persons on whom they rely, unless there are circumstances which would cause any reasonable man in a like position to make such an inquiry. As Lord Halsbury stated in *Dovey v. Cory* [(1901) A.C. 477]:

“I cannot think that it can be expected of a director that he should be watching either the inferior officers of the bank or verifying the calculations of the auditors himself. The business of life could not go on if people could not trust those who are put into a position of trust for the express purpose of attending to details of management.”

(c) The purpose of this subdivision is to relieve a person from any liability by reason of being or having been a director of a corporation, if that person has exercised his duties in the manner contemplated by this section.

#### [Notes of Decisions \(78\)](#)

West's Ann. Cal. Corp. Code § 309, CA CORP § 309

Current with urgency legislation through Ch. 351 of 2015 Reg.Sess.

West's Annotated California Codes  
Corporations Code (Refs & Annos)  
Title 1. Corporations  
Division 2. Nonprofit Corporation Law (Refs & Annos)  
Part 2. Nonprofit Public Benefit Corporations (Refs & Annos)  
Chapter 2. Directors and Management (Refs & Annos)  
Article 3. Standards of Conduct (Refs & Annos)

West's Ann.Cal.Corp.Code § 5231

§ 5231. Good faith; standard of care; reliance on information presented by others; liability

Effective: January 1, 2010

[Currentness](#)

(a) A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner that director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

(b) In performing the duties of a director, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by:

(1) One or more officers or employees of the corporation whom the director believes to be reliable and competent in the matters presented;

(2) Counsel, independent accountants or other persons as to matters which the director believes to be within that person's professional or expert competence; or

(3) A committee upon which the director does not serve that is composed exclusively of any or any combination of directors, persons described in paragraph (1), or persons described in paragraph (2), as to matters within the committee's designated authority, which committee the director believes to merit confidence, so long as, in any case, the director acts in good faith, after reasonable inquiry when the need therefor is indicated by the circumstances and without knowledge that would cause that reliance to be unwarranted.

(c) Except as provided in [Section 5233](#), a person who performs the duties of a director in accordance with subdivisions (a) and (b) shall have no liability based upon any alleged failure to discharge the person's obligations as a director, including, without limiting the generality of the foregoing, any actions or omissions which exceed or defeat a public or charitable purpose to which a corporation, or assets held by it, are dedicated.

**Credits**

(Added by Stats.1978, c. 567, p. 1750, § 5, operative Jan. 1, 1980. Amended by Stats.1979, c. 724, p. 2242, § 24, operative Jan. 1, 1980; [Stats.2009, c. 631 \(A.B.1233\)](#), § 14.)

[Notes of Decisions \(1\)](#)

West's Ann. Cal. Corp. Code § 5231, CA CORP § 5231

Current with urgency legislation through Ch. 322, also including 324-325, of 2015 Reg.Sess.

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JUDGMENT OF THE COURT (FIRST CHAMBER)  
30 JANUARY 1974<sup>1</sup>

**Raymond Louwage and Marie-Thérèse Louwage, née Moriame  
v Commission of the European Communities**

Case 148/73

S u m m a r y

1. *Acts of an institution — Internal directive — Binding nature*
2. *Officials — Reimbursement of expenses — Daily subsistence allowance — Conditions of grant*  
(*Staff Regulations, Annex VII, Article 10*)

1. Although an internal directive has not the character of a rule of law which the administration is bound to observe, it nevertheless sets forth a rule of conduct indicating the practice to be followed, from which the administration may not depart without giving reasons which have led it to do so, since otherwise the principles of equality of treatment would be infringed.
2. Daily subsistence allowance is due to an official who, to comply with the obligation to reside in the place where he is employed, must remove to a residence other than that which he occupied previously, without however being able to give up this latter.

In Case 148/73

RAYMOND LOUWAGE and his wife MARIE-THÉRÈSE LOUWAGE, NÉE MORIAME, officials of the Commission of the European Communities, of 51 avenue des Mouflons, Overijse, represented by Victor Biel, advocate of the Cour Supérieure de Justice du Grand-Duché, 71, rue des Glacis, Luxembourg, in whose chambers they have chosen their address for service,

applicants,

v

COMMISSION OF THE EUROPEAN COMMUNITIES, represented by its Legal Adviser, Joseph Griesmar, acting as agent, having chosen its address for service in

<sup>1</sup> — Language of the Case: French.

Luxembourg at the office of its Legal Adviser, Pierre Lamoureux, 4, boulevard Royal,

defendant,

in the matter of the annulment of a note from the Head of the 'Individual Rights and Privileges' Division of 25 October 1972, relating to removal expenses, installation allowance and daily subsistence allowance of the applicants,

THE COURT (First Chamber)

composed of: A. M. Donner, President of Chamber, R. Monaco and C. Ó Dálaigh (Rapporteur), Judges,

Advocate-General: G. Reischl  
Registrar: A. Van Houtte

gives the following

## JUDGMENT

### Issues of fact and of law

The facts of the case, the subject matter of the applications and the views of the parties may be summarized as follows:

#### I — Facts and procedure

1. The husband and wife applicants, at present officials of the Commission of the European Communities in Brussels, formerly lived in Luxembourg where Mrs Louwage had been engaged on 15 July 1958 on the auxiliary staff of the secretariat of the Councils and on 1 November 1958 as an established official with the European Parliament.

Mr Louwage was at first engaged in an independent profession in Luxembourg,

but after having applied for a position with the Commission of the EEC in Brussels, he was engaged on 20 July 1965 on the auxiliary staff. On 1 October 1968 he was appointed probationary official with the single Commission, and established on 1 April 1969. From Brussels he visited his family each weekend in Luxembourg.

Wishing to 're-establish a true family home', Mrs Louwage was seconded at her request from the European Parliament to the Commission in Brussels for a period of six months as from April 1971, which was renewed until she was established in April 1972.

As soon as his wife arrived in Brussels, Mr Louwage left the small flat which he

previously occupied and moved with her into another small flat while waiting for the house which they were having built at Overijse to be finished.

On 11 November 1971 without waiting for her transfer to be confirmed, but assured that it would be done so speedily, Mrs Louwage requested permission to move. She received no reply to her letter in which she pointed out that neither her husband nor herself had as yet started to move in and that they had not received either the installation allowance or the daily subsistence allowance. And yet they were not 'able to live in the family home still maintained in Luxembourg' where they returned each weekend as did their son (a student in Liège) for whom they had no facilities in Brussels.

The removal however took place on 27 January 1972 and the removal bill was settled on 22 August 1972.

2. On 25 October 1972 Mrs Louwage received a note from the Directorate of Social Affairs, signed by the Head of the 'Individual Rights and Privileges' Division, in reply to the steps which she had taken to recover the removal expenses, the payment of the daily subsistence allowance and the installation allowance due to her husband and herself. In this note:

- the administration refused any reimbursement of removal expenses until the remover had given an explanation of the error in the invoice (he had in fact submitted an invoice for 40 600 BF which was settled in the sum of 24 600 BF);
- Mrs Louwage was recognized as being entitled to an installation allowance equal to the amount of her monthly basic salary at the date of her transfer and Mr Louwage as similarly entitled subject to a reduction of 20 % of the amount of the daily subsistence allowance which he had received during the fifth and sixth months which he had lived in Brussels;

— as regards the daily subsistence allowance it would be recovered from the salary of Mr Louwage in respect of the period from 1 April to 27 September 1969 for which he had wrongfully received it as 'notional removal expenses'; as for Mrs Louwage she was not entitled, since in establishing herself in Brussels, she had 'rejoined' her husband.

3. On 30 November 1972 the applicants submitted a complaint under Article 90 of the Staff Regulations to the Director-General of Administration seeking the annulment of the decisions contained in the note of 25 October, the reimbursement of the removal expenses (24 600 BF) and the payment of the daily subsistence allowance to Mrs Louwage, for whom Brussels had always been an uncertain residence, since the family home had in fact remained established in Luxembourg.

The complaint was also directed 'against the decision to recover the daily subsistence allowance from Mr Louwage which had been paid for a notional removal'.

Finally since the Commission did not object to payment of the installation allowance, it appeared equitable to the applicants that it should be paid to each of them at the rate for a 'single person'.

4. Since there was no reply to this complaint, the applicants lodged the present appeal on 28 June 1973.

The written procedure followed the normal course. On the report of the Judge-Rapporteur, after hearing the Advocate-General, the Court (First Chamber) decided to proceed without a preparatory inquiry.

## II — Conclusions of the parties

The applicants claim that the Court should:

1. annul the note of 25 October 1972;



2. order the Commission
  - (a) to pay to Mrs Louwage a sum of 24 600 BF — with interest at 4 % as from 22 August 1972 to date of payment — as removal expenses (the applicants subsequently did not pursue their claim to interest for delay);
  - (b) to pay to Mr Louwage the amount of two months basic salary as installation allowance (the applicant subsequently abandoned the claim to the second month);
  - (c) to pay to Mrs Louwage as daily subsistence allowance for the period from 5 April 1971, the date of her taking up employment with the Commission in Brussels, to 27 January 1972, the date of her removal, the amounts provided in the table in Article 10 of Annex VII;
3. declare that Mr Louwage rightfully received the daily subsistence allowance between 1 April and 27 September 1969, that the administration is not entitled to require reimbursement from him of the said allowance, nor to recover it by deductions from his salary, and that the conditions for recovery of undue payment provided for in Article 85 of the Staff Regulations are not fulfilled (the applicant subsequently accepted the undertaking on the part of the appointing authority to abandon all claim to reimbursement);
4. order the Commission to pay the costs.

The defendant contends that the Court should:

1. reject as otiose and inadmissible the application by Mr Louwage for annulment of the decision of 25 October 1972 relating to the recovery of part of the daily subsistence allowance paid to him prior to 27 September 1969 (the applicant has accepted this);

2. reject as inadmissible and in any case unfounded the claim by Mr Louwage to an installation allowance equal to two months basic salary (the applicant has abandoned this claim);
3. reject as unfounded the claim by Mrs Louwage to complete reimbursement of the actual cost of removal from the common home as well as the claim to daily subsistence allowance for the period from 5 April 1971 to 27 January 1972;
4. reject as otiose and therefore inadmissible the application to which she is entitled, but which the defendant will show has recently been effected and in any case before judgment;
5. order the applicants to pay the costs (in the rejoinder, the defendant leaves this to the discretion of the Court).

### III — Submissions and arguments of the parties

The defendant makes no objection to the admissibility of the application.

#### *Substance*

*First submission:* infringement of Article 9 of Annex VII to the Staff Regulations

The second applicant submits that the decision contained in the note dated 25 October 1972 does not satisfy the provisions of Article 9 of Annex VII to the Staff Regulations and that the removal expenses ought to be reimbursed her.

The defendant replies that it was Mr Louwage who settled the amount of 24 600 BF and that the applicants could claim only the difference between the amount paid to the remover (24 600 BF) and the notional removal expenses which Mr Louwage had received in 1968 as daily subsistence allowance (14 650 BF), i.e. 9 950 BF.

A decision of the Commission dated 17 March 1971, taking effect as from 5 March 1968, stipulated that 'where an official has been authorized to move but has not done so during the year following his establishment... he shall be entitled to daily subsistence allowance for an initial period of six months and thereafter from the seventh month for a minimum period of a further six months to the extent of his notional removal expenses. Any over-payment shall be recovered'. This wording is to be compared with the former Article 10 (3) of Annex VII to the Staff Regulations in force when Mr Louwage was established, which, as regards the official who did not effect his removal within the year of his being established, limited the amount of his daily subsistence allowance to 'the total amount of payments to which he would have been entitled in the event of removal'.

The defendant considers that the daily subsistence allowance paid to Mr Louwage from 1 April 1969 to 27 September 1969, i.e., as from the seventh month of the period during which he benefited from it, necessarily comprised a not insignificant amount of 'notional removal expenses'. The amount of the notional expenses, relating to a removal from Luxembourg to Overijse (from 201 to 250 km) made by a head of household official in grade C, is 12 650 BF according to the scale annexed to the abovementioned directives, to which must be added 2 000 BF in respect of the son dependent on Mr Louwage. Thus in receiving from 1 April 1969 to 27 September 1969 a total daily subsistence allowance amounting to 36 000 BF, Mr Louwage had received a preliminary instalment of 14 650 BF towards 'the extent of his notional removal expenses' as a result of the requirement in the Staff Regulations that he had to be reimbursed at a flat rate and in advance for future removal expenses that were not incurred during the year following his establishment. This sum, once having gone into the conjugal community for a

very good reason (since it related to the defendant's responsibility for removal expenses not yet incurred) could not be taken into account until the spouses, having effected their common removal and thereby incurred a debt to the removal firm on behalf of their conjugal community, sought to obtain from the defendant reimbursement of the common funds paid to the removal firm in discharge of the common debt.

In view of the payment already made in 1969 to Mr Louwage, the legal administrator of the conjugal community, it appears to the defendant that only 9 950 BF remains payable.

The second applicant replies that the defendant has no obligation to the conjugal community constituted by the applicants, but towards its agents. It is to Mrs Louwage that Article 9 of Annex VII must be applied. Moreover the defendant could not recover against the *community of property* a sum which it declared it would forgo as regards Mr Louwage (letter of 31 July 1973).

The defendant does not think that there ought to be a refund to Mrs Louwage of the whole 24 600 BF, disregarding the prior lumpsum refund granted for the same reasons to the spouses. Such would create an unjustifiable enrichment of the family. No ill-feeling dictated the decision, the grounds of which had nothing to do with the question of 'penalizing the woman' by reason of her sex.

Moreover, contrary to the second applicant's view, it does not follow from the decision of 31 July 1973 that 'the notional removal expenses allowed to the husband could not be taken into account on the removal of Mrs Louwage at the end of January 1972'. The defendant has expressly abandoned the claim to recover, on the footing of undue payment, the excess paid, i.e., the difference of 21 350 BF between the daily subsistence allowance between 1 April 1969 and 27 September 1969 (36 000 BF) and the notional removal

expenses (14 650 BF). On the other hand it has not abandoned the claim to deduct from the amount of the real costs of removal, the amount of the notional expenses (14 650 BF), not because they had been wrongly paid, but to avoid a reimbursement greater in value than the liability arising from the same facts and cause, on the basis of which there had already been a prior reimbursement in the form of a fixed sum paid in advance.

*Second submission:* infringement of Article 10 of Annex VII to the Staff Regulations

The second applicant observes that she fulfilled the conditions of the former Article 10 (1) of Annex VII to the Staff Regulations, since she had not been able to continue to reside in her home and had not been able, for a period of nine months, to effect her removal (the nine months were calculated from the date of her provisional posting to Brussels and that of her removal).

The defendant recalls the terms of the decision of 31 July 1973: 'as from your secondment to the Commission on 5 April 1971 you have rejoined your husband who has been living for several years in Brussels and, by reason of this, your home has been re-established. One of the conditions referred to in the former Article 10 (1) of Annex VII to the Staff Regulations, i.e., not being able to continue to live at home, is not therefore fulfilled in your case'. The defendant disputes the claim by the second applicant that the family had lived until the day of the removal in Luxembourg. A home cannot be constituted by a flat used as a secondary weekend residence and for the rest of the time simply as a furniture store. Defined primarily by the cohabitation of the spouses, the matrimonial home was reestablished as from April 1971 in Brussels, which had become the place where they worked and the place where they cohabitated five out of seven days. This view does not seem to contradict that of the second

applicant, according to whom a transfer to Brussels was requested 'in order to re-establish a true family home'.

The second applicant replies that the defendant has admitted that until April 1971 the matrimonial home was in Luxembourg. To satisfy the requirements of Article 20 of the Staff Regulations the second applicant had left the said home and had shown that she was no longer able to live there. The second applicant disputes that the matrimonial home was re-established in Brussels on her arrival there. Even if this were so it would have no effect on the application of Article 10 since the daily subsistence allowance was paid on condition that the employee had left his home and that he had not been able to effect his removal. These two conditions were fulfilled. Moreover, a removal on the basis of a secondment, as was the applicant's case, would not have been possible.

The former Article 10 of Annex VII, in force at the time the rights arose, would resolve the question in the second applicant's favour, even if the argument that the matrimonial home had been re-established in Brussels had to be accepted. Indeed the first sentence of the said Article adopts the criterion of interruption in the continuity of residence and not that of change of residence. The official was entitled to the daily subsistence allowance when he was able to prove that there had been a break in the continuity of residence in his home. Since the defendant admitted that the home prior to 5 April 1971 was in Luxembourg, the small flat in Brussels was a different home from that in Luxembourg and there was a change of home and a break in continuity within the meaning of Article 10 of the Annex VII in force in April 1972.

The defendant disputes that in April 1971 the second applicant had 'left her home'. Such would have been the case had the home remained in Luxembourg. But it is not possible to leave a home if it

remained in the same place. There was, at the same time as the change of residence of a person who came to live in another town with her husband, a simultaneous transfer of the home. Since home is the principal place of cohabitation, there can be only one. The second applicant began in April 1971 and thereafter continued to live in her home, which was the couple's small flat in Brussels, for the former flat in Luxembourg simultaneously lost the character of a home and became a secondary residence.

The object of Article 10 of Annex VII is to enable the administration to accept liability for necessary but temporary expenses of double residence arising for an official from the fact that he is temporarily obliged to live alone in a hotel or in a second flat at the place of his new post, whereas the rest of his family (wife and children) continue to live in the place where he previously had his post. It is clear that in this case the official could show 'that he cannot continue to reside in his own home'.

But this is not the present case. Since April 1971 the home of the applicants was no longer in Luxembourg. They preferred to live for some months in a

small flat and to retain in addition their former flat in Luxembourg as a weekend residence. If they had been able as from April 1971 to establish their matrimonial home in the house at Overijse, in the event that it had been finished, and to move their furniture, the second applicant would not have thought she had a case to claim the daily subsistence allowance under Article 10 of Annex VII, by reason of the fact that the removal of the common furniture would already have taken place.

The present claim for the second applicant amounts to making the defendant responsible for the fact that the house in Overijse was not habitable as from April 1971.

The oral hearing took place on 15 November 1973.

The applicants were represented by Victor Biel, advocate at the Cour Supérieure de Justice of the Grand-Duché of Luxembourg, and the Commission of the European Communities by its Legal Adviser, Joseph Griesmar, acting as agent.

The Advocate-General delivered his opinion at the hearing on 5 December 1973.

## Grounds of judgment

- 1 By an application filed on 29 June 1973, the applicants have asked the Court to annul the decisions contained in a note from the Head of the 'Individual Rights and Privileges' Division of 25 October 1972, refusing to apply for their benefit the provisions of Articles 5, 9 and 10 of Annex VII to the Staff Regulations.
- 2 During the course of the proceedings the applicants abandoned certain claims and others have been satisfied.

- 3 The two points remaining in dispute concern the claims of the second applicant to obtain on the one hand a refund of the removal expenses involved in her transfer from the European Parliament in Luxembourg to the Commission in Brussels and on the other hand the payment of subsistence allowance for the period from 5 April 1971, the date of her first provisional secondment to the Commission, to 27 January 1972, date of her removal.

### The first claim

- 4 The second applicant claims reimbursement of the whole of the expenses of removal of the common furniture, amounting to 24 600 BF.
- 5 The defendant relies on the principle that, while reimbursement of the removal expenses is due to the two spouses, they are not each entitled to the whole, and therefore admits liability only for an amount equal to the difference between the actual cost of the removal and the daily subsistence allowance that the first applicant received as a fixed payment in advance made because he had not moved within a year after taking up his duties.
- 6 The first applicant received, as daily subsistence allowance, from 1 April 1969, date from which his establishment took effect, to 27 September 1969, a sum of 36 000 BF, 14 650 BF of which the defendant regards as representing the notional removal expenses.
- 7 In support of this argument the defendant refers to the terms of an internal directive of the Commission of 17 March 1971 according to which as from 5 March 1968 'where an official has been authorized to move but has not done so during the year following his establishment . . . he shall be entitled to daily subsistence allowance for an initial period of six months and thereafter from the seventh month for a maximum period of a further six months to the extent of the notional removal expenses'.
- 8 By a note dated 14 May 1969 the administration authorized the first applicant to effect his removal within a period of one year as from the date his establishment took effect, i.e., before 1 April 1970.

- 9 The daily subsistence allowance referred to in Article 10 of Annex VII to the Staff Regulations is paid to an official who is head of household for a period of 180 days.
- 10 The said note of 14 May 1969 limited this allowance in the case of the first applicant to four months from the notification of the authorization to move, i. e., to 27 September 1969.
- 11 The afore-mentioned terms of the internal directive of the Commission imply that the first plaintiff was entitled to daily subsistence allowance for a period of six months, i.e., from 1 April 1969 to 1 October 1969, then as from the seventh month, 'to the extent of the amount of the notional removal expenses'.
- 12 Although an internal directive has not the character of a rule of law which the administration is always bound to observe, it nevertheless sets forth a rule of conduct indicating the practice to be followed, from which the administration may not depart without giving the reasons which have led it to do so, since otherwise the principles of equality of treatment would be infringed.
- 13 The date from which the calculation of the first period of six months must be made is that of the establishment of the official.
- 14 The first plaintiff was established with effect from 1 April 1969.
- 15 The daily subsistence allowance must therefore be calculated from this date.
- 16 It is only from 1 October 1969 that it would have been paid 'to the extent of the notional removal expenses'.
- 17 However it is not disputed that it has not been paid to the first applicant since 27 September 1969.

- 18 It is established therefore that the first applicant has never received any payment whatsoever as notional removal expenses.
- 19 As regards this claim the appeal succeeds.

### The second claim

- 20 The second applicant maintains that under Article 10 of Annex VII to the Staff Regulations, as it stood at the time, she is entitled to the benefit of daily subsistence allowance for the period between the date of her first secondment to Brussels and that of her removal.
- 21 This Article provides that 'where an official furnishes evidence that he cannot continue to reside in his own home and has not removed to the place where he is employed, he shall be entitled for not more than twelve months to a daily subsistence allowance . . .?'
- 22 The administration disputes that in the case in question the second applicant could not continue to reside in her home, which, as from her arrival in Brussels, was re-established in the small flat into which she moved with her husband.
- 23 The second applicant replied that the matrimonial home remained in Luxembourg, since a removal of the common furniture to Brussels could not be envisaged so long as her position remained that of a secondment.
- 24 Moreover, in not granting the second applicant the authorization to remove which she had requested, the administration had confirmed that it had not yet taken a decision regarding her.
- 25 The basis for daily subsistence allowance lies *inter alia* in the obligation on the part of the official to remove to a residence other than that which he occupied previously, without however being able to give up this latter.

- 26 The defendant has not established that such was not the case.
- 27 The fact that this official at the place of her secondment rejoined her husband, himself an official, in a provisional residence is not decisive, since it is established that their matrimonial home remained in Luxembourg.
- 28 So long, therefore, as the removal had not taken place, i.e., before 27 January 1972, the second applicant ought to have received the daily subsistence allowance within the limits provided for by the Staff Regulations.
- 29 Thus the appeal succeeds on the second claim.

#### C o s t s

- 30 Under the terms of Article 69 (2) of the Rules of Procedure, the unsuccessful party shall be ordered to pay the costs.
- 31 The defendant has failed in its submissions and must therefore pay the costs.

On those grounds,

Upon reading the pleadings;  
Upon hearing the report of the Judge-Rapporteur;  
Upon hearing the oral observations of the parties;  
Upon hearing the opinion of the Advocate-General;  
Having regard to the Staff Regulations, especially Articles 9 and 10 of Annex VII;  
Having regard to the Protocols on the Statute of the Court of Justice;  
Having regard to the Rules of Procedure of the Court of Justice of the European Communities, especially Article 69;



THE COURT (First Chamber)

hereby:

1. Annuls the decision by which the Commission refused the applicants reimbursement of removal expenses amounting to 24 600 BF.
2. Annuls the decision by which the Commission refused to pay the second applicant daily subsistence allowance for the period between 5 April 1971 and 27 January 1972.
3. Orders the Commission to bear the whole of the costs of the proceedings.

Donner

Monaco

Ó Dálaigh

Delivered in open court in Luxembourg on 30 January 1974.

A. Van Houtte

A. M. Donner

Registrar

President of the First Chamber

OPINION OF MR ADVOCATE-GENERAL REISCHL  
DELIVERED ON 5 DECEMBER 1973 <sup>1</sup>

*Mr President,  
Members of the Court,*

The proceedings which I am considering today are concerned with claims under Annex VII to the Staff Regulations, arising when officials of the Communities fulfil the duty under Article 20 of the Staff Regulations on taking up their appointment or on transfer, i.e. take up residence at the place where they are employed.

I will briefly mention the following facts. Mr and Mrs Louwage, the applicants in the proceedings, have had their matrimonial home in Luxembourg since 1956. Mr Louwage was at first employed outside the Communities. From 20 July 1964 he was employed as auxiliary with the Commission in Brussels. He was appointed a probationer there with effect from 1 October 1968 and an established official (Salary grade C 4) with effect from 1 April 1969. Mrs Louwage was

<sup>1</sup> — Translated from the German.

 KeyCite Yellow Flag - Negative Treatment

Called into Doubt by [Estate of Blume v. Marian Health Center](#), 8th Cir.(Iowa), February 19, 2008

104 Cal.App.3d 648, 163 Cal.Rptr. 831

JEFFREY APPLEBAUM, Plaintiff and Respondent,

v.

BOARD OF DIRECTORS OF BARTON

MEMORIAL HOSPITAL, Defendant and Appellant.

Civ. No. 18455.

Court of Appeal, Third District, California.

Apr 15, 1980.

### SUMMARY

The trial court granted the petition of a physician for a writ of administrative mandate compelling a private hospital to restore plaintiff's obstetrical staff privileges. Complaints about plaintiff's delivery techniques from nurses had been transmitted to the hospital chief of staff by a certified obstetrics specialist on the staff. An ad hoc committee composed of physician members of the obstetrics department was appointed to investigate. The majority of that committee recommended suspension and the executive committee of the hospital agreed. After a review requested by plaintiff, a medical staff appeal committee agreed with the recommendation of suspension and the executive committee ratified that decision. (Superior Court of El Dorado County, No. 30698, William E. Byrne, Judge.)

The Court of Appeal affirmed, holding that, apart from any question of actual bias on the part of any of the physicians involved and from the merits of the charges, the procedure followed by the hospital violated plaintiff's fair procedure rights to an impartial tribunal by virtue of a practical probability of unfairness. In so holding, the court pointed out that the charges were brought by one of the two specialists on whom members of the ad hoc committee were accustomed and required to rely for obstetrics expertise, that his associate supported the charges, that five members of the ad hoc committee were also on the twelve-member executive committee and that, though the appeal committee did hear testimony from an obstetrical specialist in plaintiff's defense, half of the hospital's obstetric department and another specialist testified adversely. In conclusion, the court held that the trial court's order of reinstatement did not usurp

the hospital's discretion to determine whether plaintiff should retain his obstetrical privileges, since reinstatement pending a proper administrative hearing did not preclude exercise of the hospital's legally vested discretion to exclude from its facilities physicians it properly concluded did not meet its standards. (Opinion by Reynoso, J., with Evans, Acting P. J., and Blease, J., concurring.)

### HEADNOTES

#### Classified to California Digest of Official Reports

(1)

Healing Arts and Institutions § 5--Hospitals, Mental Institutions, and Nursing Homes--Officers and Employees--Private Hospitals--Right of Fair Procedure.

The common law right to fair procedure protects individuals from arbitrary exclusion or expulsion from private organizations which control important economic interests. Such rights apply when the organization involved is one affected with a public interest, such as a private hospital. The essence of the concept of fair procedure, like that of due process, is fairness. Adequate notice of charges and a reasonable opportunity to respond are basic to both sets of rights.

(2)

Healing Arts and Institutions § 5--Hospitals, Mental Institutions, and Nursing Homes--Officers and Employees--Private Hospitals--Right of Fair Procedure--Staff Members.

In an administrative mandamus proceeding, the trial court properly concluded that the procedure employed by a private hospital in suspending the obstetrical privileges of a staff member was impermissibly unfair. Apart from any question of actual bias on the part of any of the physicians involved and from the merits of the charges, the procedure violated the member's fair procedure rights to an impartial tribunal by virtue of a practical probability of unfairness, where general practitioner and pediatric specialist members of an ad hoc committee appointed by the hospital chief of staff to investigate charges against the physician were accustomed, and required, to rely for obstetrics expertise on the specialist who brought the charges or his associate who supported them, where review of the committee decision was by a 12-member executive committee on which 5 members of the ad hoc committee sat, and where, though an appeal committee composed of doctors from other departments of the hospital did hear testimony from an obstetrical specialist

in the physician's defense, half of the hospital's obstetrics department and another specialist testified adversely.

[See [Cal.Jur.3d, Healing Arts and Institutions, § 36](#); [Am.Jur.2d, Hospitals and Asylums, § 10](#).]

(3)

Healing Arts and Institutions § 5--Hospitals, Mental Institutions, and Nursing Homes--Officers and Employees--Private Hospitals--Right of Fair Procedure--Scope of Judicial Review and Relief.

In an administrative mandamus proceeding against a private hospital by a staff member whose obstetrical privileges had been suspended, the trial court's order of reinstatement, based on its finding of a denial of fair procedure, did not usurp the hospital's discretion to determine whether plaintiff should retain his obstetrical privileges. Reinstatement pending a proper administrative hearing did not preclude exercise of the hospital's legally vested discretion to exclude from its facilities physicians it properly concluded did not meet its standards.

#### COUNSEL

Wilke, Fleury, Hoffelt & Gray, Joe S. Gray and Alan G. Perkins for Defendant and Appellant.

Horan, Lloyd & Karachale and Charles G. Warner for Plaintiff and Respondent.

REYNOSO, J.

A private hospital board (hereinafter Hospital) appeals from a judgment granting a doctor's petition for a writ of administrative mandamus ([Code Civ. Proc., § 1094.5](#)) compelling restoration of his obstetrical staff privileges. The hospital asserts the vitality of the peer review concept. Its principal argument is that the trial court erred in its conclusion that the hospital procedures are impermissibly unfair. We affirm the judgment.

#### I

Plaintiff is a licensed physician and a board certified family practitioner. He began private practice in the South Lake Tahoe area in 1976, became an associate staff member at the hospital in May of that year, and was accepted as an active staff member a year later.

The hospital is a private, nonprofit institution with an open medical staff. In January of 1978, there were 14 general and family practitioners \*651 on the staff. Five doctors,

including plaintiff, had obstetrical privileges at the hospital. Two of the five, Drs. Furman and Hembrow, were board certified specialists in obstetrics; they were also associated in their practice. Two general practitioners and plaintiff had privileges for uncomplicated deliveries only; they were expected to consult with specialists in nonroutine cases. There were also two pediatricians on the department staff.

#### A. Hospital Proceedings

The present controversy began when the head nurse and the night supervisor in obstetrics expressed concern about plaintiff's delivery techniques to the hospital administrator and to Dr. Furman. Furman wrote to the hospital's chief of staff transmitting the nurses' complaints and requesting an investigation pursuant to the hospital's bylaws. As grounds for his request, Furman listed incompetence in the performance of deliveries and care of the newborn, unauthorized use of experimental drugs, falsification of medical records, improper conduct of labor, and the performance of procedures exceeding granted privileges.

The matter was discussed at a meeting of the executive committee of the hospital on September 29, 1977. Both Furman, as chief of surgery, and Hembrow, as chief of obstetrics, were members of the committee. Furman refrained from voting on decisions concerning plaintiff's privileges at all stages of hospital proceedings. An ad hoc committee, composed of the six physician members of the obstetrics department, including Furman and Hembrow, was appointed by the chief of staff to investigate the charges against plaintiff. Furman was asked to chair the committee but he declined to act in that capacity.

The ad hoc committee met on October 3. Dr. Furman presented his letter and those from the nurses. He also discussed eight patient records in which he found problems with plaintiff's treatment. Drs. Auerback and McFarren, pediatricians, commented unfavorably on five patient records and Auerback expressed his feeling that plaintiff at times treated cases which were beyond his expertise as a family practitioner. Dr. Hembrow commented that he had seen plaintiff perform some procedures in a way he felt showed "gross inexperience in most instances."

When plaintiff appeared before the committee, he objected to the charges in Furman's letter as vague and to the failure of the bylaws to \*652 allow him representation at the meeting. He also claimed the presence of Furman and Hembrow on the committee destroyed its impartiality because their

feelings were adverse to him. Dr. Furman then led the committee's questioning of plaintiff concerning his use of drugs not approved by the Federal Drug Administration, lack of consultation with other doctors on some problems and delivery of breech babies. Plaintiff told the committee that he used the non-FDA approved drugs only on two patients who had been placed on the medication previously by Sacramento obstetricians and on one patient after a telephone consultation with Sacramento Medical Center personnel. He also commented on the difficulties of obtaining consultations from Dr. Hembrow on patients receiving Medi-Cal benefits and on Dr. Furman's criticism of his handling of case in which he had asked Furman to assist. Plaintiff had previously (Aug. 18, 1977) written a letter to the executive committee pointing out the lack of adequate consultation from obstetricians for Medi-Cal patients. At the conclusion of the meeting plaintiff indicated his willingness to follow more detailed guidelines for obstetrics and to undergo a trial period provided consultation was made available to him.

The ad hoc committee agreed plaintiff had shown evidence of poor medical judgment and incompetence in the performance of deliveries and care of the newborn in that he had used experimental drugs without proper authorization and mismanaged labor by excessive use of drugs and improper combinations of drugs. It found plaintiff performed contraindicated procedures, procedures in excess of his privileges for uncomplicated deliveries, and failed to obtain proper consultation. A majority of the ad hoc committee recommended to the executive committee that plaintiff's obstetrical privileges be suspended after he had completed the care of patients presently at 32 weeks' gestation and delivered them under the supervision of other physicians in the obstetrics department.

The ad hoc committee's report was submitted to a meeting of the executive committee on November 22 after the members of the executive committee had been given time to review the transcript of the ad hoc committee hearing. Five of the members of the ad hoc committee (all but Dr. McFarren) attended the executive committee meeting; six other physicians and the hospital administrator were also present. The executive committee interviewed plaintiff and discussed possible recommendations limiting his staff privileges in obstetrics. It reconvened on November 29, and after further discussion decided that \*653 plaintiff should perform all deliveries until January 1, 1978, with another member of the obstetrics staff and place the newborns under the supervision of the pediatrics service, and that after January

1, 1980, plaintiff's obstetrical privileges would be suspended until he had completed further training satisfactory to the executive committee and served a probationary period in which he would transfer primary care of any nonroutine delivery to another member of the obstetrics staff.

On December 6, 1977, the hospital administrator wrote to plaintiff informing him of the executive committee's recommendation and summarily suspending him in accordance with the terms of the recommendation. The letter included the executive committee's findings that plaintiff had failed to obtain pediatric consultations in thirteen specified cases, failed to obtain obstetrical consultations in thirty-four cases, demonstrated incompetent techniques in delivery and resuscitation in two cases, used improper drugs inappropriately in three cases, exceeded his privileges by using a vacuum extractor in two cases, and used dangerous combinations of high doses of narcotics and narcotic antagonists in three cases. Patient record numbers were given for each of the charges. The executive committee later deferred the January 1 suspension until a recommendation from the medical staff appeal committee was received.

Plaintiff then requested review of the executive committee's decision by a medical staff appeal committee pursuant to the hospital bylaws. Members of the appeal committee were three physicians not previously involved in the dispute. The committee held formal hearings on January 11 and January 28, 1978; it heard testimony from the hospital administrator, plaintiff, Dr. Furman, the two general practitioner members of the obstetrics staff, an expert for the hospital, and one for plaintiff.

On January 19, 1978, between the two appeal committee meetings, Dr. Furman wrote to plaintiff informing him he would no longer do consultations. Furman's letter was presented to the appeal committee as an exhibit.

After the lunch break at the second meeting of the appeal committee, counsel for the hospital asked that the record reflect the composition of the executive committee had changed after the appeal committee was appointed and asked the two appeal committee members who were now also serving on the executive committee to indicate they would refrain \*654 from taking part in the executive committee's future consideration of plaintiff's hospital privileges. The two members agreed. Counsel indicated the question of overlapping membership had been raised by plaintiff in an unsuccessful attempt to obtain a writ of mandate from the

superior court the day before the second appeal committee meeting.

Counsel for plaintiff told the committee that one basis for the writ application was his concern that the members on the appeal committee may have been influenced by discussions about plaintiff at the January 24 meeting of the executive committee. Plaintiff had attempted to obtain a tape recording of the meeting but had not been able to do so. None of the committee members made any comment on this information and the hearing proceeded.

The appeal committee voted agreement with the recommendation that plaintiff's obstetrical staff privileges be suspended and the executive committee ratified the decision on January 30, 1978.

### **B. Superior Court Proceedings**

Plaintiff filed his writ petition in superior court on February 1, 1978, contending that the hospital proceedings violated due process of law because both the ad hoc committee and the appeal committee were prejudiced against him, the former by the presence of the complaining physician and the latter by disparaging remarks about his character and personality made at the January 24 executive committee meeting in the presence of two of the three appeal committee members. In a declaration attached to the petition, plaintiff asserted Drs. Furman and Hembrow had shown increasing reluctance to consult on Medi-Cal patients before October of 1977. He claimed 40 percent of his income was derived from obstetrical practice and a substantial portion of his obstetrical patients were Medi-Cal patients. He also claimed disparaging and untrue remarks about him had been made during a discussion of his case at the executive committee meeting on January 24 in the presence of two appeal committee members while the appeal committee hearings were in recess and that before the appeal committee began deliberations counsel for the hospital had informed his counsel that an adverse decision would be served on plaintiff within two days.

The court issued an alternative writ on February 7, 1978. The parties later stipulated that plaintiff had exhausted his administrative remedies, \*655 the appeal committee decision had been accepted by all relevant hospital authorities, and all proceedings following the appeal committee hearings were fair and provided adequate due process.

The hospital's answer to plaintiff's petition denied the allegations of unfairness in any of the proceedings and admitted only that the appeal committee members were "sometimes present" at the January 24 executive committee meeting.

A hearing was held in superior court on April 13, 1978. Counsel for plaintiff argued that the evidence was insufficient to support suspension of obstetrical privileges, and that due process had been violated in the hospital proceedings. On the other hand, counsel for the hospital argued that the record would support an independent judgment that the privileges were properly suspended and plaintiff's rights to fair procedure had been protected at all stages of the proceedings.

On August 24, 1978, the court issued a memorandum decision in which it concluded: (1) independent review of the record showed the main areas of contention about plaintiff's obstetrical procedures revolved around professional differences, (2) the guidelines under which plaintiff made the questioned decisions defined very broadly the complications requiring consultations, (3) due process was initially violated by the presence of Dr. Furman on the ad hoc committee, and (4) further due process violations occurred when appeal committee members heard disparaging comments about plaintiff. The court also found the testimony at the ad hoc and appeal committee proceedings did not establish malpractice by plaintiff but did demonstrate that he was not capable of dealing with all the complications of delivery, had difficulty obtaining proper consultations and failed to keep adequate records of treatment and consultation. The court speculated that the lack of complete records resulted in some of the ad hoc committee's adverse findings and that petitioner would voluntarily further his education through continued training.

The hospital requested findings of fact and conclusions of law which it later contested at a hearing on October 23, 1978. Judgment for plaintiff was entered on October 24, 1978, and the final findings were filed November 17, 1978. The findings of fact reflected the opinions of the court given in the memorandum decision. The court reached three legal conclusions: (1) Dr. Furman's role in the ad hoc committee proceedings \*656 violated due process of law, (2) due process was again violated when appeal committee members heard disparaging comments about plaintiff at the executive committee meeting, and (3) independent review of the record



showed the evidence was insufficient to support the hospital's action.

The hospital then moved for a new trial, contending the proceedings met applicable standards of due process, the use of plaintiff's declaration to support the factual finding that prejudicial derogatory remarks were made was improper, and the evidence was insufficient to support the court's conclusion. A 1978 amendment of the [Code of Civil Procedure section 1094.5](#), subdivision (d) to provide for a substantial evidence standard of review for claims of abuse of discretion by private hospital boards was called to the court's attention by a letter from the hospital on January 17, 1979, after the new trial motion was heard and submitted.

The new trial motion was denied on January 26, 1979. The court concluded the statute was not retroactive and had no effect in the present case. It also noted that it considered Dr. Furman's participation in the initiation, investigation and initial adjudication of the charges against plaintiff a violation of minimal guarantees of due process. The hospital then appealed.

## II

### A. Fairness Lacking in Hospital Procedure

We first consider the trial court's conclusion that the hospital proceedings were impermissibly tainted by the role of plaintiff's accuser, Dr. Furman, in the adjudicatory process. The issue appears to be a novel one in this setting. ([1])Although California courts have long recognized a common law right to fair procedure protecting individuals from arbitrary exclusion or expulsion from private organizations which control important economic interests ([James v. Marinship Corp.](#) (1944) 25 Cal.2d 721 [155 P.2d 329, 160 A.L.R. 900]; [Pinsker v. Pacific Coast Society of Orthodontists](#) (1974) 12 Cal.3d 541 [116 Cal.Rptr. 245, 526 P.2d 253]; [Westlake Community Hosp. v. Superior Court](#) (1976) 17 Cal.3d 465 [131 Cal.Rptr. 90, 551 P.2d 410]), review of private hospital staff decisions has only recently been accomplished via administrative mandamus proceedings. ([Anton v. San Antonio Community Hosp.](#) (1977) 19 Cal.3d 802 [140 Cal.Rptr. 442, 567 P.2d 1162].) \*657 Since the actions of a private institution are not necessarily those of the state, the controlling concept in such cases is fair procedure and not due process. Fair procedure rights apply when the organization involved is one affected with a public interest, such as a private hospital. (See Sloss & Becker, *The Organization Affected With A Public Interest*

*and Its Members-Justice Tobriner's Contribution to Evolving Common Law Doctrine* (1977) 29 Hastings L.J. 99.)

The distinction between fair procedure and due process rights appears to be one of origin and not of the extent of protection afforded an individual; the essence of both rights is fairness. Adequate notice of charges and a reasonable opportunity to respond are basic to both sets of rights. ([Ezekial v. Winkley](#) (1977) 20 Cal.3d 267 [142 Cal.Rptr. 418, 572 P.2d 32]; [People v. Ramirez](#) (1979) 25 Cal.3d 260 [158 Cal.Rptr. 316, 599 P.2d 622].)

Specific requirements for procedural due process vary depending upon the situation under consideration and the interests involved. ([People v. Ramirez](#), *supra.*, at p. 264; [Mathews v. Eldridge](#) (1976) 424 U.S. 319, 335 [47 L.Ed.2d 18, 33, 96 S.Ct. 893].) Where due process requires an administrative hearing, an individual has the right to a tribunal "which meets at least currently prevailing standards of impartiality." ([Wong Yang Sung v. McGrath](#) (1950) 339 U.S. 33, 50 [94 L.Ed. 616, 628, 70 S.Ct. 445].) Biased decision makers are constitutionally impermissible and even the probability of unfairness is to be avoided. ([Withrow v. Larkin](#) (1975) 421 U.S. 35, 47 [43 L.Ed.2d 712, 723, 95 S.Ct. 1456]; [In re Murchison](#) (1955) 349 U.S. 133, 136 [99 L.Ed. 942, 946, 75 S.Ct. 623].) The factor most often considered destructive of administrative board impartiality is bias arising from pecuniary interests of board members. (See [American Motors Sales Corp. v. New Motor Vehicle Bd.](#) (1977) 69 Cal.App.3d 983 [138 Cal.Rptr. 594], and cases cited therein.) Personal embroilment in the dispute will also void the administrative decision ([Mennig v. City Council](#) (1978) 86 Cal.App.3d 341 [150 Cal.Rptr. 207]), although neither prior knowledge of the factual background which bears on a decision nor prehearing expressions of opinions on the result disqualifies an administrative body from acting on a matter before it. ([City of Fairfield v. Superior Court](#) (1975) 14 Cal.3d 768, 782 [122 Cal.Rptr. 543, 537 P.2d 375].)

Due process questions are raised when the administrative agency's initial view of the facts based on evidence derived from nonadversarial \*658 processes as a practical or legal matter forecloses fair and effective consideration of the merits at an adversary hearing leading to the ultimate decision. ([Withrow v. Larkin](#), *supra.*, 421 U.S. at p. 58 [43 L.Ed.2d at p. 730].) This is exactly the claim that plaintiff made to the trial court and the basis for the judgment below. We see no impediment to an analysis of the situation using the precedents established under the due process concept. Our

Supreme Court has declined to fix rigid procedures for the protection of fair procedure rights (*Ezekial v. Winkley, supra.*, 20 Cal.3d at p. 278), but it is inconceivable to us that such rights would not include impartiality of the adjudicators.

Before proceeding along these lines, however, we pause to note another apparently unique feature of this case. The hospital's action did not completely eliminate plaintiff's staff privileges or remove him from staff membership. There is no indication in the record that his use of hospital facilities other than those in the obstetrical department was affected by the investigation and adjudication. Since plaintiff testified that about 40 percent of his income was derived from his obstetrical practice, his interest in obstetrical privileges was substantial and we do not find that a partial exclusion of this magnitude merits any less procedural protection than revocation of full staff membership. Neither party argues otherwise.

Plaintiff's position before the trial court is a familiar one in the context of administrative law. Without using the term, he contended the ad hoc committee proceedings constituted an impermissible combination of investigatory, prosecutorial and adjudicatory functions in that body.

The combination of functions argument often arises in the context of professional licensing revocation cases when an administrative board adjudicates competence issues after its agents have instigated and investigated charges against a licensee. Since the situation before us is in many ways analogous to a license revocation, we will examine the precedents in that area. The federal position on the issue is that due process is not violated by the combination of investigative and adjudicative functions unless the facts of a case show foreclosure of fairness as a practical or legal matter. (*Withrow v. Larkin, supra.*, 421 U.S. 35.) Most states, including California, have taken the same approach to combination of functions argument. (See Davis, *Case Commentary: Withrow v. Larkin and the "Separation of Functions" Concept in State Administrative Proceedings* (1975) 27 Admin.L.Rev. 407; \*659 *Winning v. Board of Dental Examiners* (1931) 114 Cal.App. 658 [300 P. 866]; *Griggs v. Board of Trustees* (1964) 61 Cal.2d 93 [37 Cal.Rptr. 194, 389 P.2d 722]. But see *Abrams v. Jones* (1922) 35 Idaho 532 [207 P. 724]; *State v. Kelly* (1960) 145 W.Va. 70 [112 S.E.2d 641].)

California law requires that disciplinary hearings of designated state agencies be conducted by administrative law

judges from the state Office of Administrative Hearings. (Gov. Code, § 11502.) The administrative law judge prepares and submits a proposed decision for the agency's consideration. (Gov. Code, § 11517, subd. (c).) Although the agency need not adopt the decision, it is required to review the record of the hearing before arriving at a different conclusion. (*Ibid.*) These statutory requirements reflect legislative concern with due process and fair hearings in administrative proceedings. (Clarkson, *Practice Before California Licensing Agencies* (1956) 44 Cal.L.Rev. 197.) Legislation in at least two other states (Maine and Missouri) goes further and makes the findings of hearing officers binding on the agency unless the agency succeeds in a later court proceeding. (See Sandberg et al., *Fair Treatment For the Licensed Professional: The Missouri Administrative Hearing Commission* (1972) 37 Mo.L.Rev. 410; Sawyer, *The Quest For Justice In Maine Administrative Procedure: The Administrative Code in Application and Theory* (1966) 18 Me.L.Rev. 218.)

In the case before us, of course, there was no administrative law judge or other third party involved in the factual determinations which resulted in revocation of plaintiff's obstetrical privileges. The investigation was not conducted by state employees insulated from the adjudicatory body by layers of public bureaucracy; it was done by a group which included the instigator of the charges, had overlapping membership in the body (executive committee) which reviewed both the initial and final decisions and to which the majority of the formal adjudicators later belonged. ([2])The question before us is whether this situation, completely apart from any question of actual bias on the part of any of the physicians involved and from the merits of the charges, presents a violation of fair procedure rights to an impartial tribunal by virtue of a practical probability of unfairness. We hold that it does.

As a practical matter and without in any way impugning their good faith, the general practitioner and pediatric specialist members of the ad hoc committee were in an extremely difficult position. The charges were brought by one of the two specialists on whom they were accustomed \*660 and, indeed, required to rely for obstetrical expertise and with whom they were in frequent and intimate professional contact. His associate supported the charges and the committee was thus presented with a solid front of the only special expertise available to it. To presume impartiality of the ad hoc committee in such circumstances goes beyond what can reasonably be expected of human beings in this

professional setting. In this situation a realistic appraisal of psychological tendencies and human weakness compels the conclusion that the risk of prejudgment or bias was too high to maintain the guarantee of fair procedure. (See *Withrow v. Larkin, supra.*, 421 U.S. 35.)

We recognize that the ad hoc committee's function under the hospital bylaws was nominally investigatory, not adjudicative. Nevertheless, the chances of a contradictory conclusion by another body within the hospital were virtually nil. The bylaws mandated review of the ad hoc committee's decision by the executive committee, an apparently twelve-member body upon which five members of the ad hoc committee sat. Having made an adverse decision, the five could hardly be expected not to support it before the executive committee. The appeal committee, later also connected to the executive committee, was composed of doctors from other departments within the hospital. Although the appeal committee did hear testimony from an obstetrical specialist in plaintiff's defense, half of the hospital's obstetrics department and another specialist testified adversely. To some extent, at least, the same psychological factors which impugned the impartiality of the ad hoc committee were at work on the appeal committee members. At the very least, they would be tempted to consider extraneous matters, such as the personal collegial preferences of the obstetrics department members, in addition to the merits of the charges. We paraphrase Justice Taft's remarks in *Tumey v. Ohio* (1927) 273 U.S. 510, 532 [71 L.Ed. 749, 758, 47 S.Ct. 437, 50 A.L.R. 1243]: Every procedure which would offer a possible temptation to the average man as a judge which might lead him not to hold the balance nice, clear and true between the accused and accuser denies the former due process of law. The procedure at issue

here, given the circumstances in which it was accomplished, violated this standard of fairness. The fatal flaw in the proceedings before us was the lack of impartiality in the fact-finding process.

#### **B. Trial Court Reinstatement Order Proper**

([3]) Since we affirm the judgment on the basis of fair procedure defects in the administrative process, we need address only one more of \*661 the hospital's arguments. The hospital claims the order of reinstatement somehow usurped its discretion to determine whether plaintiff should retain his obstetrical privileges and a proper order would have been a remand for additional proceedings. There is no merit in this contention; fair hearings are not a matter of discretion but are required by law. Reinstatement pending a proper administrative hearing does not preclude exercise of the hospital's legally vested discretion to exclude from its facilities physicians it properly concludes do not meet its standards. ( *Hackethal v. Loma Linda Community Hospital Corp.* (1979) 91 Cal.App.3d 59, 67 [153 Cal.Rptr. 783].) The trial court properly restored the status quo.

The judgment is affirmed.

Evans, Acting P. J., and Blease, J., concurred.

A petition for a rehearing was denied May 15, 1980, and the opinion was modified to read as printed above. Appellant's petition for a hearing by the Supreme Court was denied June 25, 1980. Richardson, J., was of the opinion that the petition should be granted.



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**Distinguished by** [Maheshwari v. Vista Hosp. Systems, Inc.](#), Cal.App. 4 Dist., September 9, 2003

176 Cal.App.3d 1118, 224 Cal.Rptr. 352

EDWARD S. SALKIN, Plaintiff and Appellant,  
v.  
CALIFORNIA DENTAL ASSOCIATION  
et al., Defendants and Respondents.

No. G001275.

Court of Appeal, Fourth District, Division 3, California.  
Jan 24, 1986.

### SUMMARY

In an action by an orthodontist who was publicly censured by two related private professional organizations of dentists to which he belonged, seeking to overturn the censure and to require a new hearing of the charges against him on the ground he had been denied due process, the trial court denied the petition for mandamus, ruling that judicial review of disciplinary procedures of private professional organizations is, as a matter of law, only available when the punishment is expulsion or exclusion from membership. (Superior Court of Orange County, No. 388316, Judith M. Ryan, Judge.)

The Court of Appeal reversed with directions to overrule defendants' demurrer and undertake further proceedings, holding that a private organization if tinged with public stature or purpose may not expel or discipline a member adversely affecting substantial property, contract or other economic rights, except as a result of fair proceedings. It held plaintiff's petition was sufficient to put the above elements in issue and that he sought the appropriate remedy. (Opinion by Crosby, J., with Trotter, P. J., and Wallin, J., concurring.)

### HEADNOTES

#### Classified to California Digest of Official Reports

(1)  
Constitutional Law § 107--Procedural Due Process--Components--Quasi-public Organizations.  
In the context of disciplinary action by quasi-public organizations against their members, procedural due process requires adequate notice of charges and a reasonable

opportunity to respond, an opportunity to confront and cross-examine the accusers and to examine and refute the evidence, and the opportunity to present a defense.

(2)  
Associations and Clubs § 6--Unincorporated--Actions--Dental Societies--Censure of Member--Judicial Review.  
In an action by an orthodontist who was publicly censured by two related private professional organizations of dentists to which he belonged, seeking to overturn the censure and to require a new hearing of the charges against him on the ground he had been denied due process, the trial court erred in denying the petition and ruling that judicial review of disciplinary procedures by private professional organizations is, as a matter of law, only available when the punishment is expulsion or exclusion from membership. A private organization, if tinged with public stature or purpose, may not expel or discipline a member adversely affecting substantial property, contract or other economic rights, except as a result of fair proceedings which may be provided for in organization by-laws, carried forward in an atmosphere of good faith and fair play.

[See [Cal.Jur.3d, Associations and Clubs, § 20](#); [Am.Jur.2d, Associations and Clubs, § 37](#).]

#### COUNSEL

Joe A. Dickerson for Plaintiff and Appellant.  
Pepper, Hamilton & Scheetz, Jesse D. Miller, Peter H. Mason, James A. Howell, Peterson, Ross, Schloerb & Seidel, Peter M. Sfikas and John W. Heinemann for Defendants and Respondents.

#### CROSBY, J.

May a petition in mandate alleging a member of a private professional association was denied procedural due process in a disciplinary proceeding state a cognizable cause of action where the punishment imposed is less than expulsion? *Yes*.

#### I

Orthodontist Edward S. Salkin was publicly censured by two related private professional organizations of dentists of which he is a member, the California and American Dental Associations. His petition, alleging he was denied due process in violation of the bylaws and suffered damage to his dental practice and professional reputation as a result, sought to overturn \*1120 the censure and to require a new hearing of the charges against him. Both organizations demurred. They

argued, and the superior court agreed, judicial review of the disciplinary procedures of private professional organizations is, as a matter of law, only available where the punishment imposed is expulsion or exclusion from membership.

The California Dental Association is a constituent organization of the American Dental Association, and Salkin belongs to both. Each organization is voluntary; and membership is not required in order to practice dentistry or any dental specialty in this state, although Salkin's last amended petition alleges CDA "exercises a degree of control and discipline over all licensed dentists of California." (But see *Bus. & Prof. Code*, § 1611, which subjects dentists to licensing and regulation by the State Board of Dental Examiners.) CDA's disciplinary authority over its members is delineated in the ADA bylaws. Salkin pleads, "Respondent has a clear and present duty to deal fairly and equitably with all of its members in all of its functions, and specifically has those obligations as it affects its members' rights to fair hearings, appeals and disciplinary proceedings under its by-laws."

The petition goes on to allege Salkin was informed by CDA on September 3, 1982, he would be expelled unless he returned \$1,675 in fees collected from the parents of two juvenile patients. The discipline was based on an August 17, 1978 recommendation of the peer review committee of its member organization, the Orange County Dental Association. It read in part as follows: "The orthodontic specialty Peer Review Committee of the California State Society of Orthodontists was called upon to evaluate the patients and the records. They reviewed the diagnostic records taken prior to treatment, and those taken at the time of transfer. The patients were also examined clinically. ¶ Their findings showed that there had been no progress in correcting James' malocclusion during the year of treatment, and that Jill's malocclusion had worsened during the eight months she was under orthodontic care. They felt the original treatment plans were in error and the mechanotherapy used could not produce an improvement in either esthetics or occlusion."

Salkin was advised he could appeal the decision based on the sufficiency of the evidence or any defects in the procedure followed by the local committee. His attorney then requested the right to review the evidence offered at the hearing, which neither he nor his client was permitted to attend, and any transcript or record of the proceedings. CDA declined: "In [an] effort to provide further clarification for you on CDA's position with regard to this and similar requests, [Section](#)

[1157 of the California Evidence Code](#) is cited. Specifically it states ... 'neither the proceedings nor the records of ... dental review committees ... shall be subject to discovery.'" \*1121

Salkin next appealed to the ADA. On June 2, 1983, the Council on Bylaws and Judicial Affairs of the ADA reduced the proposed penalty from expulsion to censure and issued a six-page opinion, which is attached as an exhibit to the petition. The opinion, in so many words, appears to concede Salkin's case was not handled fairly or in accordance with the bylaws. Excerpts appear in the margin.<sup>1</sup>

1 "The Council is troubled ... by ... the inadequacies of the hearing before the peer review committee. The Appellant appeared in person, with counsel, before this Council and again commented upon the extremely brief hearing which he was afforded by the OCDS peer review committee. The Appellant stated that he had elected a conservative course of treatment because he was concerned about the level of the patient's cooperation. He therefore elected to commence treatment without any tooth removal. However, affording the Appellant less than five minutes to state his case did not give an opportunity to adequately present this position. Nor did the time granted afford an opportunity for the peer review panel to confront the Appellant with the [California State Society of Orthodontics] advisory opinion and permit him to confront the issues it raised. The confusion as to the amount in question to be refunded is an indication that the limited time afforded the Appellant did not allow a full examination of all the facts and issues involved. ¶ It is especially notable that at the time the limited hearing was afforded to the Appellant, the OCDS peer review committee had already reached a prior determination adverse to the Appellant in a prior proceeding. The hearing was afforded only after the Appellant on appeal had asserted the validity [*sic*] of the proceedings because of his denial of a hearing. Under such circumstances, it would appear incumbent upon the OCDS to afford the Appellant ample time to state his position. The Council sees nothing in the *California Evidence Code* [provision] in question [[section 1157](#)] which would have prevented the OCDS peer review committee from discussing various aspects of the specialist's committee opinion with the Appellant so the Appellant could be apprised of the facts which the committee was considering. This would have afforded the Appellant an opportunity to meet the issues. This was not done. ¶ The preface of the *Peer Review Procedure Manual* of the Council on Dental Care Programs of the American Dental Association provides 'It is not only essential that justice be done; it must be perceived to

have been done.' This admonition does not appear to have been followed in this case. The Council notes that in the majority of the constituent dental societies, peer review is a voluntary proceeding. California [*sic*], however, by Section 3 of its *Code of Ethics*, requiring compliance with the mandates of peer review committees as a matter of professional ethics, renders cooperation with peer review committees mandatory. In doing such, it is incumbent upon the California Dental Association to assure that due process is provided to the participants in such proceedings. Cf. *Hackethal v. California Medical [Assn.]* (1982) 138 Cal.App.3d 435] (outlining principles of fair procedures for disciplinary hearings) ... [¶] The Council believes that the penalty of expulsion is too harsh to impose .... In view of the age of this case, a remand would not serve the interests of either party. Therefore, the Council affirms the decision of the CDA Judicial Council, but believes that justice requires reducing the penalty imposed from expulsion to censure.”

## II

(1) If the discipline imposed had amounted to expulsion or exclusion from membership, the associations concede Salkin would have been entitled to procedural due process as that concept has been defined in our law: “Adequate notice of charges and a reasonable opportunity to respond are basic to both due process and fair procedure. ( *Applebaum v. Board of Directors* [1980] 104 Cal.App.3d [648,] 657 [163 Cal.Rptr. 831].) ... [¶] \*1122 There must be an opportunity to confront and cross-examine the accusers and to examine and refute the evidence. ( *Cason v. Glass Bottle Blowers Assn.* (1951) 37 Cal.2d 134, 144 [231 P.2d 6, 21 A.L.R.2d 1387].) ” [¶] The individual must have the opportunity to present a defense. ( *Pinsker v. Pacific Coast Society of Orthodontists* [1974] 12 Cal.3d [541,] 555 [116 Cal.Rptr. 245, 526 P.2d 253].)“ ( *Hackethal v. California Medical Assn.* (1982) 138 Cal.App.3d 435, 442 [187 Cal.Rptr. 811].)

(2) Nonetheless, the associations claim the reduction of the discipline imposed from expulsion to censure eliminates Salkin's right to petition for relief. There is some backhanded support for that notion. For example, the *Hackethal* case, cited by the ADA Council itself, does view the problem of judicial interference with the membership relations of private associations in that context (which is not surprising since only expulsion was involved there): “Fair procedure is a developing concept in California. It is applicable when an organization makes a decision to exclude or expel an individual. It is a common law principle under which a private organization is legally required to refrain from arbitrary action. The action to exclude or expel must be substantively

rational and procedurally fair.“ ( *Id.*, at p. 441.) Although discipline short of expulsion was not at issue there, defendants insist the import of *Hackethal* is that judicial review of professional disciplinary proceedings is precluded where a lesser sanction is imposed. We decline to endorse the inference, however: It is supported neither in logic nor, as we shall see, law.

Defendants' reliance on *Pinsker v. Pacific Coast Society of Orthodontists* (1974) 12 Cal.3d 541 [116 Cal.Rptr. 245, 526 P.2d 253] is also misplaced. *Pinsker* is an exclusion case. The Society of Orthodontists argued against judicial scrutiny of a decision to exclude an individual from membership based on the significant difference between exclusion of a nonmember and expulsion of a member. There is no doubt that the membership contract, particularly as evidenced in the bylaws, is an important justification offered for judicial intervention in many of the cases. (See, e.g., *Bernstein v. Alameda etc. Med. Assn.* (1956) 139 Cal.App.2d 241, 253 [293 P.2d 862].) Thus, to the extent judicial intervention might be justified on contract principles and an organization's duty to its members, the society's position was reasonable enough. Nevertheless, the Supreme Court rejected the contention and extended procedural due process protections to excluded nonmembers of professional organizations. This holding hardly seems helpful to the present defendants.

Moreover, dictum in *Pinsker* is not supportive of the conclusion urged by the associations; for at one point in its opinion the court approves judicial intervention in cases involving discipline less than expulsion: “In this state \*1123 “a member of an unincorporated association may not be suspended or expelled ... without charges, notice and a hearing, even though the rules of the association make no provision therefor.” ( *Swital v. Real Estate Commissioner* [1953] 116 Cal.App.2d 677, 679 [254 P.2d 587]; *Cason v. Glass Bottle Blowers Assn.*, *supra.*, 37 Cal.2d 134, 143-144.) This requirement of procedural fairness has been an established part of the California common law since before the turn of the century. (See, e.g., *Von Arx v. San Francisco G. Verein* [1896] 113 Cal. 377 [45 P. 685]; *Otto v. Tailors P. & B. Union* [1896] 75 Cal. 308, 314-315 [17 P. 217].) “ (*Id.*, at p. 553, italics added.)

Defendants have produced exactly no case authority directly supporting their claim that judicial enforcement of procedural due process in disciplinary proceedings of private professional organizations will be reserved to expulsion or exclusion cases. But our research has yielded several cases

in which the courts have squarely held, in accordance with the *Pinsker* dictum, that suspension cases will be afforded the same scrutiny accorded those involving expulsion. In *Ellis v. American Federation of Labor* (1941) 48 Cal.App.2d 440 [120 P.2d 79], a prehearing suspension of three unincorporated labor unions from the national association was overturned in these words: "It is settled however in this state and elsewhere that a member of an unincorporated association may not be suspended or expelled, nor a subordinate body suspended or its charter revoked, without charges, notice and a hearing, even though the rules of the association make no provision therefor." ( *Id.*, at pp. 443-444.)

And the notion was not new in *Ellis*. *Grand Grove A. O. of D. v. Duchein* (1894) 105 Cal. 219<sup>2</sup> [38 P. 947] and *Knights of Ku Klux Klan v. Francis* (1926) 79 Cal.App. 383 [249 P. 539] reached the same conclusion years earlier: "It is well settled that a member of a benevolent association cannot be expelled without being given a hearing, and that a by-law which authorizes such a course is unreasonable and without effect [citations]; and the same rules are applicable whether the action of the body is an absolute severing of the relations or a suspension by which the rights of the suspended party are destroyed or impaired. There is no distinction in principle between expelling a member from a subordinate [organization] and revoking the charter of the [member] itself or suspending its charter." ( *Grand Grove A. O. of D. v. Duchein*, *supra.*, at p. 225.)

<sup>2</sup> The full title of the case is worth remembering every century or so: *The Grand Grove of the United Ancient Order of Druids of California v. The Garibaldi Grove, No. 71, of the United Ancient Order of Druids and C. Duchein*.

Nor is the concept that the courts *will* interfere in appropriate cases where the discipline falls short of expulsion outdated. In \*1124 *California State University, Hayward v. National Collegiate Athletic Assn.* (1975) 47 Cal.App.3d 533 [121 Cal.Rptr. 85], the Court of Appeal held an NCAA suspension of a college football team from postseason play for alleged violations of eligibility rules was subject to judicial review. The court observed, "Defendant NCAA contends that the trial court erred in failing to follow the doctrine of judicial abstention from interference in the affairs of a private voluntary association. However, courts will intervene in the internal affairs of associations where the action by the association is in violation of its own bylaws or constitution. It is true that courts will not interfere with the disciplining or

expelling of members of such associations where the action is taken in good faith and in accordance with its adopted laws and rules. But *if the decision of the tribunal is contrary to its laws or rules, or it is not authorized by the by-laws of the association, a court may review the ruling of the board and direct the reinstatement of the member.*' [Citations.]" ( *Id.*, at p. 539.) Thus, according to the *Hayward* court, "disciplining" is sufficient to invoke judicial protection of due process rights.

Courts in other jurisdictions have agreed. For example, in *Gashgai v. Maine Medical Association* (Me. 1976) 350 A.2d 571, which relies in part on the *Hayward* decision, a doctor sought and obtained an injunction to prevent circulation by a private voluntary medical association of an investigative report concerning his billing practices. The report recommended plaintiff be "severely reprimanded." ( *Id.*, at p. 573.) The Supreme Judicial Court of Maine upheld the injunction because the document "imminently threatened ... injury which was irreparable because it tended to impair Dr. Gashgai's opportunity to earn a livelihood through the practice of his chosen profession and, therefore, required the injunctive relief ordered." ( *Id.*, at p. 574.) Public censure, the discipline imposed in this case, is virtually identical in its nature and possible consequences.

The Supreme Court of Florida reached a similar conclusion in *McCune v. Wilson* (Fla. 1970) 237 So.2d 169. In approving an injunction against a disciplinary proceeding involving a member of the South Florida chapter of the American Institute of Real Estate Appraisers, the court explained its departure from the usual rule of judicial abstention in cases involving the dealings of private associations: "Professional organizations, although voluntary in nature, often attain a quasi-public significance. In public view, membership in such organizations may appear to be a tangible demonstration of professional competence and skill, professional responsibility, and acceptance by one's professional peers. The fact that an individual member expelled from membership may not be prohibited from practicing his chosen occupation or profession is not a sufficient test to determine whether he needs and is entitled to judicial protection from unfair proceedings or arbitrary \*1125 actions. When a voluntary association achieves this quasi-public status, due process considerations come into play ..." ( *Id.*, at p. 172.)

Here, both defendant associations are of "quasi-public significance." Even if they were not, however, the discipline



imposed was *public* censure; and the associations could be seen to have created their own exception.

Nor, as we have previously concluded above, is expulsion required as a prerequisite to judicial intervention: "Disciplinary action against a member of a professional organization, although falling short of expulsion from occupation, may have an import which transcends the organization itself because it conveys to the community that the disciplined member was found lacking by his peers. For this reason, it is suitable and proper that an organization, whether a domestic or foreign nonprofit corporation, or a nonchartered nonprofit association, be held to reasonable standards of due process and fairness, especially those inherent in its own by-laws, rules or customs." (*Ibid.*)

Then, in words which could have been written for this case, the court adds, " While the courts should be [loath] to intervene in purely private organizational matters, nonintervention is not justified where a quasi-public organization takes action and imposes penalties which carry the odor of public sanctions. It is clear that not all private associations must observe due process standards. However, such standards must be observed when a private association becomes quasi-public, assumes a public purpose of its own, incorporates and seeks the tax shelters and other protections of public law, or otherwise assumes a larger

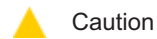
purpose or stature than pleasant, friendly and congenial social relationships." (*Ibid.*)

For the guidance of the court in the further disposition of this case on remand, we adopt these final words of the Florida Supreme Court: "We hold that a private organization, ... if tinged with public stature or purpose, may not expel or discipline a member adversely affecting substantial property, contract or other economic rights, except as a result of fair proceedings which may be provided for in organization by-laws, carried forward in an atmosphere of good faith and fair play." (*Id.*, at p. 173.) Salkin's petition was sufficient to put each of the above elements in issue; and he did seek the appropriate remedy, a writ of mandate. (*Westlake Community Hosp. v. Superior Court* (1976) 17 Cal.3d 465, 482-485 [131 Cal.Rptr. 90, 551 P.2d 410].) \*1126

The judgment is reversed with directions to overrule the demurrer and proceed in accordance with the views expressed above. Salkin is entitled to costs on appeal.

Trotter, P. J., and Wallin, J., concurred.

A petition for a rehearing was denied February 19, 1986, and the petition of respondent California Dental Association for review by the Supreme Court was denied May 1, 1986. \*1127



Caution

As of: October 9, 2015 1:01 PM EDT

## *Pinsker v. Pac. Coast Soc. of Orthodontists*

Supreme Court of California

September 20, 1974

L.A. No. 30228

### Reporter

12 Cal. 3d 541; 526 P.2d 253; 116 Cal. Rptr. 245; 1974 Cal. LEXIS 243

LEON J. PINSKER, Plaintiff and Appellant, v. PACIFIC COAST SOCIETY OF ORTHODONTISTS et al., Defendants and Respondents

**Prior History:** Superior Court of Los Angeles County, No. So C 3876, John F. McCarthy, Judge.

**Disposition:** The judgment is reversed and the case is remanded to the trial court with instructions to issue an injunction compelling defendant associations to set aside the rejection of plaintiff's application and to reconsider such application pursuant to a fair procedure as provided herein.

### Core Terms

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membership, societies, associations, orthodontist, orthodontics, patients, organizations, fair procedure, requirements, courts, defendants', decisions, proceedings, expulsion, dentist, application for membership, delegating, membership application, common law principle, judicial review, due process, trial court, common law, non-delegation, qualifications, personnel, charges, sharing, cases, procedural fairness

### Case Summary

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#### Procedural Posture

Plaintiff, a licensed dentist, sought review of a judgment from the Superior Court of Los Angeles County (California), which upheld defendant orthodontist societies' rejection of plaintiff's application for membership. The judgment was premised on a holding that defendants were not required to afford plaintiff an opportunity to respond to the rejection.

#### Overview

Plaintiff, a licensed dentist, sought review of a judgment that upheld defendant orthodontist societies' rejection

of plaintiff's application for membership under their rules. The superior court had accepted defendants' interpretation of their own rules and determined that defendants were not required to afford plaintiff an opportunity to respond to the rejection. On appeal, the court held that in light of defendants' important public role, they could not reject plaintiff's membership application without affording him a fair opportunity to respond to the charges against him, and because of the unique position in the field of orthodontics occupied by defendants, they had a fiduciary responsibility with respect to the acceptance or rejection of membership applications. Accordingly, the judgment was reversed, and the case was remanded with instructions to issue an injunction compelling defendants to reconsider plaintiff's application in a fair proceeding.

#### Outcome

The court reversed the superior court judgment because defendants' unique position in the field of orthodontics created a fiduciary responsibility with respect to the acceptance or rejection of membership applications, such that defendants could not reject plaintiff's application without affording him a fair opportunity to challenge his rejection.

### LexisNexis® Headnotes

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Business & Corporate Law > Unincorporated Associations

Constitutional Law > ... > Fundamental Rights > Procedural Due Process > Scope of Protection

**HN1** An organization's decision to exclude or expel an individual may be "arbitrary" either because the reason for the exclusion or expulsion is itself irrational or because, in applying a given rule in a particular case, a society has proceeded in an unfair manner.

Business & Corporate Law > Unincorporated Associations

12 Cal. 3d 541, \*541; 526 P.2d 253, \*\*253; 116 Cal. Rptr. 245, \*\*\*245

Constitutional Law > ... > Fundamental Rights > Procedural Due Process > Scope of Protection

**HN2** The proscription of "arbitrary" rejections of applicants to private societies, prohibits rejection pursuant to an unfair procedure as well as rejection based on an improper reason.

Business & Corporate Law > Unincorporated Associations

Constitutional Law > ... > Fundamental Rights > Procedural Due Process > Scope of Protection

**HN3** Where an organization occupies a special position in a professional field, an applicant for membership has a judicially enforceable right to have his application considered in a manner comporting with the fundamentals of due process, including the showing of cause for rejection.

Business & Corporate Law > Unincorporated Associations

Constitutional Law > ... > Fundamental Rights > Procedural Due Process > Scope of Protection

**HN4** An organization's decision to expel or exclude an individual may be arbitrary either because the reason underlying the rejection is irrational or because the organization has proceeded in an unfair manner. Taken together, these decisions establish the common law principle that whenever a private association is legally required to refrain from arbitrary action, the association's action must be both substantively rational and procedurally fair.

Business & Corporate Law > Unincorporated Associations

Constitutional Law > ... > Fundamental Rights > Procedural Due Process > Scope of Protection

**HN5** A California court will provide relief to any individual expelled from a private association who can demonstrate (1) that the society's rule or proceedings were contrary to "natural justice," (2) that the society had not followed its own procedures or (3) that the expulsion was maliciously motivated.

Business & Corporate Law > Unincorporated Associations

Constitutional Law > ... > Fundamental Rights > Procedural Due Process > Scope of Protection

**HN6** The holders of the monopoly must not exercise their power in an arbitrary, unreasonable manner so as to bring injury to others.

Business & Corporate Law > Unincorporated Associations

Constitutional Law > ... > Fundamental Rights > Procedural Due Process > Scope of Protection

Constitutional Law > Substantive Due Process > Scope

**HN7** Once it is determined that judicial scrutiny of a particular decision is justified to protect against arbitrary action, such overview includes an evaluation of both the substantive and procedural aspects of an association's decision.

Business & Corporate Law > Unincorporated Associations

Constitutional Law > ... > Fundamental Rights > Procedural Due Process > Scope of Protection

**HN8** In situations involving the expulsion of members from a society, procedural fairness is an indispensable prerequisite. In California, a member of an unincorporated association may not be suspended or expelled without charges, notice and a hearing, even though the rules of the association make no provision therefor.

Business & Corporate Law > Unincorporated Associations

Constitutional Law > ... > Fundamental Rights > Procedural Due Process > Scope of Protection

**HN9** An expulsion from an association cannot properly rest upon a rule which is substantively capricious or contrary to public policy.

Business & Corporate Law > Unincorporated Associations

Constitutional Law > ... > Fundamental Rights > Procedural Due Process > Scope of Protection

Governments > Fiduciaries

**HN10** A court will uphold judicial review if denial of membership in an association would effectively impair an applicant's right to fully practice his profession.

Business & Corporate Law > Unincorporated Associations

Constitutional Law > ... > Fundamental Rights > Procedural Due Process > Scope of Protection

**HN11** An applicant for membership in an organization has a judicially enforceable right to have his application considered in a manner comporting with the fundamentals of due process, including the showing of cause for rejection.

Business & Corporate Law > Unincorporated Associations

Constitutional Law > ... > Fundamental Rights > Procedural Due Process > Scope of Protection

**HN12** A "fair procedure" requires that before the denial of an application to a private society, an applicant be notified of the reason for the proposed rejection and given a fair opportunity to defend himself.

Constitutional Law > ... > Fundamental Rights > Procedural Due Process > Scope of Protection

**HN13** A basic ingredient of the "fair procedure" required under the common law is that an individual who will be adversely affected by a decision be afforded some meaningful opportunity to be heard in his defense.

Business & Corporate Law > Unincorporated Associations  
Constitutional Law > ... > Fundamental Rights > Procedural Due Process > Scope of Protection

**HN14** The common law requirement of a fair procedure does not compel formal proceedings with all the embellishments of a court trial, nor adherence to a single mode of process. It may be satisfied by any one of a variety of procedures which afford a fair opportunity for an applicant to present his position.

Business & Corporate Law > Unincorporated Associations

**HN15** An association itself should in the first instance pass on the merits of an individual's application rather than shift this burden to the courts.

Business & Corporate Law > Unincorporated Associations  
Constitutional Law > ... > Fundamental Rights > Procedural Due Process > Scope of Protection

**HN16** In adjudicating a challenge to a society's rule as arbitrary, a court properly exercises only a limited role of review. In making such an inquiry, a court must guard against unduly interfering with a society's autonomy by substituting judicial judgment for that of the society in an area where the competence of the court does not equal that of the society. If a society has refused membership through the application of a reasonable standard -- one which comports with the legitimate goals of the society and the rights of the individual and the public -- then judicial inquiry should end. Only when a society rule is contrary to established public policy, or is so patently arbitrary and unreasonable as to be beyond the pale of the law should a court prohibit its enforcement.

Business & Corporate Law > Unincorporated Associations

**HN17** In a private association context rules are often drawn by laymen and so long as a society provides an

adequate and timely explanation an applicant should not be permitted to dispute the society's official interpretation.

Business & Corporate Law > Unincorporated Associations

**HN18** One perfectly legitimate objective of professional associations is to attempt to elevate professional standards in order to attain quality medical and dental care.

## Headnotes/Syllabus

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### Summary

#### CALIFORNIA OFFICIAL REPORTS SUMMARY

An orthodontists' society denied a dentist's application for membership without giving him an opportunity to present his position with respect to the society's contention that he violated a society rule which, as interpreted by the society, prohibited delegation of orthodontic services to a dentist not educationally qualified for membership in the society. In the dentist's action challenging the denial, the trial court gave judgment against him. (Superior Court of Los Angeles County, No. C 3876, John F. McCarthy, Judge.)

The Supreme Court reversed and remanded the case to the trial court with instructions to issue an injunction compelling defendants to set aside the rejection of plaintiff's application and to reconsider the application pursuant to a fair procedure as provided in the reviewing court's opinion. The court rested its decision on the common law requirement of "fair procedure," after emphasizing the distinction between such requirement and technical "due process" requirements attributable to constitutional provisions. In a prior review, the Supreme Court had determined that the society is affected with a public interest and has a fiduciary responsibility with respect to the resolution of membership applications. Thus, it was held in the present review that the dentist's application was subject to the common law fair procedure requirement under which the applicant is to be notified of the reason for a proposed rejection and given a fair opportunity to defend himself. It was concluded that the rule precluding delegation is not arbitrary nor contrary to public policy and constitutes a permissible basis for rejection of an application for membership. But it was held that before rejecting plaintiff's application, defendants must give him an opportunity to refute the contention that he is



violating the rule. (Opinion by Tobriner, J., expressing the unanimous view of the court.)

### Headnotes

#### CALIFORNIA OFFICIAL REPORTS HEADNOTES

Classified to McKinney's Digest

#### CA(1) (1)

Associations § 1 > Unincorporated Associations > Fair Procedure Requirements.

-- Whenever a private association is required under common law principles of fair procedure to refrain from arbitrary action, its action must be both substantively rational and procedurally fair.

#### CA(2) (2)

Associations § 11 > Unincorporated Associations > Membership > Suspension or Expulsion.

-- A member of an unincorporated association may not be suspended or expelled without charges, notice and a hearing, even though the association's rules make no provision for such matters. Furthermore, an expulsion from such an association cannot properly rest on a rule which is substantively capricious or contrary to public policy.

#### CA(3) (3)

Associations § 7 > Unincorporated Associations > Membership.

-- Under common law principles, a fair procedure requires that before an application for membership in a society subject to the requirements of such procedure may be denied, the applicant must be notified of the reason for the proposed rejection and given a fair opportunity to defend himself.

#### CA(4) (4)

Associations § 7 > Unincorporated Associations > Membership > Fair Procedure.

-- A basic ingredient of the fair procedure required under common law is that an individual who will be adversely affected by a decision be afforded some meaningful opportunity to be heard in his defense. However, this fair procedure requirement does not compel formal proceedings with all the embellishments of a court trial nor adherence to a single mode of process. Thus, with respect to denial of an application for membership in an association subject to that requirement, it may be

satisfied by any one of a variety of procedures which afford the applicant an opportunity to present his position.

#### CA(5) (5)

Physicians § 7.6 > Orthodontists > Professional Organizations > Application for Membership.

-- Minimal common law standards of fair procedure were not met in denying a dentist's application for membership in an orthodontists' society which was subject to such standards without affording him an opportunity to present his position with respect to the society's contention that he violated its rule prohibiting an orthodontist from "delegating to a person less qualified any service or operation which requires the professional competence of an orthodontist," under its interpretation that the expression "person less qualified" included a licensed dentist without the requisite educational qualifications to be eligible for membership.

#### CA(6) (6)

Associations § 7 > Unincorporated Associations > Membership > Determination of Qualifications.

-- As a matter of policy, a private unincorporated association which is under a duty to satisfy the common law requirement of fair procedure in connection with denial of applications for membership should, itself, in the first instance, pass on the merits of an individual's application, rather than shift the burden to the courts.

#### CA(7) (7)

Associations § 7 > Orthodontists' Society > Validity of Membership Requirement.

-- A rule prescribed by orthodontists' associations prohibiting delegation of orthodontic services to a dentist not educationally qualified for membership is neither arbitrary nor contrary to public policy. And an applicant's knowing violation of such rule serves as a permissible basis for rejection of his application for membership.

#### CA(8) (8)

Associations § 12 > Unincorporated Associations > Intervention of Courts.

-- In adjudicating a challenge to a professional society's rule as arbitrary, a court exercises only a limited role of review. Only where the rule is contrary to established public policy or is so patently arbitrary and unreasonable as to be beyond the pale of the law should a court prohibit enforcement of the rule.

**Counsel:** Gyler & Gottlieb and Emanuel Gyler for Plaintiff and Appellant.

Hassard, Bonnington, Rogers & Huber, Overton, Lyman & Prince, Fred S. Lack, Jr., and Richard G. Logan for Defendants and Respondents.

**Judges:** In Bank. Opinion by Tobriner, J., expressing the unanimous view of the court. Wright, C. J., McComb, J., Mosk, J., Burke, J., Sullivan, J., and Clark, J., concurred.

**Opinion by:** TOBRINER

## Opinion

[\*543] [\*\*255] [\*\*\*247] Dr. Leon Pinsker, a licensed dentist specializing in orthodontics, commenced this action in August 1962, contending that the defendant [\*544] orthodontist societies<sup>1</sup> had arbitrarily rejected his application for membership. In the initial phase of these proceedings, defendants contended that because membership in their association was not an "economic necessity" for Dr. Pinsker, the organizations' admission decisions were not properly subject to judicial review even if Pinsker had been arbitrarily or capriciously excluded. The trial court granted judgment for defendants, but on appeal our court reversed, concluding that "[because] of the unique position in the field of orthodontics occupied by defendant . . . organizations . . . a public interest is shown, and the associations must be viewed as having a fiduciary responsibility with respect to the acceptance or rejection of membership applications." ( [Pinsker v. Pacific Coast Soc. of Orthodontists \(1969\) 1 Cal.3d 160, 166 \[81 Cal.Rptr. 623, 460 P.2d 495\]](#).)

We held that "an applicant for membership has a judicially enforceable right to have his application considered in a manner comporting with the fundamentals of due process, including the showing of cause for rejection." (*Id.*) We remanded the matter to the trial court to afford defendants an opportunity to demonstrate that they had met these requirements in rejecting [\*\*256] [\*\*\*248] Dr. Pinsker's membership application.

On remand, defendants based their exclusion of Dr. Pinsker on the ground of his continuing violation of one of the societies' "Principles of Ethics," a provision prohibiting an orthodontist from "delegating to a person less qualified any services or operation which requires the professional competence of an orthodontist." Dr. Pinsker challenged the defendants' position on three grounds: first, he contended that under any reasonable interpretation of the rule his conduct did not violate it; second, that even under the societies' interpretation of the rule he committed no violation; and third, that in any event the societies rejected his application arbitrarily because they did not give him an opportunity to respond to the charges against him.

The trial court ruled in favor of defendants, upholding the societies' interpretation of the rule, and concluding that on the basis of the evidence Dr. Pinsker had indeed violated it. Although the court recognized that the societies had not afforded Dr. Pinsker an opportunity to respond to [\*545] the charges or a hearing of any sort, the court held that precedent called for no such opportunity.

As discussed below, we have decided that in rejecting Dr. Pinsker's application, defendant societies failed to comply with the minimal requisites of a fair procedure required by established common law principles. As our past cases recognize, *HN1* an organization's decision to exclude or expel an individual may be "arbitrary" either because the reason for the exclusion or expulsion is itself irrational or because, in applying a given rule in a particular case, the society has proceeded in an unfair manner. Although the fair procedure required in this setting clearly need not include the formal embellishments of a court trial, an affected individual must at least be provided with some meaningful opportunity to respond to the "charges" against him.

We have further concluded that in reconsidering Dr. Pinsker's application, defendants may validly impose the nondelegation rule and may properly reject his application if he has in fact continued to share patients with a dentist who lacks the requisite educational qualifications for membership in defendant societies.

### 1. *The facts.*

<sup>1</sup> Three related organizations are joined as defendants: the American Association of Orthodontists (hereafter referred to as the national society or organization), the Pacific Coast Society of Orthodontists ( the regional society or organization) and the Pacific Coast Society of Orthodontists, Southern Component (the local society or organization). The local society is primarily responsible for passing on membership applications; acceptance by the local society apparently automatically qualifies one as a member of both the regional and national societies.

Dr. Pinsker obtained a general license to practice dentistry in California in 1953 and began his practice in this state the following year. In 1956, Pinsker formed a partnership in the City of Long Beach with Dr. Max Schleimer, a dentist who since 1954 had limited his practice to orthodontics; thereafter, both Pinsker and Schleimer practiced only orthodontics. California does not provide for the separate licensing of specialists in the field of orthodontics and thus all licensed dentists can legally practice this specialty.

In 1958, Pinsker enrolled in a 16-month post-graduate course at Columbia University Division of Orthodontics in New York City. He successfully completed the course in January 1960, and received a Certificate of Training in Orthodontics, the rough equivalent of a master's degree. In May 1959, while still at Columbia, Pinsker submitted an application for membership to the local society.<sup>2</sup> In the fall of 1959, before Pinsker returned [\*546] from New York, a member of the local society, Dr. Spears, visited the offices of Pinsker and Schleimer at the request of the chairman of the local society's membership committee, and wrote a brief note to the chairman [\*\*257] [\*\*\*249] listing the personnel employed at the offices.<sup>3</sup>

Several months thereafter, in April 1960, Spears discussed his visit to Pinsker's office at a meeting of the local society's membership committee, reporting that Pinsker had a partnership arrangement with Dr. Schleimer, who was not a member of defendant organizations and who did not possess the requisite post-graduate course work then required for eligibility. Dr. Cottingham, the chairman of the local membership

committee, testified that at approximately the same time he received information from another society member, Dr. Donaldson, indicating that Pinsker and Schleimer "shared" patients, that is, each worked on all the patients who came into the office.

At trial Dr. Cottingham explained that the committee members felt that if Pinsker were permitting Schleimer to perform orthodontic work on Pinsker's patients, Pinsker would probably be in violation of section 3 of the association's "Principles of Ethics," which provided in part: "The orthodontist has an obligation to protect the health of his patient by not delegating to a person less qualified any service or operation which requires the professional competence of an orthodontist." The members interpreted the phrase "person less qualified" to include a licensed dentist who did not have the requisite education qualifications to be eligible for membership in their societies; thus, if Pinsker were sharing patients with Schleimer, they believed that he would be improperly delegating work to a "person less qualified."

As a result of the questions raised at the meeting, Dr. Cottingham wrote a letter to Pinsker on May 2, requesting a clarification of his partnership practice. This letter, however, did not specify the society's particular concern but simply requested, in general terms, that Pinsker "give a description [\*547] of your practice, the number and status of your partners or associates and copies of your office stationery."<sup>4</sup> Pinsker responded on May 9, 1960, disclosing that he had "been engaged in the exclusive practice of orthodontics since January of 1957, with my partner Dr. Max Schleimer."

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<sup>2</sup> In our opinion, we discussed the interrelationship of the defendant organizations, their various professional functions and their prestigious position in the field of orthodontics. We need not repeat that discussion here but note simply that the national society and its constituent bodies are widely recognized as the sole professional organizations in this country which set standards for, and certify proficiency in, the practice of orthodontics. (See [Pinsker v. Pacific Coast Soc. of Orthodontists, supra](#), 1 Cal.3d 160, 163, 166.)

<sup>3</sup> Dr. Spears' note to the committee chairman stated: "Pinsker in Lakewood is a bit questionable. He is back at Columbia now finishing his course. Has a couple of New York *boys* [original italics] running his office. Three nurses, a lab. man and the two dentists. [para. ] I will call on him when he returns in January. I see no hurry in processing him until he finishes his course at least."

The note's reference to "New York *boys*" remains unexplained. Testimony at trial established that neither Schleimer nor the other dentist present at the time of Spears' visit (Pinsker's temporary replacement) were from New York and that neither was particularly young for a practicing dentist. In addition, although the note indicated that Spears intended to call on Pinsker when he returned from Columbia, the record shows that Spears never made another visit to Pinsker's offices nor contacted him in any way.

<sup>4</sup> Dr. Cottingham's May 2 letter to Pinsker reads in pertinent part: "Doctor Robert Lee, Chairman of the Southern Component of the Pacific Coast Society of Orthodontists, has informed me that you have completed your graduate [work] at Columbia University and wish to have your application for associate membership reprocessed."

On May 11, 1960, the local membership committee again met and formally took up Pinsker's application for association membership. Pinsker was given no indication that he might be in violation of the societies' nondelegation rule and no opportunity either in writing or in person to present his side of the story. On the basis of the limited information before it, the membership committee voted unanimously to reject Pinsker's application on the ground that he was engaged in a patient-sharing practice which constituted a violation of the non-delegation rule.

[\*\*258] [\*\*\*250] Shortly thereafter, Dr. Neff, the secretary of the local society, informed Pinsker that his membership application had been denied. Pinsker at first unsuccessfully sought an explanation of the reason for the society's denial but ultimately found it lay in his alleged sharing of patients with Dr. Schleimer. Pinsker testified that he discontinued this practice in late July 1960.

In June 1960, after Pinsker had questioned the basis for his rejection, the local society rescinded its initial rejection of Pinsker and notified him that his application had been reinstated and that he would "hear the outcome . . . in the near future." Months later, on January 9, 1961, the local society, after some communication with the regional and national societies, considered Pinsker's application for a final time. Pinsker was not afforded an opportunity either to appear in person or submit a written statement on his own behalf for consideration at the meeting.

Aside from the information which had been related eight months earlier by Dr. Spears and Dr. Donaldson, the only information before the committee on January 9 consisted of a report by Dr. Neff on a conversation that he had had with two orthodontists "while waiting for

lunch "earlier that same day. In his deposition<sup>5</sup> Dr. Neff recalled the conversation as follows: [\*548] "I asked Dr. Shannon and Dr. Jensen, both of whom practice in Long Beach, if they still knew whether Dr. Pinsker still employed these two dentists.<sup>6</sup> Both replied that they were certain that at least one was still there." This statement, of course, indicates only that Pinsker and Schleimer were still in practice together in January 1961, and does not establish that Dr. Shannon or Dr. Jensen knew whether the dentists' "patient-sharing" procedure had continued. Nevertheless, on the basis of the foregoing matter, the local society decided to reject Pinsker's application for membership,

On January 23, 1961, Dr. Pinsker was notified that his application for membership had been denied; no reason was given for the decision. Pinsker commenced the present action on August 2, 1962.

At the trial defendants contended that since Pinsker had violated the society's non-delegation rule, they did not arbitrarily reject Pinsker's application. In support of this contention, defendants called as a witness an officer of the national association who testified that the "common understanding" within the national association was that the proscription on delegation of orthodontic operations applied to *all* persons not qualified for membership in defendant societies, including licensed dentists. Because it was conceded that Dr. Schleimer lacked the requisite educational qualifications for membership, at least under 1960 standards, defendants maintained that so long as Pinsker continued to share patients with Schleimer, the societies were justified in rejecting his application.

Defendants also called a number of former patients of Pinsker and Schleimer, who testified that the patient-sharing procedure continued well after July 1960, when Pinsker testified that he had fully

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"The membership committee is proceeding with your application. Will you send me a brief description of your course, the number of clock hours involved and the nature of the degree that you received. Also will you please give a description of your practice, the number and status of your partners or associates and copies of your office stationery."

<sup>5</sup> Plaintiff objected to the admission of Dr. Neff's deposition on the ground that defendants had not shown that Neff was currently unavailable to testify. At the earlier phase of the trial, prior to this court's first opinion, the defendants had produced medical evidence that Neff could not testify in person because of a heart condition. Although that medical evidence was somewhat stale by the time the trial was resumed after appeal, plaintiff did not produce any evidence to suggest that Neff's physical condition had improved and the trial court admitted the evidence. Plaintiff now complains that the admission of this matter was reversible error, but since we have determined that plaintiff is entitled to reconsideration of his application on other grounds, we need not pass on the propriety of the trial court's ruling.

<sup>6</sup> Dr. Neff was apparently under the mistaken belief that Pinsker's temporary replacement had remained in the office after Pinsker's return from Columbia.



implemented his patient segregation system. Although this evidence had not been presented to the local society when it rejected Pinsker in January 1961, and, for [\*259] [\*\*\*251] the most part involved incidents occurring well after such rejection, the trial court considered that testimony.

In response, Pinsker posited the arbitrariness of his rejection on three [\*549] separate grounds. First, the society had failed to afford him a fair opportunity to be heard. Second, he had in fact segregated his patients as soon as he had been advised to do so by defendants; he testified that thereafter Dr. Schleimer only worked on his patients in "emergencies." Finally, even if his "patient-sharing" had continued, the society's non-delegation rule could not reasonably be construed to prohibit the delegation of work to a licensed dentist.

The trial court rejected all of Pinsker's contentions and awarded judgment for defendants. Although it acknowledged that the societies had afforded Pinsker no opportunity to be heard, the court concluded that since the defendants had conducted some investigation into the matter and since the application had not been "summarily denied," the requirements of procedural fairness had been satisfied. On the factual question of whether Pinsker had actually segregated his patients in July 1960, the court resolved the conflicting testimony against Pinsker and found that the sharing of patients had continued well after his rejection in January 1961. Finally, the court concluded that defendants' interpretation of the non-delegation rule was not arbitrary.

2. *In light of defendants' important public role, the societies could not reject plaintiff's membership application without affording him a fair opportunity to respond to the charges against him.*

a. *Under established common law precedents, HN2 the proscription of "arbitrary" rejections prohibits rejection pursuant to an unfair procedure as well as rejection based on an improper reason.*

In our initial *Pinsker* opinion we held that in light of the **HN3** special position occupied by defendant

organizations in the professional field of orthodontics "an applicant for membership has a judicially enforceable right to have his application considered *in a manner comporting with the fundamentals of due process, including the showing of cause for rejection.*" (Italics added; [Pinsker v. Pacific Coast Soc. of Orthodontists, supra, 1 Cal.3d 160, 166](#) [hereafter *Pinsker I*].) Defendants contend that under this holding judicial review is limited to determining whether there was "cause" for rejection, that is, whether the applicant was rejected for an accepted noncapricious reason. Because *Pinsker I* did not explicitly elaborate a requirement of a fair decision-making *procedure*, defendants claim that they need only demonstrate that as a *substantive* matter the reason for Pinsker's rejection was not irrational. In other words, defendants initially claim that they were under no legal constraints to follow a fair procedure in determining whether or not to exclude Pinsker from their organizations.

[\*550] This attempt to confine our prior holding to matters of "substantive" nonarbitrariness, however, ignores the entire body of common law precedents<sup>7</sup> upon which *Pinsker I* rests. As we shall explain, these authorities recognize that **HN4** an organization's decision to expel or exclude an individual may be arbitrary either because the reason underlying the rejection is irrational or because the organization has proceeded in an unfair manner. **CA(1)** (1) Taken together, these decisions establish the [\*260] [\*\*\*252] common law principle that whenever a private association is legally required to refrain from arbitrary action, the association's action must be both substantively rational and procedurally fair. A review of the cases makes this overriding principle abundantly clear.

In [Falcone v. Middlesex County Medical Soc. \(1961\) 34 N.J. 582 \[170 A.2d 791, 89 A.L.R. 952\]](#), the seminal decision in this country granting judicial review of a professional association's rejection of an application for membership, the court canvassed the historical development of judicial decisions in this entire field. The *Falcone* court observed that while courts in general "have been understandably reluctant to interfere with the internal affairs of membership associations . . . in

<sup>7</sup> It is important to note that the legal duties imposed on defendant organizations arise from the common law rather than from the Constitution as such; although *Pinsker I* utilized "due process" terminology in describing defendant associations' obligations, the "due process" concept is applicable only in its broadest, nonconstitutional connotation. (See Selznick, *Law, Society and Industrial Justice* (1969) p. 257.) In an attempt to avoid confusing the common law doctrine involved in the instant case with constitutional principles, we shall refrain from using "due process" language and shall simply refer instead to a requirement of a "fair procedure."

particular situations, where the considerations of policy and justice were sufficiently compelling judicial scrutiny and relief were not found wanting." ([170 A.2d at p. 796.](#)) As the *Falcone* court noted, the earliest common law response came in "situations [involving] improper expulsions from pre-existing membership which called forth judicial directions for reinstatement or other suitable relief." (Italics added; *id.*)<sup>8</sup>

[\*551] The *Falcone* court proceeded to explain that the common law principle of judicial review of expulsions from membership associations had developed, in more recent years, to encompass a comparable judicial scrutiny of *exclusions* from membership in a special, limited category of private associations such as labor unions or professional and trade associations. Because of their monopolistic position in a given field of employment, such organizations wield enormous power, and for an individual seeking to make a living in a given trade or profession, membership in such organizations is frequently "an economic necessity."

As *Falcone* recognized, one of the earliest and most influential decisions applying common law principles to a private association's exclusion from membership was Chief Justice Gibson's celebrated opinion for this court in [James v. Marinship Corp. \(1944\) 25 Cal.2d 721 \[155 P.2d 329, 160 A.L.R. 900\]](#), invalidating a labor union's

policy of excluding blacks from full membership. In *Marinship* our court declared: "Where a union has . . . attained a monopoly of the supply of labor . . . such a union occupies a quasi public position similar to that of a public service business and it has certain corresponding obligations. It may no longer claim the same freedom from legal restraint enjoyed by golf clubs or fraternal associations. Its asserted right to choose its own members does not merely relate to social relations; it affects the fundamental right to work for a living. [Citation.] [**\*\*261**] [**\*\*\*253**] " ([25 Cal.2d at p. 731.](#))<sup>9</sup>

Finding the underlying rationale of *Marinship* applicable to a medical society that enjoyed a virtual monopoly over the use of local hospital facilities, the *Falcone* court upheld the propriety of judicial review of the medical society's rejection of the application of a physician for membership. After undertaking such review, the court decided that the society's [**\*552**] ground for exclusion "must be viewed as patently arbitrary and unreasonable and beyond the pale of the law." ([170 A.2d at p. 800.](#))

Our decision in *Pinsker I* represents our most recent application of the general common law principles which originated in the association expulsion cases and which through *Marinship*, *Falcone* and similar authorities,<sup>10</sup> have been applied to the exclusion of members by "public service" organizations. (See Tobriner & Grodin,

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<sup>8</sup> In *Dawkins v. Antrobus* [1881] 17 Ch.D. 615, an English court of appeal established that **HN5** a court would provide relief to any individual expelled from a private association who could demonstrate (1) that the society's rule or proceedings were contrary to "natural justice," (2) that the society had not followed its own procedures or (3) that the expulsion was maliciously motivated. The English common law concept of "natural justice" includes the basic principle "that a man may not be condemned unheard." (See Wade, *Administrative Law* (Oxford 1967) p. 154. See generally, Chafee, *The Internal Affairs of Associations Not for Profit* (1930) 43 Harv.L.Rev. 993, 1014-1020; Grodin, *Union Government and the Law: British and American Experiences* (1961) p. 101.)

This common law principle authorizing judicial review of association expulsions became a part of California law as early as 1888 ([Otto v. Tailors' P. & B. Union, 75 Cal. 308 \[17 P. 217\]](#)). Since then, this common law principle has been reiterated in a long and unbroken line of California decisions. (See [Von Arx v. San Francisco G. Verein \(1896\) 113 Cal. 377 \[45 P. 685\]](#); [Taboada v. Sociedad Espanola etc. \(1923\) 191 Cal. 187, 191-192 \[215 P. 673, 27 A.L.R. 1508\]](#); [Ellis v. American Federation of Labor \(1941\) 48 Cal.App.2d 440, 443-444 \[120 P.2d 79\]](#); [Cason v. Glass Bottle Blowers Assn. \(1951\) 37 Cal.2d 134, 143-144 \[231 P.2d 6, 21 A.L.R.2d 1387\]](#); [Swital v. Real Estate Commissioner \(1953\) 116 Cal.App.2d 677, 679 \[254 P.2d 587\]](#); [Cunningham v. Burbank Bd. of Realtors \(1968\) 262 Cal.App.2d 211, 214 \[68 Cal.Rptr. 653\]](#); [Ascherman v. San Francisco Medical Soc. \(1974\) 39 Cal.App.3d 623 \[114 Cal.Rptr. 681\]](#).)

<sup>9</sup> Quoting from an earlier New Jersey decision, Chief Justice Gibson explained the common law basis of the obligations imposed on such an organization: "[A] monopoly raises duties which may be enforced against the possessors of the monopoly. This has been recognized from the earliest times. The rule that one who pursued a common calling was obliged to serve all comers on reasonable terms seems to have been based on the fact that innkeepers, carriers, farriers, and the like, were few, and each had a virtual monopoly in his neighborhood. . . . [The] **HN6** holders of the monopoly must not exercise their power in an arbitrary, unreasonable manner so as to bring injury to others." ([25 Cal.2d at p. 732](#), quoting [Wilson v. Newspaper & Mail Deliverers' Union \(1938\) 123 N.J. Eq. 347 \[197 A. 720\]](#).)

<sup>10</sup> See, e.g., [Williams v. Int. etc. of Boilermakers \(1946\) 27 Cal.2d 586 \[165 P.2d 903\]](#); [Thorman v. Intl. Alliance etc. Employees \(1958\) 49 Cal.2d 629 \[320 P.2d 494\]](#); [Directors' Guild of America, Inc. v. Superior Court \(1966\) 64 Cal.2d 42, 52-54 \[48 Cal.Rptr.](#)

*The Individual and the Public Service Enterprise in the New Industrial State* (1967) 55 Cal.L.Rev. 1247, 1256-1260.) In *Pinsker I* we concluded that although membership in defendant orthodontic associations could not be said to be "an economic necessity," the associations still wielded monopoly power and affected sufficiently significant economic and professional concerns so as to clothe the societies with a "public interest."<sup>11</sup>

Thus, *Pinsker I* constitutes only the latest development in a century-old progression of common law decisions establishing the proper role which courts should play with respect to membership decisions reached by private associations. Throughout this progression, the authorities indicate that **HN7** once it is determined that judicial scrutiny of a particular decision is justified to protect against arbitrary action, such overview includes an evaluation of both the substantive and procedural aspects of the association's decision. (See generally Chafee, *The Internal Affairs of Associations Not for Profit* (1930) 43 Harv.L.Rev. 993, 1014-1020.) California decisions clearly illustrate the dual nature of this review.

[\*\*262] [\*\*\*254] **HN8** In situations involving the expulsion of members from a society, the [\*553] courts have long held that procedural fairness is an indispensable prerequisite. **CA(2)** (2) "In this state 'a member of an unincorporated association may not be suspended or expelled . . . without charges, notice and a hearing, even though the rules of the association make no provision therefor.'" ( *Swital v. Real Estate Commissioner, supra*, 116 Cal.App.2d 677, 679; *Cason v. Glass Bottle Blowers Assn., supra*, 37 Cal.2d 134, 143-144.) This requirement of procedural fairness has been an established part of the California common law since before the turn of the century. (See, e.g., *Von Arx v. San Francisco G. Verein, supra*, 113 Cal. 377; *Otto v. Tailors P. & B. Union, supra*, 75 Cal. 308, 314-315.)

In addition to requiring a fair procedure, the common law decisions establish that **HN9** an expulsion from an association cannot properly rest upon a rule which is substantively capricious or contrary to public policy. Thus, for example in *Bernstein v. Alameda etc. Med. Assn. (1956) 139 Cal.App.2d 241 [293 P.2d 862]*, the court held that the defendant medical society could not lawfully expel a doctor for making disparaging statements about another doctor's professional work in the course of legal proceedings. (See also *Higgins v. American Society of Clinical Pathologists (1968) 51 N.J. 191 [238 A.2d 665, 671]*; *Spayd v. Ringing Rock Lodge No. 665 (1921) 270 Pa. 67 [113 A. 70, 14 A.L.R. 1443]*; *Hurwitz v. Directors Guild of America, Inc. (2d Cir. 1966) 364 F.2d 67, 73-77.*)

Defendants concede that courts have applied this dual-pronged analysis in reviewing *expulsion* decisions but contend that in the *exclusion* area courts have confined their review of arbitrariness to substantive matters, and have not required compliance with procedural fairness. Defendants apparently rely on the fact that in both the *Marinship* and *Falcone* cases the arbitrariness issue arose in a substantive context.

The authorities, however, belie the defendants' claim that the requirement of procedural fairness adheres only in expulsion cases. In *Wyatt v. Tahoe Forest Hospital Dist., supra*, 174 Cal.App.2d 709, for example, the court invalidated the rejection of a doctor's application for membership on a hospital staff because the hospital had failed to afford the applicant any opportunity to be heard. And in *Martino v. Concord Community Hosp. Dist., supra*, 233 Cal.App.2d 51, 56-57, the court reiterated the *Wyatt* holding and extended its requirement of procedural fairness to a situation in which an application for staff membership had simply been deferred rather than rejected. Although the *Wyatt* and *Martino* cases involve rejections of membership for a hospital staff rather than for a professional association,

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710, 409 P.2d 934]; *Wyatt v. Tahoe Forest Hospital Dist. (1959) 174 Cal.App.2d 709 [345 P.2d 93]*; *Martino v. Concord Community Hosp. Dist. (1965) 233 Cal.App.2d 51, 56-57 [43 Cal.Rptr. 255]*; *Kronen v. Pacific Coast Society of Orthodontists (1965) 237 Cal.App.2d 289 [46 Cal.Rptr. 808]*.

<sup>11</sup> Our holding in *Pinsker I* that a strict showing of "economic necessity" is not an indispensable prerequisite to judicial review was presaged by the court's decision in *Directors' Guild of America, Inc. v. Superior Court, supra*, 64 Cal.2d 42, 52-54. In *Directors' Guild* we recognized that although membership in a labor union that did not have a union shop contract might not be an "economic necessity" for an employee in the trade, in practical terms his exclusion from membership worked significant economic and professional hardship. Consequently we declared: "The . . . grounds for condemnation of arbitrary rejection from membership apply as forcefully to the situation in which the union does not have a union shop contract as to that in which it does. The need of the worker for union participation is not reduced because the union does not enjoy a union shop; the basis for membership lies in the right and desirability of representation, not in the union's economic control of the job." (64 Cal.2d at pp. 53-54; see also *Kronen v. Pacific Coast Society of Orthodontists, supra*, 237 Cal.App.2d 289, 304.)



in view of the fiduciary responsibilities imposed on the defendant [\*554] associations because of their "public service" functions, the prior cases are not distinguishable from the present matter. In each instance, the **HN10** courts uphold judicial review because denial of membership would effectively impair the applicant's right "to fully practice his profession." (*174 Cal.App.2d at p. 715*. Cf. *Rosner v. Eden Township Hospital Dist. (1962) 58 Cal.2d 592, 598 [25 Cal.Rptr. 551, 375 P.2d 431]*.)<sup>12</sup>

[\*\*263] [\*\*\*255] Moreover, several recent out-of-state authorities provide additional support for the conclusion that defendants' membership decisions must be rendered pursuant to fair procedures. In *Blende v. Maricopa County Medical Society (1964) 96 Ariz. 240 [393 P.2d 926]*, for example, the Arizona Supreme Court held that if a medical society's denial of a doctor's application for membership would impair the physician's practice of his profession "then his membership application may not be denied arbitrarily, but only on a showing of just cause established by the Society *under proceedings embodying the elements of due process*." (Italics added; *393 P.2d at p. 930*; see also *Sussman v. Overlook Hospital Assn., supra, 95 N.J. Super. 418*; *Silver v. Castle Memorial Hospital, supra, 53 Hawaii 475*.)

Our decision in *Pinsker I* drew upon the foregoing authority in concluding that **HN11** "an applicant for membership [in defendant organizations] has a judicially enforceable right to have his application considered in a manner comporting with the fundamentals of due process, *including* the showing of cause for rejection." (Italics added; *1 Cal.3d at p. 166*.) The development of the common law, reviewed above, buttresses the proposition evident from the very language of *Pinsker I*: a showing of "cause" for rejection is but one of the requirements of a nonarbitrary decision. In addition, an applicant for membership in defendant societies is entitled to have his application decided pursuant to a fair procedure. (See generally Sloss, *Procedural Due Process in Voluntary Associations* (1973) 48 State Bar J. 138.)

[\*555] b. **CA(3)** (3) *Under common law principles, HN12 a "fair procedure" requires that before the denial*

*of an application, an applicant be notified of the reason for the proposed rejection and given a fair opportunity to defend himself.*

Defendants further contend that even if they were legally required to utilize a "fair procedure" in passing on Dr. Pinsker's application, as we have said, they satisfied their obligation by conducting an investigation into Pinsker's case and by resting their rejection of his application on the information disclosed by that investigation. Although the trial court apparently agreed with this contention, we conclude that the procedure followed in the instant case does not meet minimal common law standards.

In *Cason v. Glass Bottle Blowers Assn., supra, 37 Cal.2d 134, 143*, this court declared: "It is a fundamental principle of justice that no man may be condemned or prejudiced in his rights without an opportunity to make his defense, and this principle is applicable not only to courts but also to labor unions and similar organizations." **CA(4)** (4) We thus recognize that **HN13** a basic ingredient of the "fair procedure" required under the common law is that an individual who will be adversely affected by a decision be afforded some meaningful opportunity to be heard in his defense. Every one of the numerous common law precedents in the area establishes that this element is indispensable to a fair procedure. (See, e.g., *Von Arx v. San Francisco G. Verein, supra, 113 Cal. 377, 379-380*; *Taboada v. Sociedad Espanola, etc., supra, 191 Cal. 187, 191*; *Cunningham v. Burbank Bd. of Realtors, supra, 262 Cal.App.2d 211, 214*.)

**HN14** The common law requirement of a fair procedure does not compel formal proceedings with all the embellishments of a court trial (see, e.g., *Cason v. Glass Bottle Blowers Assn., supra, 37 Cal.2d pp. 137, 143*), nor adherence to a single mode of process. It may be satisfied by any one of a variety of procedures which afford a fair opportunity for an applicant to present his position. As such, this court should not attempt to fix a rigid procedure that must invariably be observed. Instead, the associations themselves should retain the initial and primary responsibility for devising a method

<sup>12</sup> Although the defendants in both *Wyatt* and *Martino* were public entities, neither decision relied on this factor in reaching the conclusion that procedural fairness was required in the admission process. Moreover, in *Willis v. Santa Ana etc. Hospital Assn. (1962) 58 Cal.2d 806, 810 [26 Cal.Rptr. 640, 376 P.2d 568]*, our court explicitly held that private hospitals are under similar constraints to protect against arbitrary exclusion from membership. (See also *Sussman v. Overlook Hospital Assn. (1967) 95 N.J. Super. 418 [231 A.2d 389]*; *Silver v. Castle Memorial Hospital (1972) 53 Hawaii 475 [497 P.2d 564]*; *Bricker v. Sceva Speare Memorial Hospital (1971) 111 N.H. 276 [281 A.2d 589, 592-593]*; *Davidson v. Youngstown Hospital Association (1969) 19 Ohio App.2d 246 [48 Ohio Ops.2d 371, 250 N.E.2d 892]*.)



which provides an applicant adequate notice of the "charges" against him and a reasonable opportunity [\*\*264] [\*\*\*256] to respond.<sup>13</sup> In drafting such [\*\*556] procedure, and determining, for example, whether an applicant is to be given an opportunity to respond in writing or by personal appearance, the organization should consider the nature of the tendered issue and should fashion its procedure to insure a *fair* opportunity for an applicant to present his position. Although the association retains discretion in formalizing such procedures, the courts remain available to afford relief in the event of the abuse of such discretion.

**CA(5)** (5) In the instant case defendants concede that Pinsker was not afforded any opportunity to respond to the charges raised against him. Although Pinsker contends that he had terminated "patient sharing" nearly six months prior to the January 1961 meeting, he was given no chance to demonstrate such termination, and, indeed, was apparently unaware that anyone still questioned his qualifications. Under these circumstances, we conclude that the procedure followed by the defendant association did not meet the minimum standards required under the common law.<sup>14</sup>

The case of *Wyatt v. Tahoe Forest Hospital Dist.*, *supra*, [174 Cal.App.2d 709](#), directly supports this conclusion. In *Wyatt*, as in the instant case, the defendant's ex parte investigation of an applicant's qualifications uncovered information which defendant contended warranted the rejection of plaintiff's application.<sup>15</sup> Despite the thoroughness of the investigation and the apparent reliability of the information gathered, the *Wyatt* court held that the applicant was still entitled to be accorded an opportunity to be heard in his own defense. (See

also *Sussman v. Overlook Hospital Assn.*, *supra*, [95 N.J. Super. 418 \[231 A.2d 389, 393\]](#).)

Defendants suggest, however, that even if they did act improperly in denying Pinsker's application without affording him an opportunity to present his position, the error has been fully cured because Pinsker was afforded [\*\*557] a full hearing on the merits at the trial of this action. Dr. Pinsker was entitled, however, to a ruling on his membership application by the *defendant associations* pursuant to a fair procedure; the trial judge possessed neither the professional expertise nor the discretionary latitude of such associations, and consequently his decision is not an adequate substitute for a determination by such bodies. **CA(6)** (6) Moreover, we believe as a matter of policy that the **HN15** association itself should in the first instance pass on the merits of an individual's application rather than shift this burden to the courts. For courts to undertake the task "routinely in every such case constitutes [\*\*265] [\*\*\*257] both an intrusion into the internal affairs of [private associations] and an unwise burden on judicial administration of the courts." (*Ferguson v. Thomas* ([5th Cir. 1970](#)) [430 F.2d 852, 858](#).)

The case of *Ellis v. American Federation of Labor*, *supra*, [48 Cal.App.2d 440](#), confirms this approach. In *Ellis*, after concluding that the defendant labor association had improperly suspended plaintiff without a hearing, the court declared through Justice Dooling: "This court will not undertake to inquire at this time whether the [plaintiff] committed any breach of its obligations . . . or was guilty of any conduct which would justify the suspension or revocation . . . after proper notice and a hearing. The very purpose of such hearing

<sup>13</sup> Of course, if an unsuccessful applicant does not care to know the reason for his rejection or does not wish to contest his exclusion, there is no necessity for an association to conduct a meaningless procedure. Accordingly, it is permissible for an association to initially reject an applicant without explanation, so long as the association clearly indicates to the applicant that, if he desires, the association will inform him of the reason for the rejection and will afford him an opportunity to respond.

<sup>14</sup> Because we have determined that the failure to provide Pinsker an opportunity to present his position invalidates the associations' decision, we need not pass on plaintiff's additional contention that the hearsay evidence relied on by defendants was so insubstantial as to render the rejection arbitrary or capricious. (Cf. *Tesoriero v. Miller* (1949) [274 App.Div. 670 \[88 N.Y.S.2d 87\]](#).) The authorities do make clear, however, that in this context the hearsay nature of the evidence would not in itself render the information insufficient. (See *Sussman v. Overlook Hospital Assn.*, *supra*, [95 N.J. Super. 418 \[231 A.2d 389, 393\]](#); *Silver v. Castle Memorial Hospital*, *supra*, [53 Hawaii 475 \[497 P.2d 564, 571\]](#).) The case of *Martin v. State Personnel Board* (1972) [26 Cal.App.3d 573 \[103 Cal.Rptr. 306\]](#), relied on by plaintiff, involved an administrative hearing governed by [Government Code section 11513](#), and is not applicable here.

<sup>15</sup> Indeed, the information uncovered by the investigation in *Wyatt* was of an entirely different magnitude than the matters disclosed in the instant case. In *Wyatt*, defendants learned that plaintiff had had his medical license revoked on two occasions, had been charged several times with procuring an illegal abortion, and had been fined for removing public property. ([174 Cal.App.2d at pp. 711-712](#).)

would be to determine those facts. Having determined that [plaintiff] may not legally be suspended or revoked without a hearing, it would be improper to substitute a hearing in this or the trial court for the hearing that [plaintiff] is entitled to have within the federation to which it belongs." (*48 Cal.App.2d at p. 445*. See also *Sussman v. Overlook Hospital Assn., supra, 95 N.J. Super. 418.*)<sup>16</sup>

Thus, we conclude that defendants should reconsider plaintiff's application for membership pursuant to a fair procedure.<sup>17</sup>

**[\*558]** 3. **CA(7)** (7) *Defendant associations' rule prohibiting the delegation of orthodontic services to a dentist not educationally qualified for membership in their associations is neither arbitrary nor contrary to public policy, and an applicant's knowing violation of such rule serves as a permissible basis for the rejection of his application for membership.*

At the further proceedings, which we have outlined above, the applicability and validity of defendants' nondelegation regulation will inevitably be questioned and, because the issue has been fully briefed in this court, we address the matter.

The rule at issue here provides in full: "Use of Auxiliary Personnel. -- The orthodontist has an obligation to protect the health of his patient by not delegating to a person less qualified any service or operation which requires the professional competence of an orthodontist. The orthodontist has a further obligation of supervising the work of all auxiliary personnel in the interests of rendering the best service to the patient." Pinsker concedes the validity of this rule as applied to "auxiliary personnel" not licensed to practice dentistry, but he attacks defendants' interpretation of this section as proscribing the sharing of patients with his partner, a licensed dentist.

**CA(8)** (8) As an initial matter we note that **HN16** in adjudicating a challenge to the society's **[\*\*266]** **[\*\*\*258]** rule as arbitrary a court properly exercises only a limited role of review. As the Arizona Supreme Court observed in *Blende v. Maricopa County Medical Society, supra, 96 Ariz. 240 [393 P.2d 926, 930]*: "In making such an inquiry, the court must guard against unduly interfering with the Society's autonomy by substituting judicial judgment for that of the Society in an area where the competence of the court does not equal that of the Society . . . If the society has refused membership . . . through the application of a reasonable standard -- one which comports with the legitimate goals of the Society and the rights of the individual and the public -- then judicial inquiry should end." Only when a society rule is contrary to established public policy (see, e.g., *Rosner v. Eden Township Hospital Dist., supra, 58 Cal.2d 592; Bernstein v. Alamedaetc. Med. Assn., supra, 139 Cal.App.2d 241; Higgins v. American Society of Clinical Pathologists, supra, 238 A.2d 665*), or is so "patently arbitrary and unreasonable" as to be "beyond the pale of the law" (see *Falcone v. Middlesex County Medical Soc., supra, 34 N.J. 582 [170 A.2d 791, 800]*), should a court prohibit its enforcement.

On its face, the rule at issue appears quite reasonable, promoting high quality patient care by prohibiting orthodontists from delegating to less qualified personnel "any service or operation which requires the professional **[\*559]** competence of an orthodontist." As noted, Dr. Pinsker does not challenge the general application of this provision but urges the arbitrariness only of defendants' interpretation of the section.

Defendants interpret the rule to preclude an orthodontist from delegating an orthodontic "service or operation" to any person who is not a "qualified" orthodontist: defendants, in turn, define a "qualified" orthodontist as one who meets the current educational and professional

<sup>16</sup> Although the argument is not explicitly articulated, defendants also appear to contend that plaintiff "waived" his right to a hearing before the association because he never took the initiative to request one. Under the society's by-laws, however, it was clear that no right to a hearing existed, and under similar circumstances California courts have uniformly held that an applicant's failure to seek a hearing is no bar to judicial relief. (See, e.g., *Martino v. Concord Community Hospital Dist., supra, 233 Cal.App.2d 51, 56; Swital v. Real Estate Commissioner, supra, 116 Cal.App.2d 677, 680; Ellis v. American Federation of Labor, supra, 48 Cal.App.2d 440, 444.*)

<sup>17</sup> Although plaintiff claims that the improper denial of a hearing entitled him to an order compelling the societies to admit him immediately into membership, we find no precedent for such an order in a situation in which a rejection is defective because of the failure to provide a hearing. (Cf. *Rosner v. Eden Township Hospital Dist., supra, 58 Cal.2d 592, 599* (admission to hospital staff compelled when grounds for rejection invalidated).) In all prior cases in which a hearing has been improperly denied, the courts have simply ordered that a hearing be afforded. (See, e.g., *Wyatt v. Tahoe Forest Hospital Dist., supra, 174 Cal.App.2d 709, 716; Martino v. Concord Community Hospital Dist., supra, 233 Cal.App.2d 51, 60.*)

eligibility requirements for membership in their societies. Because Dr. Schleimer did not satisfy the educational requirements prevailing in 1959 and 1960,<sup>18</sup> defendants concluded that Pinsker's alleged sharing of patients with Schleimer constituted a violation of the rule.

Pinsker attacks this construction of the provision on several grounds. First, he contends that nothing in the section indicates that the principle of nondelegation applies to licensed dentists as well as to more traditional "auxiliary personnel," e.g., nurses, dental hygienists, and laboratory technicians. Second, he claims that since Dr. Schleimer's general dentistry license permits him to practice orthodontics defendants cannot properly categorize him as an "unqualified" orthodontist simply because he has not taken all the post-graduate courses currently required of an applicant for membership in their societies. Finally, Pinsker points out that in 1957 Dr. Schleimer did meet all the requirements for membership in defendant associations and thus possesses the same educational qualifications as many society members who joined the associations in 1957 or earlier; since defendants conceded at trial that all members of their society are considered "qualified" orthodontists, Pinsker claims it is arbitrary for defendants to treat Dr. Schleimer differently from other dentists who have comparable educational backgrounds. As discussed below, we conclude that none of these contentions is sufficient to invalidate defendants' interpretation of the rule in question.

First, although the wording of the rule is somewhat ambiguous, Pinsker has conceded that in June 1960 defendants informed [**\*\*267**] [**\*\*\*259**] him of the interpretation which they placed on the section. Under these circumstances, legal doctrines calling for the construction of ambiguous documents against their draftsmen have little place; **HN17** in the private association context such rules are often drawn by laymen and so long as the society provides an [**\*560**] adequate and timely explanation an applicant should not be permitted to dispute the society's official interpretation.<sup>19</sup>

Second, the fact that California law designates Dr. Schleimer as "qualified" to practice orthodontics by virtue of his general dentistry license does not preclude defendant societies from establishing a higher standard of qualification for their own purposes. Judicial authorities have made it clear that **HN18** one perfectly legitimate objective of professional associations is to attempt to elevate professional standards in order to attain quality medical and dental care. (See [Falcone v. Middlesex County Medical Soc., supra, 34 N.J. 582 \[170 A.2d 791, 800\]](#); [Salter v. New York State Psycho. Ass'n \(1964\) 14 N.Y.2d 100 \[248 N.Y.S.2d 867, 870-871, 198 N.E.2d 250\]](#).) The imposition of additional educational requirements above those required for a state license certainly composes one permissible means of attaining such a goal. Moreover, with the continuing advances in medical science, a professional society may well conclude that "qualification" in a given specialty such as orthodontics calls for completion of some courses which concentrate on that specialty. Such additional educational requirements are precisely the kind of regulations which courts are usually ill-equipped to evaluate: the expert judgment of the professional association in these matters must generally prevail.

Finally, defendant societies may properly place Dr. Schleimer in a different category than individuals who may have comparable formal educational backgrounds but who have previously been admitted into the societies. "Grandfather clauses" in *statutory* eligibility schemes have long been accepted (see, e.g., [Ex parte Whitley \(1904\) 144 Cal. 167 \[77 P. 879\]](#); [Watson v. Maryland \(1910\) 218 U.S. 173 \[54 L.Ed. 987, 30 S.Ct. 644\]](#); Annot. 136 A.L.R. 207, 219-223). We cannot reasonably impose more rigid requirements on eligibility rules devised by nongovernmental bodies. Moreover, defendants could properly conclude that through participation in the associations' numerous professional activities, society members have been exposed to new professional developments not generally available to non-members.

<sup>18</sup> At the time Dr. Pinsker applied for membership, an applicant was required to have been in the exclusive practice of orthodontics and to have completed an orthodontics course of a minimum of 1,500 hours at an approved dental school. These requirements were more stringent than in earlier years. Thus, for example, in 1957, a dentist was apparently eligible for membership if he had simply been in the exclusive practice of orthodontics for two years.

<sup>19</sup> Our reaction would be entirely different, however, if defendants had rejected Pinsker's application without giving him any fair warning as to the actual meaning of the rule; under such circumstances, the ambiguity of the rule could well render an immediate rejection arbitrary. Although defendants' initial denial of Pinsker's application in May 1960 appears vulnerable to such criticism, defendants apparently recognized the unfairness of the procedure and thereafter reinstated Pinsker's application and afforded him an explanation of the rule at issue.

In sum, we conclude that defendants have not acted arbitrarily in interpreting their "auxiliary personnel" rule as prohibiting Pinsker from [\*561] sharing patients with Schleimer. In reaching this conclusion, however, we intimate no opinion as to whether Pinsker has in fact continued "patient-sharing" subsequent to having been informed that such practice violated defendants' rules. We hold only that if defendants properly conclude on the basis of fair proceedings that Pinsker has in fact continued sharing patients with Schleimer, such a practice would provide a nonarbitrary ground for rejecting his application.

#### 4. Conclusion.


In our initial decision we held that "[because] of the unique position in the field of orthodontics occupied by defendant . . . organizations . . ., the associations must be viewed as having a fiduciary responsibility with respect to the acceptance or rejection of membership

applications." ( [Pinsker v. Pacific Coast Soc. of Orthodontics, supra, 1 Cal.3d 160, 166.](#)) [\*\*268] [\*\*\*260] In our present decision we have explained that under the common law, one obligation flowing from this "public service" status is that defendant organizations may not reject an application without affording the applicant a fair opportunity to answer the charges against him. Because defendants failed to afford Dr. Pinsker such an opportunity, we have concluded that he is entitled to an injunctive order requiring defendants to reconsider his application pursuant to a fair procedure.

The judgment is reversed and the case is remanded to the trial court with instructions to issue an injunction compelling defendant associations to set aside the rejection of plaintiff's application and to reconsider such application pursuant to a fair procedure as provided herein.

Pinsker v. Pacific Coast Soc. of Orthodontists, 1 Cal.3d 160 (1969)

460 P.2d 495, 81 Cal.Rptr. 623

 KeyCite Yellow Flag - Negative Treatment  
 Declined to Extend by [El-Attar v. Hollywood Presbyterian Medical Center](#), Cal., June 6, 2013

1 Cal.3d 160

Supreme Court of California,  
 In Bank.

Leon J. PINSKER, Plaintiff and Appellant,  
 v.

PACIFIC COAST SOCIETY OF ORTHODONTISTS  
 et al., Defendants and Respondents.

L.A. 29658. | Nov. 12, 1969.

Action by dentist seeking injunction to require orthodontics associations to admit him as a member. The Superior Court, Los Angeles County, John F. McCarthy, J., granted judgment to defendants at close of plaintiff's evidence, and plaintiff appealed. The Supreme Court, McComb, J., held that in view of fact that membership in orthodontics associations was a practical necessity for a dentist who wished not only to make a good living as an orthodontist but also to realize maximum potential achievement and recognition in such specialty, applicant for membership had a judicially enforceable right to have his application considered in a manner comporting with fundamentals of due process, including showing of cause for rejection.

Reversed.

Opinion, [Cal.App.](#), 75 [Cal.Rptr.](#) 712, vacated.

West Headnotes (3)

[1]

### Health

 Professional Societies

Dentist whose application for membership in orthodontics associations had been rejected could establish right to judicial intervention by showing that exclusion from membership in associations deprived him of substantial economic advantages. [West's Ann.Bus. & Prof.Code](#), § 1600 et seq.

[42 Cases that cite this headnote](#)

[2]

### Health

 Professional Societies

In view of fact that membership in orthodontics associations was a practical necessity for a dentist who wished not only to make a good living as an orthodontist but also to realize maximum potential achievement and recognition in such specialty, applicant for membership had a judicially enforceable right to have his application considered in a manner comporting with fundamentals of due process, including showing of cause for rejection. [West's Ann.Bus. & Prof.Code](#), § 1600 et seq.

[38 Cases that cite this headnote](#)

[3]

### Appeal and Error

 Evidence

Upon retrial following reversal of judgment granted to defendants at close of plaintiff's evidence, defendants were entitled to present evidence in support of their defense or in rebuttal. [West's Ann.Code Civ.Proc.](#) § 631.8.

[11 Cases that cite this headnote](#)

### Attorneys and Law Firms

\*\*\*624 \*\*496 \*162 Leslie B. Joseph, Gyler & Gottlieb and Emanuel Gyler, Long Beach, for plaintiff and appellant.

Peart, Hassard, Smith & Bonnington, Alan L. Bonnington, San Francisco, Overton, Lyman & Prince and Fred S. Lack, Jr., Los Angeles, for defendants and respondents.

### Opinion

McCOMB, Justice.



Plaintiff appeals from a judgment granted to defendants pursuant to [section 631.8 of the Code of Civil Procedure](#) at the close of plaintiff's evidence, insofar as the judgment is based on the view that, in the absence of a showing of 'economic necessity' for membership in defendant organizations, plaintiff is not entitled to judicial review of their denial of his application for membership. Defendants are American Association of Orthodontists (AAO), Pacific Coast Society of Orthodontists (PCSO), \*163 Pacific Coast Society of Orthodontists, Southern Component (PCSOS), and various officers and committee members thereof.<sup>1</sup>

<sup>1</sup> Defendant AAO is a Pennsylvania nonprofit corporation. Defendants PCSO and PCSOS are likewise nonprofit corporations, the former being one of at least eight regional constituent societies of the AAO, and the latter being a component of the PCSO in a certain geographical area.

Facts: Plaintiff is a member of the American Dental Association (ADA) and obtained a license in 1953 to practice general dentistry in this state, granted pursuant to the Dental Practice Act. ([Bus. & Prof.Code, s 1600 et seq.](#)) He began to practice here in 1954, and two years later formed a partnership in Long Beach with Dr. Max Schleimer. Plaintiff and Dr. Schleimer, as partners, practiced orthodontics, one of eight dental specialties recognized by the ADA, which sets the standards for the dental profession in the United States.

The Dental Practice Act does not provide for the separate licensing of specialist<sup>497</sup> in the field of orthodontics. The only recognized certification therein is the 'Diplomate' certificate conferred by the American Board of Orthodontics (ABO), which is recognized by the ADA as the sole certifying board within this specialty. Membership in the AAO is apparently, if not absolutely essential, at least extremely helpful in obtaining ABO certification. It may also be a prerequisite to attaining membership in certain foundations dedicated to special orthodontics techniques and being admitted to certain advanced educational programs. In order to attain membership in the AAO, a dentist practicing in plaintiff's area must first become a member of the PCSOS, membership in which would, in turn, qualify him as a member of the PCSO, as well as the AAO.

After formation of the partnership with Dr. Schleimer, plaintiff, who had taken certain postgraduate courses in mouth rehabilitation before coming to California, enrolled at Columbia University Division of Orthodontics. There he completed a 17-months' postgraduate course and

received a Certificate of Training in Orthodontics, the rough equivalent of a master's degree. In this way, plaintiff obtained more than 1500 clock hours of course work in orthodontia at a dental school certified by the ADA Council on Dental Education, one of the requirements for membership in defendant organizations.

While he was still at Columbia, plaintiff applied for membership in PCSOS, with the understanding that his application would be passed upon after completion of his course work. After returning to California, plaintiff was notified by letter that his application had been denied, but no reason was stated for his rejection.

After plaintiff requested that the Secretary of PCSOS give him some \*164 reason for the rejection, he was contacted by Dr. Lee, a Long Beach member of PCSOS, at the secretary's request. According to plaintiff's testimony, Dr. Lee told him that ordinarily the reason for rejection is confidential, but that he felt he could divulge it 'off the record,' and stated: 'Aren't you in there (practicing in partnership with) Dr. Schleimer, who is a non-member of the Association, and aren't you working on each other's patients? \* \* \* (If you can change that relationship, I would think that your application might be favorably reconsidered.' Plaintiff allegedly promised to take immediate steps to segregate his patients from those of Dr. Schleimer. He reapplied for membership and claims that the separation of patients was completed within a few weeks after his conversation with Dr. Lee. Defendants offer to prove, on a resumption of trial sought by them, that this is not so. A few months after plaintiff's second application was filed, he received a notice of 'final rejection,' which, like the first notice, contained no reasons.

Thereafter, plaintiff filed the present action seeking an injunction to require defendants to admit him as a member of AAO and PCSOS.<sup>2</sup> In granting defendants' motion under [section 631.8 of the Code of Civil Procedure](#) upon the close of plaintiff's case, the trial court concluded that 'There is no economic or other necessity for membership in defendant associations justifying judicial intervention. \* \* \* Plaintiff has no right to judicially compel defendants to admit him to membership.' Thus, the trial court followed the rule urged by defendants that a voluntary association's refusal of membership to an applicant does not give rise to a legal remedy, no matter how arbitrary or unfair the refusal, unless the applicant can show that the refusal infringes a contractual or property right of his or that the organization effectively controls his right and ability to earn a living. (See [James v. Marinship Corp., 25 Cal.2d 721, 155 P.2d 329, 160 A.L.R. 900](#); [Smith v. Kern County Medical Assn., 19 Cal.2d 263, 120 P.2d 874](#); \*\*\*626 \*\*498 [Tatkin](#)

v. Superior Court, In and For Los Angeles County, 160 Cal.App.2d 745, 755, 326 P.2d 201; *Falcone v. Middlesex County Medical Society*, 34 N.J. 582, 170 A.2d 791, 89 A.L.R.2d 952; compare *Kronen v. Pacific Coast Society of Orthodontists*, 237 Cal.App.2d 289, 46 Cal.Rptr. 808; *Blende v. County Medical Society*, 96 Ariz. 240, 245, 393 P.2d 926, 930 (applicant's general right to due process).

<sup>2</sup> Plaintiff further sought damages for infringement of advantageous relationships, malicious misconduct, and restraint of trade, but he does not appeal from the trial court's finding that he failed to prove any such damage.

At the trial, it was stipulated, and the trial court found, that plaintiff had fulfilled all the requirements for membership as stated in the constitution and bylaws of defendant organizations except that he had not been elected to membership by the board of directors.

<sup>[1]</sup> Questions: First. Can plaintiff, by showing that exclusion from \*165 membership in defendant associations deprives him of substantial economic advantages, establish a right to judicial intervention with respect to the denial of his application for membership?

Yes. Membership in AAO and its constituent organizations is not essential for a dentist desiring to specialize in orthodontics. Plaintiff's specialization in orthodontics is proper under both the Dental Practice Act and the ADA's code of ethics, and his earnings therefrom are substantial. However, although any licensed practitioner has a right to hold himself out as a qualified specialist, evidence of membership in a specialty group acknowledged by the ADA is the only available sanction of specialized professional qualification; and the trial court found that membership in defendant associations would be economically advantageous to plaintiff and that he had suffered financial loss by reason of their refusal to elect him to membership. Plaintiff contends that he has therefore established an enforceable right to compel defendant associations to admit him.

Plaintiff argues that by being excluded from defendant associations he has been deprived of educational, financial, and professional advantages. He alleges that had he been granted membership, he could anticipate an increase in the number of dentist referrals received, could charge substantially larger fees than he does, and would be eligible to take certain courses not open to him now because he lacks membership in defendant associations.

In cases involving exclusion from membership in trade and professional organizations, the emphasis has been

upon the economic necessity, as opposed to the mere social utility, of membership. As stated in *Falcone v. Middlesex County Medical Soc.*, 34 N.J. 582, 170 A.2d 791, 799: 'When courts originally declined to scrutinize admission practices of membership associations they were dealing with social clubs, religious organizations and fraternal associations. Here the policies against judicial intervention were strong and there were no significant countervailing policies. When the courts were later called upon to deal with trade and professional associations exercising virtually monopolistic control, different factors were involved. The intimate personal relationships which pervaded the social, religious and fraternal organizations were hardly in evidence and the individual's opportunity of earning a livelihood and serving society in his chosen trade or profession appeared as the controlling policy consideration. \* \* \* Public policy strongly dictates that this power (of exclusion) should not be unbridled but should be viewed judicially as a fiduciary power to be exercised in reasonable and lawful manner for the advancement of the interests of the medical profession and the public generally \* \* \*.'

In \*166 *Kronen v. Pacific Coast Society of Orthodontists*, 237 Cal.App.2d 289, 46 Cal.Rptr. 808, the Court of Appeal determined preliminarily that a dentist whose application for membership in defendant associations had been rejected was entitled to judicial review of the circumstances surrounding the rejection to determine whether the rejection was an arbitrary or unlawful exercise of the power to exclude him. In that case, the rejection of the plaintiff's \*\*\*627 \*\*499 application was found to be proper, because he failed to meet the requirement that he be recommended by two active members of the constituent society. In the present case, on the other hand, plaintiff had met all the requirements except election to membership. Nevertheless, statements of the Courts of Appeal in its discussion of the right to judicial review are pertinent here. It was there said, at page 304(3) 46 Cal.Rptr. at p. 819: 'It is common knowledge that in this day of specialization, the doctor or dentist limiting his practice to a specialty enjoys a prestigious position with attendant economic advantages. It appears to us on this record that as a practical matter, an orthodontist like plaintiff cannot successfully limit his practice to orthodontics unless he becomes an active member of defendant organizations.'

<sup>[2]</sup> Because of the unique position in the field of orthodontics occupied by defendant AAO and its constituent organizations, membership therein, although not economically necessary in the strict sense of the word (as was the case in *Falcone*), would appear to be a practical necessity for a dentist who wishes not only to make a good living as an orthodontist but also to realize maximum potential achievement and recognition in such

specialty. Defendant associations hold themselves out to the public and the dental profession generally as the sole organizations recognized by the ADA, which is itself a virtual monopoly, to determine standards, both ethical and educational, for the practice and certification of orthodontics. Thus, a public interest is shown, and the associations must be viewed as having a fiduciary responsibility with respect to the acceptance or rejection of membership applications. (See *Tobriner and Grodin. The Individual and the Public Service Enterprise in the New Industrial State* (1967) 55 Cal.L.Rev. 1247.) Under the circumstances, an applicant for membership has a judicially enforceable right to have his application considered in a manner comporting with the fundamentals of due process, including the showing of cause for rejection.

Second. Are defendants entitled to offer evidence upon a retrial to show that their reason for excluding plaintiff was not an arbitrary or capricious one?

Yes. [Section 631.8 of the Code of Civil Procedure](#) provides, in pertinent part, as follows: ‘After a party has completed his presentation of evidence in a trial by the court, the other party, Without waiving his right to offer \*167 evidence in support of his defense or in rebuttal in the event the motion is not granted, may move for a judgment. (Italics added.)

<sup>[3]</sup> In the present case, the motion was granted, but since the judgment is being reversed on appeal, the situation is the same as if the motion had not been granted. ([Columbia Engineering Co. v. Joiner](#), 231 Cal.App.2d 837, 858(17), 42 Cal.Rptr. 241; see also [Greening v. General Air-Conditioning Corp.](#), 233 Cal.App.2d 545, 43 Cal.Rptr. 662.) Accordingly, defendants are entitled to present evidence in support of their defense or in rebuttal.

A contention has been made that defendants did not claim in the trial court that plaintiff’s application was rejected for cause and that they should therefore be foreclosed from presenting evidence on such issue. An examination of the record reveals, however, that in their answer defendants denied the allegation of plaintiff’s complaint that his application was denied ‘arbitrarily, capriciously and without cause’ and stated in their proposed findings of fact that the denial of plaintiff’s application ‘was not arbitrary, capricious or without cause as alleged, or otherwise.’ Although defendants’ counsel agreed that ‘for the purpose of this proceeding’ plaintiff had met all requirements except election to membership, defendants never maintained that there was not, in fact, a cause for the rejection of his application; and statements made by counsel \*\*500 \*\*\*628 for both plaintiff and defendants, as well as by the trial court, show that the understanding of all concerned was that if defendants’ motion was denied, they would have an opportunity to present evidence that plaintiff’s application was not arbitrarily rejected. Under the circumstances, defendants should be afforded an opportunity to show the truth or falsity of their assertion that their reason for excluding plaintiffs from membership was not an arbitrary or capricious one.

That portion of the judgment appealed from is reversed.

TRAYNOR, C.J., and PETERS, TOBRINER, MOSK, BURKE and SULLIVAN, JJ., concur.

#### All Citations

1 Cal.3d 160, 460 P.2d 495, 81 Cal.Rptr. 623



INTERNATIONAL CENTRE FOR DISPUTE RESOLUTION

Independent Review Process Panel

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In the Matter of an Independent Review Process

Between:

Booking.com B.V.

*Applicant*

-and-

ICDR Case No: 50-20-1400-0247

Internet Corporation for Assigned Names  
and Numbers (ICANN)

*Respondent*

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FINAL DECLARATION

The Panel:

Hon. A. Howard Matz

David H. Bernstein, Esq.

Stephen L. Drymer (Chair)

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## DECLARATION

WE, THE UNDERSIGNED PANELISTS, members of the Independent Review Process Panel (“**IRP Panel**” or “**Panel**”), having been designated in accordance with ICANN Bylaws dated 11 April 2013, hereby issue the following Final Declaration (“**Declaration**”):<sup>1</sup>

### I. INTRODUCTION

1. This Declaration is issued in the context of an Independent Review Process (“**IRP**”) as provided for in Article IV, Section 3 of the Bylaws of the Internet Corporation for Assigned Names and Numbers (“**ICANN**”; “**ICANN Bylaws**” or “**Bylaws**”). In accordance with those Bylaws, the conduct of this IRP is governed by the International Arbitration Rules of the International Centre for Dispute Resolution as amended and in effect June 1, 2009 (“**ICDR**”; “**ICDR Rules**”) as supplemented by the Supplementary Procedures for Internet Corporation for Assigned Names and Numbers (ICANN) Independent Review Process (“**Supplementary Procedures**”).
2. The subject matter of the dispute here concerns alleged conduct by the ICANN Board in relation to one particular facet of the process by which new generic top-level domains (“**gTLDs**”, also known as gTLD “**strings**”) are applied for, reviewed and delegated into the Internet’s domain name system (“**DNS**”) root zone.
3. As explained in this Declaration, the Applicant, Booking.com, alleges that, in establishing and overseeing the process by which so-called *string similarity reviews* are conducted, and in refusing to reconsider and overturn a decision to place Booking.com’s applied-for gTLD string .hotels in a so-called *string contention set*, the Board acted in a manner inconsistent with applicable policies, procedures and rules as set out in ICANN’s Articles of Incorporation, Bylaws and gTLD Applicant Guidebook (“**Guidebook**”).
4. Reading between the lines of the parties’ submissions, the Panel senses that both sides would welcome the opportunity to contribute to an exchange that might result in enabling disputants in future cases to avoid having to resort to an IRP to resolve issues such as have arisen here. Certainly the Panel considers that the present matter would ideally have been resolved amicably by the parties. This is particularly true given that the matter here concerns two of ICANN’s guiding principles – transparency and fairness – as applied to one of ICANN’s most essential activities – the delegation of new gTLDs<sup>2</sup> – in circumstances in which various members of the Internet community, including certain members of the ICANN Board’s New gTLD Program Committee, have expressed their own concerns regarding the string similarity review process. That being the case, though, the Panel does not shy away from the duty imposed by the Bylaws to address the questions before it and to render the

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<sup>1</sup> As requested by the ICDR, the Declaration was provided to the ICDR in draft form on 26 January 2015 for non-substantive comments on the text (if any). It was returned to the Panel on 2 March 2015.

<sup>2</sup> As stated in the very first sentence of the Guidebook: “New gTLDs have been in the forefront of ICANN’s agenda since its creation.”

present Declaration, in accordance with, and within the constraints of the Bylaws, the ICDR Rules and the Supplementary Procedures.

## II. THE PARTIES

### A. The Applicant: Booking.com

5. The Applicant, Booking.com, is a limited liability company established under the law of the Netherlands. Booking.com describes itself as “the number one online hotel reservation service in the world, offering over 435,605 hotels and accommodations.”<sup>3</sup> Booking.com’s primary focus is on the U.S. and other English-language markets.
6. Booking.com is represented in this IRP by Mr. Flip Petillion and Mr. Jan Janssen of the law firm *Crowell & Moring* in Brussels, Belgium.

### B. The Respondent: ICANN

7. The Respondent, ICANN, is a California not-for-profit public benefit corporation, formed in 1998. As set forth in Article I, Section 1 of its Bylaws, ICANN’s mission is “to coordinate, at the overall level, the global Internet’s system of unique identifiers, and in particular to ensure the stable and secure operation of the Internet’s unique identifier systems.” ICANN describes itself as “a complex organization that facilitates input from a wide variety of Internet stakeholders. ICANN has a Board of Directors and staff members from around the globe, as well as an Ombudsman. ICANN, however, is much more than just the corporation—it is a community of participants.”<sup>4</sup>
8. ICANN is represented in this IRP by Mr. Jeffrey A. LeVee, Esq. and Ms. Kate Wallace, Esq. of the law firm *Jones Day* in Los Angeles, California, USA.

## III. FACTUAL AND PROCEDURAL BACKGROUND – IN BRIEF

9. We recount here certain uncontested elements of the factual and procedural background to the present IRP. Other facts are addressed in subsequent parts of the Declaration, where the parties’ respective claims and the Panel’s analysis are discussed.

### A. ICANN’s Adoption of the New gTLD Program and the Applicant Guidebook

10. Even before the introduction of ICANN’s New gTLD Program (“**Program**”), in 2011, ICANN had, over time, gradually expanded the DNS from the original six gTLDs (.com; .edu; .gov; .mil; .net; .org) to 22 gTLDs and over 250 two-letter country-code TLDs.<sup>5</sup> Indeed, as noted above, the introduction of new gTLDs has been “in the forefront of ICANN’s agenda” for as long as ICANN has existed.

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<sup>3</sup> Request, ¶ 10.

<sup>4</sup> Response, ¶ 11-12.

<sup>5</sup> Request, ¶ 12; see also Guidebook, *Preamble*.

11. The Program has its origins in what the Guidebook refers to as “carefully deliberated policy development work” by the ICANN community.<sup>6</sup>
12. In 2005, ICANN’s Generic Names Supporting Organization (“GNSO”), one of the groups that coordinates global Internet policy at ICANN, commenced a policy development process to consider the introduction of new gTLDs.<sup>7</sup> As noted in the Guidebook:

*Representatives from a wide variety of stakeholder groups – governments, individuals, civil society, business and intellectual property constituencies, and the technology community – were engaged in discussions for more than 18 months on such questions as the demand, benefits and risks of new gTLDs, the selection criteria that should be applied, how gTLDs should be allocated, and the contractual conditions that should be required for new gTLD registries going forward.*
13. In October 2007, the GNSO formally completed its policy development work on new gTLDs and approved a set of 19 policy recommendations.
14. In June 2008, the ICANN Board decided to adopt the policies recommended by the GNSO.<sup>8</sup> As explained in the Guidebook, ICANN’s work next focused on implementation of these recommendations, which it saw as “creating an application and evaluation process for new gTLDs that is aligned with the policy recommendations and provides a clear roadmap for applicants to reach delegation, including Board approval.”<sup>9</sup>
15. This process concluded with the decision by the ICANN Board in June 2011 to implement the New gTLD Program and its foundational instrument, the Guidebook.<sup>10</sup>
16. As described by ICANN in these proceedings, the Program “constitutes by far ICANN’s most ambitious expansion of the Internet’s naming system. The Program’s goals include

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<sup>6</sup> Guidebook, *Preamble*

<sup>7</sup> Request, ¶ 13, Reference Material 7, “Public Comment Forum for Terms of Reference for New gTLDs (6 December 2005), <http://www.icann.org/en/news/announcements/announcement-06dec05-en.htm#TOR>; Reference Material 8, “GNSO Issues Report, Introduction of New Top-Level Domains (5 December 2005) at pp. 3-4. See also Guidebook, *Preamble*. Booking.com refers to the GNSO as “ICANN’s main policy-making body for generic top-level domains”. Article X of ICANN’s Articles of Incorporation provides: “There shall be a policy-development body known as the Generic Names Supporting Organization (GNSO), which shall be responsible for developing and recommending to the ICANN Board substantive policies relating to generic top-level domains” (Section 1); the GNSO shall consist of “a number of Constituencies” and “four Stakeholder Groups” (Section 2).

<sup>8</sup> Guidebook, *Preamble*. A review of this policy process can be found at <http://qns0.icann.org/issues/new-gtlds> (last accessed on January 15, 2015).

<sup>9</sup> Guidebook, *Preamble*: “This implementation work is reflected in the drafts of the applicant guidebook that were released for public comment, and in the explanatory papers giving insight into rationale behind some of the conclusions reached on specific topics. Meaningful community input has led to revisions of the draft applicant guidebook.”

<sup>10</sup> RM 10 (ICANN resolution). The Guidebook (in its 30 May 2011 version) is one of seven “elements” of the Program implemented in 2011. The other elements were: a draft communications plan; “operational readiness activities”; a program to ensure support for applicants from developing countries; “a process for handling requests for removal of cross-ownership restrictions on operators of existing gTLDs who want to participate in the [Program]”; budgeted expenditures; and a timetable.

enhancing competition and consumer choice, and enabling the benefits of innovation via the introduction of new gTLDs ...”<sup>11</sup>

17. The Guidebook is “continuously iterated and revised”, and “provides details to gTLD applicants and forms the basis for ICANN’s evaluation of new gTLD applications.”<sup>12</sup> As noted by Booking.com, the Guidebook “is the crystallization of Board-approved consensus policy concerning the introduction of new gTLDs.”<sup>13</sup>

#### **B. Booking.com’s Application for .hotels, and the Outcome**

18. In accordance with the process set out in the Guidebook, Booking.com filed an application (Application ID 1-1016-75482) for the gTLD string .hotels.
19. At the same time, Despegar Online SRL (“Despegar”), a corporation established under the law of Uruguay, applied (Application ID 1-1249-87712) for the string .hoteis.
20. “Hoteis” is the Portuguese word for “hotels”.
21. According to Booking.com, Despegar is “a competitor of Booking.com”.<sup>14</sup> Booking.com claims that it intends “to operate .hotels as a secure Internet environment providing hotel reservation services for consumers, hotels, and other stakeholders,”<sup>15</sup> while Despegar similarly intends .hoteis to be dedicated primarily to “individuals that are interested in, and businesses that offer, hotel- and travel-related content.”<sup>16</sup> That being said, a key difference between the two applications, as Booking.com acknowledges, is that Booking.com intends to focus the services it will offer under its proposed gTLD “on the U.S. (with its strongly Anglo-Saxon traditions) and other English-language markets,”<sup>17</sup> whereas Despegar intends to target “Portuguese-speaking” markets.<sup>18</sup>
22. As part of the Initial Evaluation to which all applied-for gTLDs were subject, .hotels and .hoteis were each required to undergo so-called *string review* in accordance with the Guidebook, the first component of which is a process known as *string similarity review*. As provided by the Guidebook, the string similarity review was conducted by an independent

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<sup>11</sup> Response, ¶ 14.

<sup>12</sup> Response, ¶ 14. The resolution (RM 10) adopting the Guidebook explicitly “authorizes staff to make further updates and changes to the Applicant Guidebook as necessary and appropriate, including as the possible result of new technical standards, reference documents, or policies that might be adopted during the course of the application process, and to prominently publish notice of such changes.”

<sup>13</sup> Request, ¶ 13. See also Guidebook, Module 1-2: “This Applicant Guidebook is the implementation of Board approved consensus policy concerning the introduction of new gTLDs, and has been revised extensively via public comment and consultation over a two-year period.”

<sup>14</sup> Request, ¶ 17.

<sup>15</sup> Request, ¶ 5.

<sup>16</sup> Request, ¶ 17. See also Despegar Application for .hoteis (Request, Annex 2), § 18(a).

<sup>17</sup> Request, ¶ 16.

<sup>18</sup> Request, ¶ 17. See also Despegar Application for .hoteis (Request, Annex 2), § 18(a).

String Similarity Panel (“SSP”) selected and engaged by ICANN for this purpose. (Extracts of the relevant provisions of the Guidebook can be found below, at Part IV of this Declaration.) ICANN engaged InterConnect Communications Ltd. (“ICC”), a company registered under the law of England and Wales, specializing in communications sector strategy, policy and associated regulatory frameworks,<sup>19</sup> in cooperation with University College London, to act as the SSP.

23. On 26 February 2013 ICANN published the results of all of the string similarity reviews for all of the applications for new gTLDs submitted as part of the Program. The announcement revealed, among other things, that two “non-exact match” contention sets had been created: .hotels & .hoteis; and .unicorn & .unicom.<sup>20</sup> Booking.com’s applied for string .hotels (as well as the .hoteis, .uncorn and .unicom strings) had thus failed the string similarity review.
24. The results of the string similarity review were notified to Booking.com by ICANN that same day. In its letter of 26 February 2013 ICANN wrote:

*After careful consideration and extensive review performed against the criteria in Section 2.2.1.1 of the Applicant Guidebook, the String Similarity Panel has found that the applied-for string (.hotels) is visually similar to another applied-for string (.hoteis), creating a probability of user confusion.*

*Due to this finding, the ... two strings have been placed in a contention set.*<sup>21</sup>

25. The impact of being put into a contention set is that the proposed strings in the set will not be delegated in the root zone unless and until the applicants reach agreement on which single string should proceed (with the other proposed string therefore rejected), or until after an auction is conducted, with the highest bidder being given the right to proceed to the next step in the review process.

### **C. DIDP Request and Request for Reconsideration**

26. On 28 March 2013 Booking.com submitted a request for information under ICANN’s Documentary Information Disclosure Policy (“**DIDP Request**”) asking for “all documents directly and indirectly relating to (1) the standard used to determine whether gTLD strings are confusingly similar, and (2) the specific determination that .hotels and .hoteis are confusingly similar.”<sup>22</sup>
27. On the same date, Booking.com also filed a formal Request for Reconsideration (“**Request for Reconsideration**”). The “specific action(s)” that Booking.com asked to be reconsidered were: the decision to place .hotels and .hoteis in a contention set; and the decision not to

<sup>19</sup> See <http://www.icc-uk.com/>

<sup>20</sup> Request, Annex 3. ICANN published document dated 26 February 2013. As its name suggests, a “non-exact match” connotes a determination that two different (non-identical) strings are visually similar within the meaning of the Guidebook. Another 752 applied-for gTLDs were put into 230 identical contention sets.

<sup>21</sup> Request, Annex 3, ICANN letter dated 26 February 2013.

<sup>22</sup> Request, ¶ 30 and Annex 3.

provide a “detailed analysis or a reasoned basis” for the decision to place .hotels in contention.<sup>23</sup>

28. ICANN responded to the DIDP Request on 27 April 2013. Although ICANN provided certain information regarding the review process, in its response to the DIDP Request, ICANN also noted:

*The SSP is responsible for the development of its own process documentation and methodology for performing the string similarity review, and is also responsible for the maintenance of its own work papers. Many of the items that are sought from ICANN within the [DIDP] Request are therefore not in existence within ICANN and cannot be provided in response to the DIDP Request. ICANN will, however, shortly be posting the SSP’s String Similarity Process and Workflow on the New gTLD microsite ...*<sup>24</sup>

29. By letter dated 9 May 2013 Booking.com replied to ICANN, writing that “ICANN’s response fails to provide any additional information or address any of Booking.com’s concerns as conveyed in its DIDP Request or Request for Reconsideration.”<sup>25</sup> On 14 May 2013, ICANN answered that it “intends to post the string similarity process documentation on or before ... 17 May 2013.”<sup>26</sup> ICANN further informed Booking.com that “ICANN will afford you 30 days from the posting of the process document for the submission of a revised Request for Reconsideration.”<sup>27</sup>
30. On 7 June 2013, ICANN published the “String Similarity New gTLD Evaluation Panel [i.e., the SSP] – Process Description” (“**SSP Process Description**”).<sup>28</sup>
31. On 26 June 2013 Booking.com wrote to ICANN regarding both its DIDP Request and its 28 March 2013 Request for Reconsideration. In its letter, Booking.com noted among other things that “the generalized information ICANN thus far has provided does not explain a rationale for or analysis for the decision to put .hotels and .hoteis in a contention set and therefore does not allow Booking.com to appropriately amend its Request for Reconsideration.” The letter concluded by stating: “Considering ICANN’s obligations of transparency and accountability, there cannot be any ‘compelling reason for confidentiality’.

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<sup>23</sup> Request, Annex 12, §3. The Request for Reconsideration (which appears to be in the form of a template) expressly states at §2 that it is a “Request for Reconsideration of ... Staff [vs. Board] action/inaction.” The cover letter attaching the Request states that, “[d]espite the fact that the origin of the decisions is unclear, this Reconsideration Request is being submitted as a reconsideration of a ‘Staff action’. In the event that the decisions referenced above are determined to be a ‘Board action’, this request may be amended.” As explained below, the Request for Reconsideration was amended on 7 July 2013. That amendment did not alter the stated nature of the request in §2 or the description of the specific actions that Booking.com sought to have reconsidered (§3). Unless otherwise indicated, all further references in this Declaration to the Request for Reconsideration are understood to be the *amended* Request for Reconsideration.

<sup>24</sup> Request, Annex 5.

<sup>25</sup> Request, Annex 6.

<sup>26</sup> Request, Annex 7.

<sup>27</sup> Request, Annex 7.

<sup>28</sup> Request, Annex 8.



And ... there are numerous compelling reasons for publication of [the information requested by Booking.com].”<sup>29</sup>

32. ICANN responded on 25 July 2013, explaining among other things that “the evaluation of the .hotels string by the SSP panel was performed according to the [SSP Process Description] ...” and “[t]he SSP’s work was subjected to quality review, as has been publicly discussed.”<sup>30</sup> Approximately six months later, on 9 January 2014, ICANN posted a letter dated 18 December 2013 addressed to ICANN by the SSP Manager at ICC (Mr. Mark McFadden) providing a further “summary of the process, quality control mechanisms and some considerations surrounding the non-exact contention sets for the string similarity evaluation ...” (“**SSP Manager’s Letter**”).<sup>31</sup> According to that Letter:

*When ALL of the following features of a pairwise comparison [of non-exact match strings] are evident the evaluators found the string pair to be confusingly similar:*

- *Strings of similar visual length on the page;*
- *Strings within +/- 1 character of each other;*
- *Strings where the majority of characters are the same and in the same position in each string; and*
- *The two strings possess letter combinations that visually appear similar to other letters in the same position in each string*

*o For example m~m & l~i*

33. Meanwhile, on 7 July 2013 Booking.com had submitted its amended Request for Reconsideration. In its letter attaching the amended Request for Reconsideration, Booking.com stated: “Booking.com reserves the right to further amend its Request for Reconsideration upon receipt of the information it previously requested and urges ICANN to publish the requested information as specified in our letter of 26 June 2013.”<sup>32</sup>
34. By virtue of Article IV, Section 3 of the Bylaws, ICANN’s Board Governance Committee (“**BGC**”) is charged with evaluating and making recommendation to the Board with respect to requests for reconsideration. The Board’s New gTLD Program Committee (“**NGPC**”) receives and acts on such recommendations on behalf of the ICANN Board. In accordance with this procedure, Booking.com’s Request for Reconsideration was evaluated by the BGC. In a detailed analysis dated 1 August 2013, the BGC “conclude[d] that Booking.com has not

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<sup>29</sup> Request, Annex 9.

<sup>30</sup> Request, Annex 10.

<sup>31</sup> Request, Annex 11.

<sup>32</sup> Request, Annex 13.

stated proper grounds for reconsideration and we therefor recommend that Booking.com's request be denied" ("**BGC Recommendation**").<sup>33</sup>

35. At a telephone meeting held on 10 September 2013 the NGPC, "bestowed with the powers of the Board", considered, discussed and accepted the BGC Recommendation. Booking.com's Request for Reconsideration was denied.<sup>34</sup>

#### **D. The Cooperative Engagement Process**

36. Booking.com thereafter filed a request for a Cooperative Engagement Process ("**CEP**") on 25 September 2013, with a view to attempting to reach an amicable resolution of its dispute with ICANN. In its CEP request, Booking.com wrote:

*Booking.com is of the opinion that Resolution 2013.09.10.NG02 [the Board resolution denying its Request for Reconsideration] violates various provisions of ICANN's Bylaws and Articles of Incorporation. In particular Booking.com considers that ICANN's adoption of [the Resolution] is in violation of Articles I, II(3), II and IV of the ICANN Bylaws as well as Article 4 of ICANN's Articles of Incorporation. In addition, Booking.com considers that ICANN has acted in violation of Articles 3, 5, 7 and 9 of ICANN's Affirmation of Commitment ...*<sup>35</sup>

37. The CEP ultimately did not result in a resolution, and Booking.com duly commenced the present IRP.
38. One further point should be made, here, prior to describing the commencement and conduct of the present IRP proceedings: The determination by the SSP that .hotels and .hoteis are so visually similar as to give rise to the probability of user confusion, and the resulting placement of those applied-for strings into a contention set, does *not* mean that Booking.com's application for .hotels has been denied or that .hotels will not proceed to delegation to the root zone. Rather, as noted above and explained in the extracts from the Guidebook reproduced below, the Guidebook establishes a process for resolving such contention, under which the applicants for the contending strings in the set – here, Booking.com and Despegar – may resolve the contention by negotiation, failing which the matter will proceed to auction. Ultimately, no matter the outcome of these IRP proceedings, Booking.com may yet be successful and .hotels may yet be delegated into the Internet root zone. However, the fact that .hotels has been put into a contention set does raise the risk that .hotels may never be delegated into the root zone, or that it may be more costly for Booking.com to obtain approval of its proposed string. It also has caused a significant delay in the potential delegation of the string into the root zone (which could prove to be detrimental to the ultimate success of Booking.com's proposed string if other applicants

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<sup>33</sup> Request, Annex 14, BGC Recommendation dated 1 August 2013, p.9. See also Request, Annex 15, NGPC Resolution dated 10 September 2013. As noted in footnote 1 to the BGC Recommendation, the Recommendation was ultimately finalized and submitted for posting on 21 August 2013.

<sup>34</sup> Request, Annex 15, NGPC Resolution dated 10 September 2013.

<sup>35</sup> Request, Annex 17.

whose strings were not put into a contention set are able to establish themselves as pioneer providers of hotel- and travel-related services under a different new gTLD).

#### **E. The IRP Proceedings**

39. On 19 March 2014, Booking.com submitted a Notice of Independent Review, dated 18 March 2014, as well as a Request for Independent Review Process (“**Request**”) accompanied by numerous supporting documents and reference materials.
40. In accordance with Article IV, Section 3(9) of the ICANN Bylaws, Booking.com requested that a three-member IRP panel be constituted to consider and determine the Request. As the omnibus standing panel referred to in Article IV, Section 3(6) of the ICANN Bylaws had yet to be established, Booking.com further proposed, in accordance with Article 6 of the ICDR Rules, that each party appoint one panelist, with the third (the Chair of the panel) to be appointed by the two party-appointed panelists.
41. On 25 April 2014, ICANN submitted a Response to ICANN’s Request with supporting documents (“**Response**”).
42. The parties having thereafter agreed on the number of panelists and the method of their appointment, David H. Bernstein, Esq. was duly appointed as panelist by Booking.com on 1 May 2014, and the Hon. A Howard Matz was duly appointed as panelist by ICANN on 30 May 2014.
43. On 17 July 2014, the ICDR notified the parties that Mr. Stephen L. Drymer had been duly nominated by the two party-appointed panelists as Chair of the Panel. Mr. Drymer’s appointment became effective and the Panel was duly constituted as of 1 August 2014.
44. On 21 August 2014, further to consultations among the panelists and between the Panel and the parties, the Panel convened a preparatory conference with the parties (by telephone) for the purpose of discussing organizational matters, including a timetable for any further written statements or oral argument. Both parties requested the opportunity to make supplemental submissions and to present oral argument.
45. On 22 August 2014 the Panel issued Procedural Order No. 1 in which, among other things, it established a Procedural Timetable for the IRP. As specifically requested by the parties, the Procedural Order and Timetable provided for the submission of additional written statements by the parties as well as for a brief oral hearing to take place by telephone, all on dates proposed by and agreed between the parties.<sup>36</sup>
46. In accordance with the Procedural Timetable, on 6 October 2014 Booking.com submitted its Reply to ICANN’s Response, accompanied by additional documents (“**Reply**”).

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<sup>36</sup> Paragraph 6 of Procedural Order No. 1 provided that, in its forthcoming Reply to ICANN’s Response, “Booking.com shall only address two issues raised in Respondent’s Response: (1) the nature and scope of the IRP requested; (2) the nature of the relief sought by Claimant.” Paragraph 7 of Procedural Order No. 1 provided that “Respondent’s Sur-Reply ... shall address only the issues raised in the Reply.”

47. In accordance with the Procedural Timetable, ICANN submitted a Sur-Reply on 20 November 2014 (“**Sur-Reply**”).

#### **F. The Hearing**

48. As provided by Procedural Order No. 1 and the Procedural Timetable, a hearing was held (by telephone) on 10 December 2011, commencing at 9:00 PST/18:00 CET.
49. In the light of the significance of the issues raised by the parties, and given the many questions prompted by those issues and by the parties’ extensive written submissions and supporting materials, the Panel indicated that it would allow the hearing to continue beyond the approximately one hour originally envisaged. The hearing ultimately lasted two and one-half hours. Counsel for each party made extensive oral submissions, including rebuttal and sur-rebuttal submissions, and responded to the panelists’ questions.
50. Prior to the close of the hearing each party declared that it had no objection concerning the conduct of the proceedings, that it had no further oral submissions that it wished to make, and that it considered that it had had a full opportunity to present its case and to be heard.
51. As agreed and ordered prior to the close of the hearing, the parties were provided the opportunity to file limited additional materials post-hearing, in relation to a certain question asked of them by the Panel. This was done, and, on 13 December 2014, the proceedings were declared closed.

### **IV. ICANN ARTICLES, BYLAWS AND POLICIES – KEY ELEMENTS**

52. We set out here the key elements of ICANN’s Articles of Association, Bylaws and policies on which the parties rely in their submissions and to which the Panel will refer later in this Declaration.

#### **A. Articles of Association**

*4. The Corporation shall operate for the benefit of the Internet community as a whole, carrying out its activities in conformity with relevant principles of international law and applicable international conventions and local law and, to the extent appropriate and consistent with these Articles and its Bylaws, through open and transparent processes that enable competition and open entry in Internet-related markets. To this effect, the Corporation shall cooperate as appropriate with relevant international organizations.*

*[Underlining added]*

#### **B. Bylaws**

##### **ARTICLE I: MISSION AND CORE VALUES**

###### *Section 1. MISSION*

*The mission of The Internet Corporation for Assigned Names and Numbers (“ICANN”) is to coordinate, at the overall level, the global Internet’s systems of unique identifiers,*

*and in particular to ensure the stable and secure operation of the Internet's unique identifier systems.*

*[..]*

## *Section 2. CORE VALUES*

*In performing its mission, the following core values should guide the decisions and actions of ICANN:*

- 1. Preserving and enhancing the operational stability, reliability, security, and global interoperability of the Internet.*
- 2. Respecting the creativity, innovation, and flow of information made possible by the Internet by limiting ICANN's activities to those matters within ICANN's mission requiring or significantly benefiting from global coordination.*
- 3. To the extent feasible and appropriate, delegating coordination functions to or recognizing the policy role of other responsible entities that reflect the interests of affected parties.*
- 4. Seeking and supporting broad, informed participation reflecting the functional, geographic, and cultural diversity of the Internet at all levels of policy development and decision-making.*
- 5. Where feasible and appropriate, depending on market mechanisms to promote and sustain a competitive environment.*
- 6. Introducing and promoting competition in the registration of domain names where practicable and beneficial in the public interest.*
- 7. Employing open and transparent policy development mechanisms that (i) promote well-informed decisions based on expert advice, and (ii) ensure that those entities most affected can assist in the policy development process.*
- 8. Making decisions by applying documented policies neutrally and objectively, with integrity and fairness.*
- 9. Acting with a speed that is responsive to the needs of the Internet while, as part of the decision-making process, obtaining informed input from those entities most affected.*
- 10. Remaining accountable to the Internet community through mechanisms that enhance ICANN's effectiveness.*
- 11. While remaining rooted in the private sector, recognizing that governments and public authorities are responsible for public policy and duly taking into account governments' or public authorities' recommendations.*

*These core values are deliberately expressed in very general terms, so that they may provide useful and relevant guidance in the broadest possible range of circumstances. Because they are not narrowly prescriptive, the specific way in which they apply, individually and collectively, to each new situation will necessarily depend on many factors that cannot be fully anticipated or enumerated; and because they are statements of principle rather than practice, situations will inevitably arise in which perfect fidelity to all eleven core values simultaneously is not possible. Any ICANN*

body making a recommendation or decision shall exercise its judgment to determine which core values are most relevant and how they apply to the specific circumstances of the case at hand, and to determine, if necessary, an appropriate and defensible balance among competing values.

[...]

### **ARTICLE III: TRANSPARENCY**

#### **Section 1. PURPOSE**

ICANN and its constituent bodies shall operate to the maximum extent feasible in an open and transparent manner and consistent with procedures designed to ensure fairness.

[...]

### **ARTICLE IV: ACCOUNTABILITY AND REVIEW**

#### **Section 1. PURPOSE**

In carrying out its mission as set out in these Bylaws, ICANN should be accountable to the community for operating in a manner that is consistent with these Bylaws, and with due regard for the core values set forth in Article I of these Bylaws. The provisions of this Article, creating processes for reconsideration and independent review of ICANN actions and periodic review of ICANN's structure and procedures, are intended to reinforce the various accountability mechanisms otherwise set forth in these Bylaws, including the transparency provisions of Article III and the Board and other selection mechanisms set forth throughout these Bylaws.

#### **Section 2. RECONSIDERATION**

1. ICANN shall have in place a process by which any person or entity materially affected by an action of ICANN may request review or reconsideration of that action by the Board.

2. Any person or entity may submit a request for reconsideration or review of an ICANN action or inaction ("Reconsideration Request") to the extent that he, she, or it have been adversely affected by:

a. one or more staff actions or inactions that contradict established ICANN policy(ies); or

b. one or more actions or inactions of the ICANN Board that have been taken or refused to be taken without consideration of material information, except where the party submitting the request could have submitted, but did not submit, the information for the Board's consideration at the time of action or refusal to act; or

c. one or more actions or inactions of the ICANN Board that are taken as a result of the Board's reliance on false or inaccurate material information.

3. The Board has designated the Board Governance Committee to review and consider any such Reconsideration Requests. The Board Governance Committee shall have the authority to:

a. evaluate requests for review or reconsideration;

- b. *summarily dismiss insufficient requests;*
- c. *evaluate requests for urgent consideration;*
- d. *conduct whatever factual investigation is deemed appropriate;*
- e. *request additional written submissions from the affected party, or from other parties;*
- f. *make a final determination on Reconsideration Requests regarding staff action or inaction, without reference to the Board of Directors; and*
- g. *make a recommendation to the Board of Directors on the merits of the request, as necessary.*

[...]

### Section 3. INDEPENDENT REVIEW OF BOARD ACTIONS

1. *In addition to the reconsideration process described in Section 2 of this Article, ICANN shall have in place a separate process for independent third-party review of Board actions alleged by an affected party to be inconsistent with the Articles of Incorporation or Bylaws.*

2. *Any person materially affected by a decision or action by the Board that he or she asserts is inconsistent with the Articles of Incorporation or Bylaws may submit a request for independent review of that decision or action. In order to be materially affected, the person must suffer injury or harm that is directly and causally connected to the Board's alleged violation of the Bylaws or the Articles of Incorporation, and not as a result of third parties acting in line with the Board's action.*

3. *A request for independent review must be filed within thirty days of the posting of the minutes of the Board meeting (and the accompanying Board Briefing Materials, if available) that the requesting party contends demonstrates that ICANN violated its Bylaws or Articles of Incorporation. Consolidated requests may be appropriate when the causal connection between the circumstances of the requests and the harm is the same for each of the requesting parties.*

4. *Requests for such independent review shall be referred to an Independent Review Process Panel ("IRP Panel"), which shall be charged with comparing contested actions of the Board to the Articles of Incorporation and Bylaws, and with declaring whether the Board has acted consistently with the provisions of those Articles of Incorporation and Bylaws. The IRP Panel must apply a defined standard of review to the IRP request, focusing on:*

- a. *did the Board act without conflict of interest in taking its decision?;*
- b. *did the Board exercise due diligence and care in having a reasonable amount of facts in front of them?; and*
- c. *did the Board members exercise independent judgment in taking the decision, believed to be in the best interests of the company [ICANN]?*

[...]

11. *The IRP Panel shall have the authority to:*

- a. summarily dismiss requests brought without standing, lacking in substance, or that are frivolous or vexatious;
- b. request additional written submissions from the party seeking review, the Board, the Supporting Organizations, or from other parties;
- c. declare whether an action or inaction of the Board was inconsistent with the Articles of Incorporation or Bylaws; and
- d. recommend that the Board stay any action or decision, or that the Board take any interim action, until such time as the Board reviews and acts upon the opinion of the IRP;
- e. consolidate requests for independent review if the facts and circumstances are sufficiently similar; and
- f. determine the timing for each proceeding.

[...]

14. Prior to initiating a request for independent review, the complainant is urged to enter into a period of cooperative engagement with ICANN for the purpose of resolving or narrowing the issues that are contemplated to be brought to the IRP. [...]

15. Upon the filing of a request for an independent review, the parties are urged to participate in a conciliation period for the purpose of narrowing the issues that are stated within the request for independent review. A conciliator will be appointed from the members of the omnibus standing panel by the Chair of that panel. [...]

16. Cooperative engagement and conciliation are both voluntary. However, if the party requesting the independent review does not participate in good faith in the cooperative engagement and the conciliation processes, if applicable, and ICANN is the prevailing party in the request for independent review, the IRP Panel must award to ICANN all reasonable fees and costs incurred by ICANN in the proceeding, including legal fees.

[...]

18. The IRP Panel should strive to issue its written declaration no later than six months after the filing of the request for independent review. The IRP Panel shall make its declaration based solely on the documentation, supporting materials, and arguments submitted by the parties, and in its declaration shall specifically designate the prevailing party. The party not prevailing shall ordinarily be responsible for bearing all costs of the IRP Provider, but in an extraordinary case the IRP Panel may in its declaration allocate up to half of the costs of the IRP Provider to the prevailing party based upon the circumstances, including a consideration of the reasonableness of the parties' positions and their contribution to the public interest. Each party to the IRP proceedings shall bear its own expenses.

[Underlining added]

53. Lest there be any misunderstanding as regards the proper subject matter of IRP proceedings or the role of the Panel, we note that, as was clearly established during the hearing, it is common ground between the parties that the term "action" (or "actions") as used in Article IV, Section 3 of the Bylaws is to be understood as action(s) or inaction(s) by the ICANN Board. The Panel observes that this understanding comports not only with the provisions of Article



IV, Section 2 of the Bylaws concerning “Reconsideration”, which expressly refer to “actions or inactions of the ICANN Board”, but with the clear intent of Section 3 itself, which stipulates at sub-section 11 that “[t]he IRP Panel shall have the authority to: ... (c) declare whether an action or inaction of the Board was inconsistent with the Articles of Incorporation or Bylaws.”

### C. The gTLD Applicant Guidebook

54. As noted above and as understood by all, the Guidebook is (to borrow Booking.com’s phrase) “the crystallization of Board-approved consensus policy concerning the introduction of new gTLDs.”<sup>37</sup>
55. The Guidebook is divided into “Modules”, each of which contains various sections and sub-sections. The three Modules of primary relevance here are Modules 1, 2 and 4. Module 1, titled “Introduction to the gTLD Application Process,” provides an “overview of the process for applying for a new generic top-level domains.”<sup>38</sup> Module 2, titled “Evaluation Procedures,” describes the “evaluation procedures and criteria used to determine whether applied-for gTLDs are approved for delegation.”<sup>39</sup> Module 4, titled “String Contention Procedures,” concerns “situations in which contention over applied-for gTLD strings occurs, and the methods available to applicants for resolving such contention cases.”

#### (i) *Initial Evaluation*

56. As explained in Module 1, “[i]mmediately following the close of the application submission period, ICANN will begin checking all applications for completeness.”<sup>40</sup> Initial Evaluation begins “immediately after the administrative completeness check concludes. All complete applications will be reviewed during Initial Evaluation.”<sup>41</sup>
57. Initial Evaluation is comprised of two main elements or types of review: *string review*, which concerns the applied-for gTLD string; and *applicant review*, which concerns the entity applying for the gTLD and its proposed registry services. It is the first of these – string review, including more specifically the component known as *string similarity review* – that is particularly relevant.

#### (ii) *String Review, including String Similarity Review*

58. String review is itself comprised of several components, each of which constitutes a separate assessment or review of the applied-for gTLD string, conducted by a separate reviewing body or panel. As explained in Module 2:

*The following assessments are performed in the Initial Evaluation:*

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<sup>37</sup> Request, ¶ 13.

<sup>38</sup> Module 1-2. Each Module of the Guidebook is paginated separately. “Module 1-2” refers to Guidebook Module 1, page 2.

<sup>39</sup> Module 2-2.

<sup>40</sup> Guidebook, §1.1.2.2: “Administrative Completeness Check”, Module 1-5.

<sup>41</sup> Guidebook, §1.1.2.5: “Initial Evaluation”, Module 1-8 (underlining added).

- *String Reviews*
  - *String similarity*
  - *Reserved names*
  - *DNS stability*
  - *Geographic names*

[...]

*An application must pass all these reviews to pass the Initial Evaluation. Failure to pass any one of these reviews will result in a failure to pass the Initial Evaluation.*<sup>42</sup>

59. As indicated, all complete applications are subject to Initial Evaluation, which means that all applied-for gTLD strings are subject to string review. String review is further described in Module 2 as follows:

*[String review] focuses on the applied-for gTLD string to test:*

- *Whether the applied-for gTLD string is so similar to other strings that it would create a probability of user confusion;*
- *Whether the applied-for gTLD string might adversely affect DNS security or stability; and*
- *Whether evidence of requisite government approval is provided in the case of certain geographic names.*<sup>43</sup>

60. The various assessments or reviews (i.e., string similarity, reserved names, DNS stability, etc.) that comprise string review are elaborated at Section 2.2.1 of Module 2. As mentioned, the most relevant of these reviews for our purposes is *string similarity review*, which is described in detail at Section 2.2.1.1. Because of the central importance of the string similarity review process in the context of the present dispute, this section of the Guidebook is reproduced here at some length:

#### **2.2.1.1 String Similarity Review**

*This review involves a preliminary comparison of each applied-for gTLD string against existing TLDs, Reserved Names (see subsection 2.2.1.2), and other applied-for strings. The objective of this review is to prevent user confusion and loss of confidence in the DNS resulting from delegation of many similar strings.*

*Note: In this Applicant Guidebook, “similar” means strings so similar that they create a probability of user confusion if more than one of the strings is delegated into the root zone.*

<sup>42</sup> Module 2-2. The same is true of applicant review, which is also comprised of various assessments concerning the applicant entity.

<sup>43</sup> Guidebook, §2.2: “Initial Evaluation”, Module 2-4 (underlining added). See also Module 1-9: “String reviews include a determination that the applied-for gTLD string is not likely to cause security or stability problems in the DNS ...”

The visual similarity check that occurs during Initial Evaluation is intended to augment the objection and dispute resolution process (see Module 3, Dispute Resolution Procedures) that addresses all types of similarity.

This similarity review will be conducted by an independent String Similarity Panel.

#### **2.2.1.1.1 Reviews Performed**

The String Similarity Panel's task is to identify visual string similarities that would create a probability of user confusion.

The panel performs this task of assessing similarities that would lead to user confusion in four sets of circumstances, when comparing:

[...]

- Applied-for gTLD strings against other applied-for gTLD strings;

[...]

**Similarity to Other Applied-for gTLD Strings (String Contention Sets)** – All applied-for gTLD strings will be reviewed against one another to identify any similar strings. In performing this review, the String Similarity Panel will create contention sets that may be used in later stages of evaluation.

A contention set contains at least two applied-for strings identical or similar to one another. Refer to Module 4, String Contention Procedures, for more information on contention sets and contention resolution.

[...]

#### **2.2.1.1.2 Review Methodology**

The String Similarity Panel is informed in part by an algorithmic score for the visual similarity between each applied-for string and each of other existing and applied-for TLDs and reserved names. The score will provide one objective measure for consideration by the panel, as part of the process of identifying strings likely to result in user confusion. In general, applicants should expect that a higher visual similarity score suggests a higher probability that the application will not pass the String Similarity review. However, it should be noted that the score is only indicative and that the final determination of similarity is entirely up to the Panel's judgment.

The algorithm, user guidelines, and additional background information are available to applicants for testing and informational purposes. [footnote in the original: See <http://icann.sword-group.com/algorithm/>] Applicants will have the ability to test their strings and obtain algorithmic results through the application system prior to submission of an application.

[...]

The panel will examine all the algorithm data and perform its own review of similarities between strings and whether they rise to the level of string confusion. In cases of strings in scripts not yet supported by the algorithm, the panel's assessment process is entirely manual.

The panel will use a common standard to test for whether string confusion exists, as follows:

**Standard for String Confusion** – String confusion exists where a string so nearly resembles another visually that it is likely to deceive or cause confusion. For the likelihood of confusion to exist, it must be probable, not merely possible that confusion will arise in the mind of the average, reasonable Internet user. Mere association, in the sense that the string brings another string to mind, is insufficient to find a likelihood of confusion.

#### 2.2.1.1.3 Outcomes of the String Similarity Review

An application that fails the String Similarity review due to similarity to an existing TLD will not pass the Initial Evaluation, and no further reviews will be available. Where an application does not pass the String Similarity review, the applicant will be notified as soon as the review is completed.

An application for a string that is found too similar to another applied-for gTLD string will be placed in a contention set.<sup>44</sup>

[Underlining added]

61. Module 4 of the Guidebook, as mentioned, concerns “situations in which contention over applied-for gTLD strings occurs, and the methods available to applicants for resolving such contention cases.” As explained in Module 4:

#### 4.1 String Contention

String contention occurs when either:

1. Two or more applicants for an identical gTLD string successfully complete all previous stages of the evaluation and dispute resolution processes; or
2. Two or more applicants for similar gTLD strings successfully complete all previous stages of the evaluation and dispute resolution processes, and the similarity of the strings is identified as creating a probability of user confusion if more than one of the strings is delegated.

ICANN will not approve applications for proposed gTLD strings that are identical or that would result in user confusion, called *contending strings*. If either situation above occurs, such applications will proceed to contention resolution through either community priority evaluation, in certain cases, or through an auction. Both processes are described in this module. A group of applications for contending strings is referred to as a contention set.

<sup>44</sup> Module 2-5 to 2-9. As regards the concept of string contention, see also Guidebook, §1.1.2.10: “String Contention”, Module 1-13: “String contention applies only when there is more than one qualified application for the same or similar gTLD strings. String contention refers to the scenario in which there is more than one qualified application for the identical gTLD string or for similar gTLD strings. In this Applicant Guidebook, “similar” means strings so similar that they create a probability of user confusion if more than one of the strings is delegated into the root zone.”

*(In this Applicant Guidebook, “similar” means strings so similar that they create a probability of user confusion if more than one of the strings is delegated into the root zone.)*

#### **4.1.1 Identification of Contention Sets**

*Contention sets are groups of applications containing identical or similar applied-for gTLD strings. Contention sets are identified during Initial Evaluation, following review of all applied-for gTLD strings. ICANN will publish preliminary contention sets once the String Similarity review is completed, and will update the contention sets as necessary during the evaluation and dispute resolution stages.*

*Applications for identical gTLD strings will be automatically assigned to a contention set.*

*[...]*

*The String Similarity Panel will also review the entire pool of applied-for strings to determine whether the strings proposed in any two or more applications are so similar that they would create a probability of user confusion if allowed to coexist in the DNS. The panel will make such a determination for each pair of applied-for gTLD strings. The outcome of the String Similarity review described in Module 2 is the identification of contention sets ...*

*[...]*

*As described elsewhere in this guidebook, cases of contention might be resolved by community priority evaluation [NB: community priority evaluation applies only to so-called “community” applications; it is not relevant here] or an agreement among the parties. Absent that, the last-resort contention resolution mechanism will be an auction.*

*[...]*

62. As provided in Module 4, the two methods relevant to resolving a contention such as between .hotels and .hoteis are *self-resolution* (i.e., an agreement between the two applicants for the contending strings) and *auction*:

#### **4.1.3 Self-Resolution of String Contention**

*Applicants that are identified as being in contention are encouraged to reach a settlement or agreement among themselves that resolves the contention. This may occur at any stage of the process, once ICANN publicly posts the applications received and the preliminary contention sets on its website.*

*Applicants may resolve string contention in a manner whereby one or more applicants withdraw their applications.*

*[...]*

#### **4.3 Auction: Mechanism of Last Resort**

*It is expected that most cases of contention will be resolved by the community priority evaluation, or through voluntary agreement among the involved applicants. Auction is a tie-breaker method for resolving string contention among the applications within a contention set, if the contention has not been resolved by other means.*

63. Module 5 of the Guidebook, titled *Transition to Delegation*, describes “the final steps required of an applicant for completion of the process, including execution of a registry agreement with ICANN and preparing for delegation of the new gTLD into the root zone.”<sup>45</sup> Section 5.1 states:

*ICANN's Board of Directors has ultimate responsibility for the New gTLD Program. The Board reserves the right to individually consider an application for a new gTLD to determine whether approval would be in the best interest of the Internet community. Under exceptional circumstances, the Board may individually consider a gTLD application. For example, the Board might individually consider an application as a result of GAC Advice on New gTLDs or of the use of an ICANN accountability mechanism.*<sup>46</sup>

[Underlining added]

## V. SUMMARY OF THE PARTIES' POSITIONS

64. The following brief summary of the parties' respective positions is provided with a view solely to assisting the reader to understand the present Declaration. It is *not* intended to recapitulate – and it does not recapitulate – the entirety of the parties' allegations and arguments. Additional references to the parties' positions, including submissions made by them in the course of the proceedings, are contained in the discussion at Part VI below.

### A. Booking.com's position

#### (i) *The Panel's Authority*

65. Booking.com submits that the mandate of the Panel is “to determine whether the contested actions of the ICANN Board are consistent with applicable rules”.<sup>47</sup> According to Booking.com:

*The set of rules against which the actions of the ICANN Board must be assessed includes: (i) ICANN's Articles of Incorporation and Bylaws – both of which must be interpreted in light of ICANN's Affirmation of Commitments, and both of which require compliance with inter alia International law and generally accepted good governance principles – and (ii) secondary rules created by ICANN, such as the Applicant Guidebook. In setting up, implementing and supervising its policies and processes, the Board must comply with the fundamental principles embodied in these rules. That obligation includes a duty to ensure compliance with its obligations to act in good faith, transparently, fairly, and in a manner that is non-discriminatory and ensures due process.*<sup>48</sup>

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<sup>45</sup> Module 5-2.

<sup>46</sup> Module 5-4.

<sup>47</sup> Reply, ¶ 3.

<sup>48</sup> Reply, ¶ 3.

66. Booking.com submits that IRP panels have broad authority to evaluate actions of the ICANN Board. An overly restrictive interpretation of the standard of review, such as proposed by ICANN in these proceedings, would, says Booking.com, “fail to ensure accountability on the part of ICANN and would be incompatible with ICANN’s commitment to maintain (and improve) robust mechanisms for accountability, as required by Article 9.1 of ICANN’s Affirmation of Commitments and ICANN’s core values.”<sup>49</sup>

**(ii) Booking.com’s Claims**

67. The purpose of the IRP initiated by Booking.com is, in its own words, “to challenge the ICANN Board’s handling of Booking.com’s application for the new gTLD .hotels.”<sup>50</sup> This includes the determination of the SSP to place .hotels and .hoteis in contention and the refusal of the Board (and its committees) to revise that determination. Elsewhere in its submissions, Booking.com makes an even broader claim; it asserts that it challenges the conduct of the ICANN Board in relation to what Booking.com refers to as the *setting up, implementation, supervision and review* of the entire of string similarity review process, and the Board’s alleged failure “to ensure due process and to respect its fundamental obligations to ensure good faith, transparency, fairness and non-discrimination” throughout.<sup>51</sup>
68. In effect, Booking.com’s specific claims can be divided into two broad categories: claims related to the string similarity review process generally; and claims related to the particular case of .hotels.
69. Booking.com professes that this case “is not about challenging a decision on the merits [i.e., the decision to place .hotels in contention]”; it is about “ICANN’s failure to respect fundamental [procedural] rights and principles in handling New gTLD applications, in particular in the context of String Similarity Review.”<sup>52</sup>
70. Booking.com also repeatedly emphasizes – and this is crucial – that *it does not challenge the validity or fairness of the process as set out in the Guidebook*. Rather, as indicated, it contests “the way in which that process was established, implemented and supervised by (or under the authority of) the ICANN Board.”<sup>53</sup> Equally crucial, as will be seen, is Booking.com’s acknowledgment that *the established process was followed* in the case of the review of .hotels.

**a. The string similarity review process**

71. According to Booking.com, the problem began when the ICANN Board failed to “provide transparency in the SSP selection process,” in particular by failing “to make clear how

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<sup>49</sup> Reply, ¶ 6.

<sup>50</sup> Reply, ¶ 7.

<sup>51</sup> Reply, ¶ 15.

<sup>52</sup> Reply, ¶ 14.

<sup>53</sup> Reply, ¶ 17.

[ICANN] would evaluate candidate responses or how it ultimately did so.”<sup>54</sup> The problem was compounded by the selection of ICC/University College London to perform string similarity reviews as the independent SSP. In Booking.com’s words:

*[T]he identities of the unsuccessful candidates (if any) to perform the String Similarity Review remain unknown. Applicants have never been given any information in relation to the candidate responses that were submitted. ... There is no indication that any other candidate expressed an interest in performing the String Similarity Review. No information has been provided as to the steps (if any) taken by ICANN to reach out to other potential candidates. Numerous questions remain: How did ICANN deal with the situation if there was only one (or only a very few) respondent(s) wishing to perform the String Similarity Review? How did this impact on the discussions with InterConnect Communications? What are the terms of ICANN’s contract with InterConnect Communications?*<sup>55</sup>

72. Booking.com also faults ICANN for “allowing the appointed SSP to develop and perform an unfair and arbitrary review process”, specifically, by allowing the SSP “to perform the String Similarity Review (i) without any (documented) plan or methodology ... (ii) without providing any transparency regarding the evaluators or the evaluation criteria ... and (iii) without informing applicants of its reasoning ...”.<sup>56</sup>
73. Among other things, Booking.com takes ICANN to task for establishing and posting the SSP Process Description and the SSP Manager’s Letter (see Part III.C above) only long after the string similarity review process had ended.<sup>57</sup>
74. It also alleges that the factors identified in the SSP Manager’s Letter are “arbitrary and baseless ... not supported by any methodology capable of producing compelling and defensible conclusions ... [which] has allowed applications with at least equally serious visual string similarity concerns – such as .parts/.paris, .maif/.mail, .srt/.srl, .vote/.voto and .date/.data ... – to proceed while singling out .hotels/.hoteis.”<sup>58</sup> According to Booking.com: “The failure to take actual human performance into account is at odds with the standard for assessment, *i.e.*, the likelihood of confusion on the part of the average Internet user. Hence, the approach is directly contrary to ICANN’s own policy.”<sup>59</sup>
75. Booking.com further contends that the SSP process is unfair and non-transparent due to the fact that the identity of SSP members has never been publicly disclosed.<sup>60</sup>
76. Further, Booking.com argues that the process is unfair, non-transparent and arbitrary – and thus violates ICANN policy – for failing to provide for a “well-documented rationale” for each

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<sup>54</sup> Reply, ¶ 20.

<sup>55</sup> Reply, ¶ 20.

<sup>56</sup> Reply, ¶ 23.

<sup>57</sup> Reply, ¶ 24.

<sup>58</sup> Reply, ¶ 25.

<sup>59</sup> Reply, ¶ 25.

<sup>60</sup> Reply, ¶ 26-27.



SSP determination. In the absence of reasons for each string similarity determination, says Booking.com, “there is no basis on which decisions can be evaluated and, where appropriate, challenged.”<sup>61</sup>

77. Another ground for Booking.com’s challenge is the alleged failure by the ICANN Board to providing “effective supervision or quality control” of the SSP: “If nobody but the evaluator has any insight into how the evaluation was carried out, no effective quality control can be performed.”<sup>62</sup> Nor, according to Booking.com, does the quality review of the SSP’s work supposedly performed by JAS Advisers (the independent consultant engaged by ICANN for this purpose) overcome the problem of a lack of transparency:

*Booking.com is not aware that any selection process was put in place in relation to the appointment of JAS Advisors to perform the String Similarity Review quality control. No criteria for performing the quality control were published. When ICANN was looking for evaluators, no call for expressions of interest or similar document was issued for the selection of quality controllers.*<sup>63</sup>

78. In any case, says Booking.com, the “quality control review over a random sampling of applications to, among other things, test whether the process [set out in the Guidebook] was followed,” which ICANN claims was performed on the SSP’s work,<sup>64</sup> could not provide adequate quality control of the string similarity review process.<sup>65</sup> Finally, Booking.com argues that the arbitrary and unfair result of the string similarity review concerning .hotels – i.e., the decision to place .hotels and .hoteis in contention – demonstrates that, “whatever quality control review ICANN may have engaged in ... must therefore have been deficient.”<sup>66</sup>

*b. The case of .hotels*

79. Booking.com argues, in part on the basis of expert evidence which it adduces in this IRP proceeding,<sup>67</sup> that “[t]here is no probability of user confusion if both .hotels and .hoteis were delegated as gTLD strings into the Internet root zone ... The SSP could not have reasonably found that the average reasonable Internet user is likely to be confused between the two strings.”<sup>68</sup> It continues:

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<sup>61</sup> Reply, ¶ 28-29.

<sup>62</sup> Reply, ¶ 30.

<sup>63</sup> Reply, ¶ 31. Booking.com states that it “doubts” that any quality review was in fact performed, whether by JAS Advisers or any other entity.

<sup>64</sup> Response, ¶ 30.

<sup>65</sup> Reply, ¶ 34.

<sup>66</sup> Reply, ¶ 38.

<sup>67</sup> Request, Annex 20, Expert Report of Prof. Dr. Piet Desmet of the Faculty of Arts, Department of Linguistics of Leuven University, dated 10 March 2014. Portions of the work underlying Prof. Desmet’s report were performed by Dr. Emmanuel Keuleers, Research Fellow in the Department of Experimental Psychology at Ghent University.

<sup>68</sup> Request, ¶ 58.

*Since .hotels and .hoteis are not confusingly similar, the determination that they are is contradictory to ICANN policy as established in the Applicant Guidebook. Acceptance of the determination, and repeated failure to remedy the wrongful determination, is a failure to act with due diligence and independent judgment, and a failure to neutrally and fairly apply established policies as required by Bylaws and Articles of Incorporation.<sup>69</sup>*

80. According to Booking.com, the Board should have acted to overturn the determination of the SSP either in the context of the Request for Reconsideration or under the authority accorded it by Module 5-4 of the Guidebook to “individually consider a gTLD application”.<sup>70</sup>
81. Booking.com claims that its DIDP Request alerted the Board to the need to intervene to “correct the errors in the process” related to .hotels, and that its Request for Reconsideration of the SSP determination further informed the Board of the many errors in the SSP’s review of .hotels, “giving the Board ample opportunity to correct those errors.”<sup>71</sup> Booking.com claims that the Board’s failure, when responding to the DIDP Request, “to offer any insight into the SSP’s reasoning”, its refusal to reconsider and overturn the SSP determination regarding .hotels on the sole ground (says Booking.com) that “the Reconsideration process ‘is not available as a mechanism to re-try the decisions of evaluation panels’”, and its failure to investigate Booking.com’s complaints of a lack of fairness and transparency in the SSP process, constitute violations of ICANN’s governing rules regarding string similarity review.<sup>72</sup>
82. According to Booking.com, among the most compelling evidence of ICANN’s failure in this regard are the statements made on the record by several members of the NGPC during its 10 September 2013 meeting at which Booking.com’s Request for Reconsideration was denied.<sup>73</sup> Given the importance that the Panel attaches to these statements, they are addressed in some detail in the Analysis in Part VI, below.
83. In its written submissions Booking.com asks the Panel to grant the following relief:

*Finding that ICANN breached its Articles of Incorporation, its Bylaws, and the gTLD Applicant Guidebook;*

*Requiring that ICANN reject the determination that .hotels and .hoteis are confusingly similar and disregard the resulting contention set;*

*Awarding Booking.com its costs in this proceeding; and*

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<sup>69</sup> Request, ¶ 59.

<sup>70</sup> Reply, ¶ 39.

<sup>71</sup> Reply, ¶ 41.

<sup>72</sup> Reply, ¶ 41. In the passage of Booking.com’s submissions referred to here (as elsewhere), Booking.com speaks of violations of ICANN’s obligations of “due process”, which, it says, comprise concepts such as the right to be heard, the right to receive reasons for decisions, publicity, etc. For reasons explained in Part VI, below, the Panel prefers to use the terms *fairness* and *transparency* to connote the essence of ICANN’s obligations under review in this IRP.

<sup>73</sup> See Part II.C, above.

*Awarding such other relief as the Panel may find appropriate or Booking.com may request.*

84. At the hearing Booking.com *further* requested that the Panel not only require ICANN to disregard the SSP determination regarding .hotels/.hoteis, but also order ICANN to “delegate both .hotels and .hoteis.”

#### **B. ICANN's position**

85. ICANN's position is best summed up by ICANN itself:

*Booking.com's IRP Request is really about Booking.com's disagreement with the merits of the String Similarity Panel's conclusion that .hotels and .hoteis are confusingly similar. But the Panel's determination does not constitute Board action, and the Independent Review Process is not available as a mechanism to re-try the decisions of an independent evaluation panel. The IRP Panel is tasked only with comparing contested actions of the ICANN Board to ICANN's Bylaws and Articles of Incorporation; it is not within the IRP Panel's mandate to evaluate whether the String Similarity Panel's conclusion that .hotels and .hoteis are confusingly similar was wrong.<sup>74</sup>*

86. According to ICANN, the Board “did exactly what it was supposed to do under its Bylaws, its Articles of Incorporation, and the Guidebook.”<sup>75</sup>

##### **(i) *The Panel's Authority***

87. Throughout its submissions ICANN repeatedly stresses what it says is the very limited authority enjoyed by IRP panels.
88. As provided in Article IV, Section 3(4) of ICANN's Bylaws, ICANN observes that this Panel (as all IRP panels) is charged only with “comparing contested actions of the Board to the Articles of Incorporation and Bylaws, and with declaring whether the Board has acted consistently with the provisions of those Articles of Incorporation and Bylaws.”<sup>76</sup>
89. ICANN notes that, in undertaking this *compare-and-declare* mission, the Panel is further constrained to apply the very specific “standard of review” set out in Bylaw Article IV, Section 3(4), which requires the Panel to focus on three particular questions: “did the Board act without conflict of interest in taking its decision?”; “did the Board exercise due diligence and care in having a reasonable amount of facts in front of them?”; and “did the Board members exercise independent judgment in taking the decision, believed to be in the best interests of the company [ICANN]?”<sup>77</sup>

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<sup>74</sup> Response, ¶ 9.

<sup>75</sup> Response, ¶ 8. Both parties agree that, as submitted by Booking.com, the “rules” at issue, against which the conduct of the ICANN Board is to be assessed, include the relevant provisions of the Guidebook.

<sup>76</sup> See for example Response, ¶2, ¶ 9.

<sup>77</sup> Response, ¶ 2.

90. ICANN further asserts that the IRP process “is not available as a mechanism to challenge the actions or inactions of ICANN staff or third parties that may be involved in ICANN activities,”<sup>78</sup> such as the action of the SSP which resulted in .hotels and .hoteis being placed in contention. Nor, says ICANN, may the IRP process be used as an “appeal mechanism” by which to overturn substantive decisions – such as the determination that .hotels and .hoteis are confusingly visually similar – with which an applicant may disagree.<sup>79</sup>
91. In this regard ICANN states that the affirmative relief sought by Booking.com – specifically, a declaration requiring that ICANN “reject the determination that .hotels and .hoteis are confusingly similar and disregard the resulting contention set” and (as requested at the hearing) that ICANN “delegate both .hotels and .hoteis” – exceeds the authority of the Panel.<sup>80</sup>

***(ii) ICANN's Response to Booking.com's Claims***

***a. The string similarity review process***

92. According to ICANN, “[e]arly on in the iterations of the Guidebook, it was determined that, in the initial evaluation stage, the String Similarity Panel would only examine strings for visual confusion;” and “[i]f applied-for strings are determined to so nearly resemble each other visually that it is likely to deceive or cause confusion, the string will be placed in a contention set, which is then resolved pursuant to the contention set resolution processes in Module 4 of the Guidebook.”<sup>81</sup>
93. According to ICANN, it was also determined early on that, as stated in Section 2.2.1.1 of the Guidebook, “[t]his similarity review will be conducted by an independent String Similarity Panel,” not by ICANN itself. ICC was duly selected to perform the string similarity review further to “an open and public request for proposals,” pursuant to which, as the successful bidder, “ICC was responsible for the development of its own process documents and methodology for performing the String Similarity Review consistent with the provisions of the Guidebook.”<sup>82</sup> ICANN emphasizes that “the Guidebook does not provide for any process by which ICANN (or anyone else) may conduct a substantive review of ICC’s results.”<sup>83</sup>
94. In ICANN’s submission, the alternative proposed by Booking.com, that “the ICANN Board – and the ICANN Board alone – was obligated to perform the String Similarity Review for the more than 1,900 new gTLD applications submitted,” is “untenable and is not supported by ICANN’s Bylaws or Articles.”<sup>84</sup> As noted by ICANN, the Guidebook defines six distinct

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<sup>78</sup> Response, ¶ 3.

<sup>79</sup> Response, ¶ 49.

<sup>80</sup> Response, ¶ 55.

<sup>81</sup> Response, ¶ 15 (underlining in original).

<sup>82</sup> Response, ¶ 16.

<sup>83</sup> Response, ¶ 17.

<sup>84</sup> Sur-Reply, ¶ 7.

review processes that every gTLD application is required to go through, including string similarity review; each of those review processes was conducted by independent experts specifically engaged by ICANN staff for the purpose.

95. ICANN submits that “there simply is no requirement – under ICANN’s governing documents or imposed by law – that would mandate that the ICANN Board inject itself into the day-to-day affairs of the evaluation process in the manner Booking.com proposes.”<sup>85</sup> It asserts that, consistent with well-settled legal principles, “neither ICANN’s Bylaws, nor the Articles, nor the Guidebook requires the ICANN Board to conduct any analysis of the decisions of third party experts retained to evaluate string similarity.”<sup>86</sup>
96. Moreover, ICANN asserts that “[s]imply because the ICANN Board has the discretion [under Section 5.1 (Module 5-4) of the Guidebook] to consider individual applications does not mean it is required to do so or that it should do so, particularly at an initial evaluation stage.”<sup>87</sup>
97. ICANN claims that that Booking.com’s repeated invocation of the Board’s so-called obligation to ensure “due process” in the administration of the New gTLD Program is misplaced. First, neither applicable California law nor any provision of the Bylaws, Articles of Incorporation or Guidebook “specifically affords any gTLD applicant a right to procedural ‘due process’ similar to that which is afforded in courts of law.”<sup>88</sup> Second, because ICANN conducts its activities in the public interest it nevertheless provides “more opportunity for parties to be heard and to dispute actions taken”<sup>89</sup> than most private corporate entities. Third, the “decision to proceed with the New gTLD Program followed many years of discussion, debate and deliberation within the ICANN community, including participation from end users, civil society, technical experts, business groups, governments and others.”<sup>90</sup> Fourth, and perhaps most importantly, “ICANN adhered to the policies and procedures articulated in its Bylaws, Articles of Incorporation, and the Guidebook, the latter of which was adopted only after being publicly vetted with ICANN’s stakeholders and the broader Internet community.”<sup>91</sup>
98. ICANN’s response to Booking.com’s various allegations regarding particular elements of the string similarity review process – including for example the selection of the SSP, the publication of the SSP’s methodology, the anonymity of the individuals SSP members, the supposed lack of quality control – is essentially three-fold: first, the actions challenged by Booking.com are *not Board actions*, but actions of ICANN staff or third parties, which cannot

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<sup>85</sup> Sur-Reply, ¶ 10.

<sup>86</sup> Sur-Reply, ¶ 10.

<sup>87</sup> Sur-Reply, ¶ 11. It was established during the hearing that the several references to this discretionary authority in ICANN’s written and oral submissions refer specifically to the authority conferred by Section 5.1 (Module 5-4) of the Guidebook.

<sup>88</sup> Sur-Reply, ¶ 18.

<sup>89</sup> Sur-Reply, ¶ 18.

<sup>90</sup> Sur-Reply, ¶ 18, fn 18.

<sup>91</sup> Sur-Reply, ¶ 18, fn 18.

be challenged by means of IRP proceedings; second, in any case, Booking.com's claims are *factually incorrect*, and there has been no violation of the Bylaws, Articles of Incorporation or Guidebook; third, Booking.com's claims are *time-barred* given that Article IV, Section 3(3) of the Bylaws requires that IRP requests "must be filed within thirty days of the posting of the minutes of the Board meeting ... that the requesting party contends demonstrates that ICANN violated its Bylaws or Articles of Incorporation."<sup>92</sup>

*b. The case of .hotels*

99. ICANN's position as regards the determination to place .hotels and .hoteis in contention is similar in many respects to its position regarding the string similarity review process generally. ICANN argues that the Board played no role whatsoever in performing the review of .hotels; that the SSP's determination was in any event well supported and there was no violation of applicable rules; and that the Guidebook does not provide for any process by which ICANN (or any other body, including an IRP panel) may conduct a substantive review of a string similarity determination.
100. In any event, ICANN asserts that .hotels and .hoteis in fact meet every one of the visual similarity criteria applied by the SSP, as set out in the SSP Manager's Letter. Moreover, .hotels and .hoteis scored a stunning 99% for visual similarity under the publicly available SWORD algorithm which, as provided by Section 2.2.1.1.2 (Module 2-7) of the Guidebook, establishes "one objective measure for consideration by the [SSP]". According to ICANN (in response to a question posed by the Panel during the hearing), this was the highest algorithmic score among the comparison of all non-identical pairs within the 1917 new gTLD applications received by ICANN;<sup>93</sup> the only other pair of non-exact match strings found to be confusingly visually similar – .unicorn and .unicom – scored only 94%.<sup>94</sup>
101. According to ICANN, "it was not clearly 'wrong,' as Booking.com argues, for the [SSP] to find that .hotels/.hoteis are confusingly similar."<sup>95</sup>
102. In conclusion, ICANN states that its conduct with respect to Booking.com's application for .hotels, including in evaluating Booking.com's Request for Reconsideration, was fully consistent with ICANN's Articles of Incorporation, its Bylaws and the procedures established in the Guidebook; and the fact that Booking.com disagrees with the SSP's determination to put .hotels and .hoteis in a contention set does not give rise to an IRP.
103. ICANN asks the Panel to deny Booking.com's IRP Request.

## VI. ANALYSIS

### A. The Panel's Authority

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<sup>92</sup> Sur-Reply, ¶¶ 20-42.

<sup>93</sup> A number of these applications were subsequently withdrawn.

<sup>94</sup> Identical pairs, of course, received a score of 100% for visual similarity under the SWORD algorithm.

<sup>95</sup> Response, ¶¶ 53.

104. The jurisdiction and authority of an IRP panel is expressly prescribed – and expressly limited – by the ICANN Bylaws. To recap, Article IV, Section 3 of the Bylaws provides:

*4. [The IRP Panel] shall be charged with comparing contested actions of the Board to the Articles of Incorporation and Bylaws, and with declaring whether the Board has acted consistently with the provisions of those Articles of Incorporation and Bylaws. The IRP Panel must apply a defined standard of review to the IRP request, focusing on:*

- a. did the Board act without conflict of interest in taking its decision?;*
- b. did the Board exercise due diligence and care in having a reasonable amount of facts in front of them?; and*
- c. did the Board members exercise independent judgment in taking the decision, believed to be in the best interests of the company [ICANN]?*

[...]

- 11. The IRP Panel shall have the authority to:*

[...]

*c. declare whether an action or inaction of the Board was inconsistent with the Articles of Incorporation or Bylaws; and*

*d. recommend that the Board stay any action or decision, or that the Board take any interim action, until such time as the Board reviews and acts upon the opinion of the IRP;*

[...]

*18. [...] The IRP Panel shall make its declaration based solely on the documentation, supporting materials, and arguments submitted by the parties [...]*

[Underlining added]

105. Similarly, Article 8 of the Supplementary Procedures reads:

**8. Standard of Review**

*The IRP is subject to the following standard of review: (i) did the ICANN Board act without conflict of interest in taking its decision; (ii) did the ICANN Board exercise due diligence and care in having sufficient facts in front of them; (iii) did the ICANN Board members exercise independent judgment in taking the decision, believed to be in the best interests of the company?*

*If a requestor demonstrates that the ICANN Board did not make a reasonable inquiry to determine it had sufficient facts available, ICANN Board members had a conflict of interest in participating in the decision, or the decision was not an exercise in independent judgment, believed by the ICANN Board to be in the best interests of the company, after taking account of the Internet community and the global public interest, the requestor will have established proper grounds for review.*

106. There is no dispute as regards the Panel's duty to compare the actions of the Board to ICANN's Articles of Incorporation and Bylaws (and, in this case, Guidebook) with a view to

declaring whether those actions are inconsistent with applicable policies. Where the parties disagree is with respect to the standard of review to be applied by the Panel in assessing Board conduct.

107. ICANN submits that its Bylaws “specify that a deferential standard of review be applied when evaluating the actions of the ICANN Board ... the rules are clear that the appointed IRP Panel is neither asked to, nor allowed to, substitute its judgment for that of the Board.”<sup>96</sup> Booking.com argues that this “is simply wrong. No such specification is made in ICANN’s Bylaws or elsewhere, and a restrictive interpretation of the standard of review would ... fail to ensure accountability on the part of ICANN and would be incompatible with ICANN’s commitment to maintain (and improve) robust mechanisms for accountability.”<sup>97</sup>
108. In the opinion of the Panel, there can be no question but that the provisions of the ICANN Bylaws establishing the Independent Review Process and defining the role of an IRP panel specify that the ICANN Board enjoys a large degree of discretion in its decisions and actions. So long as the Board acts without conflict of interest and with due care, it is entitled – indeed, required – to exercise its independent judgment in acting in what it believes to be the best interests of ICANN. The only substantive check on the conduct of the ICANN Board is that such conduct may not be inconsistent with the Articles of Incorporation or Bylaws – or, the parties agree, with the Guidebook. In that connection, the Panel notes that Article 1, Section 2 of the Bylaws also clearly states that in exercising its judgment, the Board (indeed “[a]ny ICANN body making a recommendation or decision”) shall itself “determine which core values are most relevant and how they apply to the specific circumstances of the case at hand.”
109. In other words, in making decisions the Board is required to conduct itself reasonably in what it considers to be ICANN’s best interests; where it does so, the only question is whether its actions are or are not consistent with the Articles, Bylaws and, in this case, with the policies and procedures established in the Guidebook.
110. There is also no question but that the authority of an IRP panel to compare contested actions of the Board to the Articles of Incorporation and Bylaws, and to declare whether the Board has acted consistently with the Articles and Bylaws, does not extend to opining on the nature of those instruments. Nor, in this case, does our authority extend to opining on the nature of the policies or procedures established in the Guidebook. In this regard it is recalled that Booking.com itself repeatedly stresses that it does not contest the validity or fairness of the string similarity review process as set out in the Guidebook, but merely whether ICANN’s actions were consistent with various elements of that process. Stated differently, our role in this IRP includes assessing whether the applicable rules – in this case, the rules regarding string similarity review – were followed, not whether such rules are appropriate or advisable.
111. Nevertheless, this does not mean that the IRP Panel may only review ICANN Board actions or inactions under the deferential standard advocated by ICANN in these proceedings. Rather, as explained below, the IRP Panel is charged with “objectively” determining whether

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<sup>96</sup> Response, ¶ 24.

<sup>97</sup> Reply, ¶ 6.



or not the Board's actions are in fact consistent with the Articles, Bylaws and Guidebook, which the Panel understands as requiring that the Board's conduct be appraised independently, and without any presumption of correctness.

112. In the only other IRP of which the Panel is aware in which such questions were addressed in a published decision, the distinguished members of the IRP panel had this to say about the role of an IRP panel, and the applicable standard of review, in appraising Board action:

*The Internet Corporation for Assigned Names and Numbers is a not-for profit corporation established under the law of the State of California. That law embodies the 'business judgment rule'. Section 309 of the California Corporations Code provides that a director must act 'in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders...' and shields from liability directors who follow its provisions. However ICANN is no ordinary non-profit California corporation. The Government of the United States vested regulatory authority of vast dimension and pervasive global reach in ICANN. In 'recognition of the fact that the Internet is an international network of networks, owned by no single nation, individual or organization' – including ICANN -- ICANN is charged with 'promoting the global public interest in the operational stability of the Internet...' ICANN 'shall operate for the benefit of the Internet community as a whole, carrying out its activities in conformity with relevant principles of international law and applicable international conventions and local law...' Thus, while a California corporation, it is governed particularly by the terms of its Articles of Incorporation and Bylaws, as the law of California allows. Those Articles and Bylaws, which require ICANN to carry out its activities in conformity with relevant principles of international law, do not specify or imply that the International [sic] Review Process provided for shall (or shall not) accord deference to the decisions of the ICANN Board. The fact that the Board is empowered to exercise its judgment in the application of ICANN's sometimes competing core values does not necessarily import that that judgment must be treated deferentially by the IRP. In the view of the Panel, the judgments of the ICANN Board are to be reviewed and appraised by the Panel objectively, not deferentially. The business judgment rule of the law of California, applicable to directors of California corporations, profit and nonprofit, in the case of ICANN is to be treated as a default rule that might be called upon in the absence of relevant provisions of ICANN's Articles and Bylaws and of specific representations of ICANN ... that bear on the propriety of its conduct. In the instant case, it is those Articles and Bylaws, and those representations, measured against the facts as the Panel finds them, which are determinative.<sup>98</sup>*

[Underlining added.]

113. While on no way bound by that decision, we agree with its conclusions in this respect.
114. At the end of the day we fail to see any significant difference between the parties' positions in this regard. The process is clear, and both parties acknowledge, that the Panel is tasked with determining whether or not the Board's actions are consistent with ICANN's Articles of Incorporation, Bylaws and the Guidebook. Such a determination calls for what the panel in

<sup>98</sup> ICDR Case No. 50 117 T 00224 08, *ICM Registry, LLC v. ICANN*, Declaration dated 19 February 2010 ("*ICM Registry*"), ¶ 136.

the *ICM Registry* matter called an “objective” appraisal of Board conduct as measured against the policies and rules set out in those instruments; all agree that it is the Articles, Bylaws and Guidebook which are determinative.

115. That being said, we also agree with ICANN to the extent that, in determining the consistency of Board action with the Articles, Bylaws and Guidebook, an “IRP Panel is neither asked to, nor allowed to, substitute its judgment for that of the Board.” In other words, it is not for the Panel to opine on whether the Board could have acted differently than it did; rather, our role is to assess whether the Board’s action was consistent with applicable rules found in the Articles, Bylaws and Guidebook. Nor, as stated, is it for us to purport to appraise the policies and procedures established by ICANN in the Guidebook (since, again, this IRP is not a challenge to those policies and procedures themselves<sup>99</sup>), but merely to apply them to the facts.
116. With the foregoing firmly in mind, the Panel turns now to the issues to be determined in order to resolve the present dispute.

#### **B. The String Similarity Review Process**

117. The Panel is not unsympathetic to Booking.com’s complaints regarding the string similarity review process as established by the Guidebook. There is no question but that that process lacks certain elements of transparency and certain practices that are widely associated with requirements of fairness. For example, the Guidebook provides no means for applicants to provide evidence or make submissions to the SSP (or any other ICANN body) and so be fully “heard” on the substantive question of the similarity of their applied-for gTLD strings to others.
118. Indeed, as stated at the outset of this Declaration, these observations and the concerns that they engender were voiced by several members of the ICANN Board’s New gTLD Program Committee which voted to accept the BGC’s Recommendation to deny Booking.com’s Request for Reconsideration. The Panel can do no better than reproduce the statements made by the NGPC members in this respect, as recorded in the minutes of the NGPC’s 10 September 2013 meeting.<sup>100</sup>

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<sup>99</sup> As discussed in more detail in the following section (at para. 117 and following) and again at Part IV of this Declaration, the important questions that Booking.com highlights in its pleadings, as to whether the string similarity review process is consistent with ICANN’s guiding principles of transparency and fairness, and regarding the published views of various members of ICANN’s NGPC in this respect, are matters which the ICANN Board, in its discretion, may wish to consider on its own motion in the context of the present case, in accordance with its authority under Section 5.1 (Module 5-4) of the Guidebook, or when it issues the Guidebook for round two of the New gTLD Program. Those questions include a lack of clarity surrounding the way in which the string similarity review is conducted by the SSP, and the absence of any means for applicants to be heard in the string similarity review process where they may have evidence to adduce or arguments to make (such as the evidence and arguments presented by Booking.com to this Panel), which could in fact be relevant to the SSP’s determination.

<sup>100</sup> Request, Annex 16.

- Mr. George Sadowski stated his intention to abstain from the vote because, although “he understood that the BGC did the right thing, [he] thought the end result that was contrary to ICANN’s ... and the user’s best interests.”
  - Ms. Olga Madruga-Forti also stated her intention to abstain from voting on the BGC recommendation “because there was not sufficient rationale provided for why the string similarity review panel made its determination.”
  - In response to a comment by the Chair that the Request for Reconsideration deserved to be denied “[b]ecause the process was followed,” Mr. Ray Plzak “agreed that the process was followed, but noted that the process needs to be reviewed to potentially add a mechanism that would allow persons who don’t agree with the outcome to make an objection, other than using a Reconsideration Request.”
  - Mr. Plzak “recommended the Committee send a strong signal to the BGC, or adopt a resolution recommending that the BGC consider development of a different mechanism to provide an avenue for the community to appeal the outcome of a decision based on the merits.”
  - Ms. Madruga-Forti agreed and “recommended that in the future, a remand or appeals mechanism may help alleviate the concerns noted.”
  - Mr. Bill Graham also agreed with Mr. Plzak’s suggestion, and noted that “generally, there is a considerable level of discomfort and dissatisfaction with the process as expressed by Committee members.”
  - The Chair “agreed with [Mr. Graham’s] sentiment.”
  - The General Counsel and Secretary noted that ICANN ... “has tried to encourage more use of the ombudsman, or other accountability mechanisms for these types of concerns.”
119. Ultimately, five members of the NGPC voted in favour of the resolution accepting the BGC’s Recommendation; two members were unavailable to vote; and four members abstained. The abstaining members offered the following voting statements:
- Mr. Plzak stated that he abstained from voting “because he is disappointed in what is being done to remedy the situation. [He] would like to see more resolve to fix the process.”
  - Ms. Madruga-Forti stated that:

*[T]he BGC has done an appropriate job of applying a limited review standard to the application for reconsideration, but unfortunately, in this circumstance, to apply that limited review accompanied by a lack of information regarding the rationale of the string similarity review panel is not possible in a logical and fair manner. The public interest would not be served by applying the limited review standard without proper information on the basis and reasoning for the decision of the panel. In my opinion, the public interest would be better served by abstaining and continuing to explore ways to*

*establish a better record of the rationale of the string similarity review panel in circumstances such as this.*

- Mr. Kuo-Wei Wu agreed with Ms. Madruga-Forti's and Mr. Plzak's voting statements.
- Mr. Sadowsky provided the following detailed statement:

*I have a strong concern regarding the ratification of the BGC recommendation to deny the reconsideration request regarding string contention between .hoteis and .hotels, and I therefore have therefore abstained when the vote on this issue was taken.*

*The reconsideration process is a very narrowly focused instrument, relying solely upon investigating deviations from established and agreed upon process. As such, it can be useful, but it is limited in scope. In particular, it does not address situations where process has in fact been followed, but the results of such process have been regarded, sometimes quite widely, as being contrary to what might be best for significant or all segments of the ... community and/or Internet users in general.*

*The rationale underlying the rejection of the reconsideration claim is essentially that the string similarity process found that there was likely to be substantial confusion between the two, and that therefore they belonged in a contention set. Furthermore, no process has been identified as having been violated and therefore there is nothing to reconsider. As a Board member who is aware of ICANN's ... Bylaws, I cannot vote against the motion to deny reconsideration. The motion appears to be correct based upon the criteria in the Bylaws that define the reconsideration process and the facts in this particular case. However, I am increasingly disturbed by the growing sequence of decisions that are based upon a criterion for user confusion that, in my opinion, is not only both incomplete and flawed, but appears to work directly against the concept that users should not be confused. I am persuaded by the argument made by the proponents of reconsideration in this case that users will in fact not be confused by .hoteis and .hotels, since if they enter the wrong name, they are very likely to be immediately confronted by information in a language that they did not anticipate.*

*Confusion is a perceptual issue. String similarity is only one consideration in thinking about perceptual confusion and in fact it is not always an issue. In my opinion, much more perceptual confusion will arise between .hotel and .hotels than between .hotels and .hoteis. Yet if we adhere strictly to the Guidebook and whatever instructions have or have not been given to string similarity experts, it is my position that we work against implementing decisions that assist in avoiding user confusion, and we work in favor of decisions that are based upon an incorrect, incomplete and flawed ex ante analysis of the ICANN Network real issues with respect to user confusion.*

*The goal of the string similarity process is the minimization of user confusion and ensuring user trust in using the DNS ... The string similarity exercise is one of the means in the new gTLD ... process to minimize such confusion and to strengthen user trust. In placing our emphasis, and in fact our decisions, on string similarity only, we are unwittingly substituting the means for the goal, and making decisions regarding the goal on the basis of a means test. This is a disservice to the Internet user community.*

*I cannot and will not vote in favor of a motion that reflects, directly or indirectly, an unwillingness to depart from what I see as such a flawed position and which does not reflect in my opinion an understanding of the current reality of the situation.*

120. These statements reflect to an important degree the Panel's own analysis.
121. The elements of the string similarity review process were established and widely published several years ago, after extensive consultation and debate among ICANN stakeholders and the Internet community. Booking.com correctly describes the process established (or "crystallized") in the Guidebook as a component of "a consensus policy" concerning the introduction of new gTLDs.<sup>101</sup>
122. The Guidebook makes clear that, as part of the initial evaluation to which all applied-for gTLDs are subject, each string would be reviewed for a number of factors, one of which is "string similarity", which involves a determination of "whether the applied-for gTLD string is so similar to other strings that it would create a probability of user confusion"<sup>102</sup>. The term "user" is elaborated elsewhere in the Guidebook, which speaks of confusion arising "in the mind of the average, reasonable Internet user."<sup>103</sup>
123. The Guidebook explains that string similarity review comprises merely a "visual similarity check",<sup>104</sup> with a view to identifying only "visual string similarities that would create a probability of user confusion."<sup>105</sup>
124. The Guidebook makes clear that string similarity reviews would be conducted by an independent third party – the SSP – that would have wide (though not complete) discretion both in formulating its methodology and in determining string similarity on the basis of that methodology.
125. Section 2.2.1.1.2 of the Guidebook, titled "Review Methodology", provides that the SSP "is informed in part by an algorithmic score for ... visual similarity," which "will provide one objective measure for consideration by the [SSP]." Section 2.2.1.1.2 further states that, in addition to "examin[ing] all the algorithm data," the SSP will "perform its own review of similarities between strings and whether they rise to the level of string confusion." It is noted that the objective algorithmic score is to be treated as "only indicative". Crucially, "the final determination of similarity is entirely up to the [SSP's] judgment." (Underlining added)
126. In sum, the Guidebook calls for the SSP to determine whether two strings are so "visually similar" as to create a "probability of confusion" in the mind of an "average, reasonable Internet user." In making this determination, the SSP is informed by an "algorithmic score", to ensure that the process comprises at least one "objective measure". However, the algorithmic score is not determinative. The SSP also develops and performs "its own review". At the end of the day, the determination is entirely a matter of "the [SSP's] judgment."

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<sup>101</sup> Request, ¶ 13.

<sup>102</sup> Guidebook, §2.2 (Module 2-4).

<sup>103</sup> Guidebook, §2.2.1.1.2. (Underlining added)

<sup>104</sup> Guidebook, §2.2.1.1. (Underlining added)

<sup>105</sup> Guidebook, §2.2.1.1.1. (Underlining added)

127. By its very nature this process is highly discretionary. It is also, to an important degree, subjective. The Guidebook provides no definition of “visual similarity”, nor any indication of how such similarity is to be objectively measured other than by means of the SWORD algorithm. The Guidebook provides no definition of “confusion,” nor any definition or description of an “average, reasonable Internet user.” As Mr. Sadowski of the NGPC put it: “Confusion is a perceptual issue.” (Mr. Sadowski further noted: “String similarity is only one consideration in thinking about perceptual confusion, and in fact it is not always an issue.) The Guidebook mandates the SSP to develop and apply “its own review” of visual similarity and “whether similarities rise to the level of user confusion”, in addition to SWORD algorithm, which is intended to be merely “indicative”, yet provides no substantive guidelines in this respect.
128. Nor does the process as it exists provide for gTLD applicants to benefit from the sort of procedural mechanisms – for example, to inform the SSP’s review, to receive reasoned determinations from the SSP, or to appeal the merits of those determinations – which Booking.com claims are required under the applicable rules. Clearly, certain ICANN NGPC members themselves consider that such input would be desirable and that changes to the process are required in order for the string similarity review process to attain its true goal, which Mr. Sadowski referred to as “the minimization of user confusion and ensuring user trust in using the DNS”. However, as even the abstaining members of the NGPC conceded, the fact is that the sort of mechanisms that Booking.com asserts are required (and which those NGPC members believe should be required) are simply not part of the string similarity review process as currently established. As to whether they *should* be, it is not our place to express an opinion, though we note that such additional mechanisms surely would be consistent with the principles of transparency and fairness.
129. We add that we agree with ICANN that the time has long since passed for Booking.com or any other interested party to ask an IRP panel to review the actions of the ICANN Board in relation to the establishment of the string similarity review process, including Booking.com’s claims that specific elements of the process and the Board decisions to implement those elements are inconsistent with ICANN’s Articles and Bylaws. Any such claims, even if they had any merit, are long since time-barred by the 30-day limitation period set out in Article IV, Section 3(3) of the Bylaws. As ICANN expressed during the hearing, if Booking.com believed that there were problems with the Guidebook, it should have objected at the time the Guidebook was first implemented.
130. When asked during the hearing about its failure to object timely, Booking.com argued that it could not have known how the Board’s actions – that is, how the process established in the Guidebook – would affect it prior to the submission of its application for .hotels. However, that is not a persuasive or meritorious answer. As did all stakeholders, Booking.com had the opportunity to challenge the Board’s adoption of the Guidebook, at the time, if it considered any of its elements to be inconsistent with ICANN’s Articles of Incorporation or Bylaws.

### **C. The Case of .hotels**

131. In the light of the preceding analysis of Booking.com’s challenge concerning the ICANN Board’s actions in relation to the string similarity review process generally, the Panel is not

persuaded by its challenge concerning the Board's conduct in relation to the review of .hotels specifically.

132. There are two principal elements to this part of Booking.com's case: a challenge in relation to the process followed by the SSP; and a challenge in relation to the Board's handling of Booking.com's Request for Reconsideration of the SSP's determination. However, the fundamental obstacle to Booking.com's case is that *the established process was followed in all respects*.
133. Booking.com itself acknowledges that "the process was followed" by the SSP, which determined that .hotels and .hoteis were so visually similar as to warrant being placed in a contention set. So too did all of the NGPC members who commented on the matter recognize that "the process was followed" – for all their stated misgivings concerning the outcome of the process.
134. The same is true of the Request for Reconsideration. The Panel is struck by the extent and thoughtfulness not only of the NGPC's consideration of the issue, certain aspects of which are discussed above, but of the BGC's detailed analysis and its Recommendation to the NGPC, on the basis of which Booking.com's Request for Reconsideration was denied. Contrary to Booking.com's allegations, in neither instance was this merely a blind acceptance of a decision of a subordinate body. In fact, the reconsideration process itself, however limited and perhaps imperfect it may be, is inconsistent with Booking.com's claims of lack of "due process".
135. Although not addressed in great detail by the parties, the Panel considers several observations made by the BGC in its 1 August 2013 Recommendation to be particularly apposite:
  - *These standing requirements [for Requests for Reconsideration] are intended to protect the reconsideration process from abuse and to ensure that it is not used as a mechanism simply to challenge an action with which someone disagrees, but that it is limited to situations where the staff [for the Board] acted in contravention of established policies.*<sup>106</sup>
  - *Although the String Similarity Review was performed by a third party, ICANN has determined that the Reconsideration process can properly be invoked for challenges of the third party's decisions where it can be stated that either the vendor failed to follow its process in reaching the decision, or that ICANN staff failed to follow its process in accepting that decision.*<sup>107</sup>
  - *Booking.com does not suggest that the process for String Similarity Review set out in the Applicant Guidebook was not followed, or that ICANN staff violated any established ICANN policy in accepting the [SSP] decision on placing .hotels and .hoteis in contention sets. Instead, Booking.com is supplanting what it believes the review*

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<sup>106</sup> BGC Recommendation, p. 2.

<sup>107</sup> BGC Recommendation, p. 4. The BGC explains that "Because the basis for the Request is not Board conduct, regardless of whether the 20 December 2012 version, or the 11 April 2013 version, of the Reconsideration Bylaws is operative, the BGC's analysis and recommendation below would not change."

methodology for assessing visual similarity should have been, as opposed to the methodology set out at Section 2.2.1.1.2 of the Applicant Guidebook. In asserting a new review methodology, Booking.com is asking the BGC (and the Board through the New gTLD Program Committee (NGPC)) to make a substantive evaluation of the confusability of the strings and to reverse the decision. In the context of the New gTLD Program, the Reconsideration process is not however intended for the Board to perform a substantive review of [SSP] decisions. While Booking.com may have multiple reasons as to why it believes that its application for .hotels should not be in contention set with .hoteis, Reconsideration is not available as a mechanism to re-try the decisions of the evaluation panels.<sup>108</sup>

▪ Booking.com also claims that its assertions regarding the non-confusability of the .hotels and .hoteis strings demonstrate that “it is contrary to ICANN policy to put them in a contention set.” (Request, pages 6-7.) This is just a differently worded attempt to reverse the decision of the [SSP]. No actual policy or process is cited by Booking.com, only the suggestion that – according to Booking.com – the standards within the Applicant Guidebook on visual similarity should have resulted in a different outcome for the .hotels string. This is not enough for Reconsideration.<sup>109</sup>

▪ Booking.com argues that the contention set decision was taken without material information, including Booking.com’s linguistic expert’s opinion, or other “information that would refute the mistaken contention that there is likely to be consumer confusion between ‘.hotels’ and ‘.hoteis.’” (Request, page 7.) However, there is no process point in the String Similarity Review for applicants to submit additional information. This is in stark contrast to the reviews set out in Section 2.2.2 of the Applicant Guidebook, including the Technical/Operational review and the Financial Review, which allow for the evaluators to seek clarification or additional information through the issuance of clarifying questions. (AGB, Section 2.2.2.3 (Evaluation Methodology).)<sup>110</sup>

▪ Just as the process does not call for additional applicant inputs into the visual similarity review, Booking.com’s call for further information on the decision to place .hotels and .hoteis in a contention set ... is similarly not rooted in any established ICANN process at issue.[...] While applicants may avail themselves of accountability mechanism to challenge decisions, the use of an accountability mechanism when there is no proper ground to bring a request for review under the selected mechanism does not then provide opportunity for additional substantive review of decisions already taken.<sup>111</sup>

▪ [W]hile we understand the impact that Booking.com faces by being put in a contention set, and that it wishes for more narrative information regarding the [SSP’s] decision, no such narrative is called for in the process.<sup>112</sup>

▪ The Applicant Guidebook sets out the methodology used when evaluating visual similarity of strings. The process documentation provided by the String Similarity Review Panel describes the steps followed by the [SSP] in applying the methodology

<sup>108</sup> BGC Recommendation, p. 5.

<sup>109</sup> BGC Recommendation, p. 6.

<sup>110</sup> BGC Recommendation, p. 6.

<sup>111</sup> BGC Recommendation, pp. 6-7.

<sup>112</sup> BGC Recommendation, p. 7.



*set out in the Applicant Guidebook. ICANN then coordinates a quality assurance review over a random selection of [SSP's] reviews to gain confidence that the methodology and process were followed. That is the process used for a making and assessing a determination of visual similarity. Booking.com's disagreement as to whether the methodology should have resulted in a finding of visual similarity does not mean that ICANN (including the third party vendors performing String Similarity Review) violated any policy in reaching the decision (nor does it support a conclusion that the decision was actually wrong).<sup>113</sup>*

▪ *The [SSP] reviewed all applied for strings according to the standards and methodology of the visual string similarity review set out in the Applicant Guidebook. The Guidebook clarifies that once contention sets are formed by the [SSP], ICANN will notify the applicants and will publish results on its website. (AGB, Section 2.2.1.1.1.) That the [SSP] considered its output as "advice" to ICANN (as stated in its process documentation) is not the end of the story. Whether the results are transmitted as "advice" or "outcomes" or "reports", the important query is what ICANN was expected to do with that advice once it was received. ICANN had always made clear that it would rely on the advice of its evaluators in the initial evaluation stage of the New gTLD Program, subject to quality assurance measures. Therefore, Booking.com is actually proposing a new and different process when it suggests that ICANN should perform substantive review (instead of process testing) over the results of the String Similarity Review Panel's outcomes prior to the finalization of contention sets.<sup>114</sup>*

▪ *As there is no indication that either the [SSP] or ICANN staff violated any established ICANN policy in reaching or accepting the decision on the placement of .hotels and .hoteis in a non-exact contention set, this Request should not proceed.<sup>115</sup>*

136. These excerpts of the BGC Recommendation not only illustrate the seriousness with which Booking.com's Request for Reconsideration was heard, they mirror considerations to which we fully subscribe and which we find apply as well, with equal force and effect, in the context of Booking.com's IRP Request.
137. It simply cannot be said – indeed, it is not even alleged by Booking.com – that the established process was not followed by the ICANN Board or any third party either in the initial string similarity review of .hotels or in the reconsideration process.
138. Booking.com was asked at the hearing to identify *with particularity* the ICANN Board's actions (including inactions) in this case that it claims are inconsistent with ICANN's Articles of Incorporation, Bylaws or the Guidebook and regarding which it asks the Panel to render a declaration. It identified four:
- The Board's adoption of certain provisions of the Guidebook, including the allegedly ill-defined, unfair and non-transparent procedures for selecting the SSP and supervising the SSP's performance of the string similarity review process. As discussed, any claims in this regard are time-barred.

<sup>113</sup> BGC Recommendation, p. 7.

<sup>114</sup> BGC Recommendation, p. 8.

<sup>115</sup> BGC Recommendation, p. 10.

- The Board’s acceptance of the SSP determination. As ICANN argues, there was no action (or inaction) by the Board here, no decision made (or not made) by the Board or any other body to accept the SSP’s determination. The Guidebook provides that applied-for strings “will be placed in contention set” where the SSP determines the existence of visual similarity likely to give rise to user confusion. Simply put, under the Guidebook the Board is neither required nor entitled to intervene at this stage to accept or not accept the SSP’s determination. Booking.com is correct that the Board could nevertheless have stepped in and reversed the SSP determination under Section 5.1 (Module 5-4) of the Guidebook, but did not do so; that inaction is addressed below.
  - The Board’s denial of Booking.com’s Request for Reconsideration. As discussed above, there is nothing in the evidence that even remotely suggests that ICANN’s conduct in this regard was inconsistent with its Articles, Bylaws or the Guidebook. On the contrary, we have already stated that the detailed analysis performed by the BGC and the extensive consideration of the BGC Recommendation by the NGCP undermine any claim that ICANN failed to exercise due care and independent judgment, or that its handling of the Request for Reconsideration was inconsistent with applicable rules or policy. As discussed above, just as in the present IRP, the question in the reconsideration process is whether the established process was followed. This was the question that the BGC and NGPC asked themselves in considering Booking.com’s Request for Reconsideration, and which they properly answered in the affirmative in denying Booking.com’s request.
  - The Board’s refusal to “step in” and exercise its authority under Section 5.1 (Module 5-4) of the Guidebook to “individually consider an application for a new gTLD to determine whether approval would be in the best interest of the Internet community.” As pointed out by ICANN during the hearing, the fact that the ICANN Board enjoys such discretion and may choose to exercise it any time does not mean that it is bound to exercise it, let alone at the time and in the manner demanded by Booking.com. In any case, the Panel does not believe that the Board’s inaction in this respect was inconsistent with ICANN’s Articles of Incorporation or Bylaws or indeed with ICANN’s guiding principles of transparency and fairness, given (1) Booking.com’s concession that the string similarity review process was followed; (2) the indisputable conclusion that any challenge to the adoption of the SSP process itself is time-barred; (3) the manifestly thoughtful consideration given to Booking.com’s Request for Reconsideration by the BGC; and (4), the fact that, notwithstanding its protestations to the contrary, Booking.com’s real dispute seems to be with the process itself rather than how the process was applied in this case (given that, as noted, Booking.com concedes that the process was indeed followed).
139. The Panel further considers that these – in addition to any and all other potential (and allegedly reviewable) actions identified by Booking.com during the course of these proceedings – fail on the basis of Booking.com’s dual acknowledgement that it does not challenge the validity or fairness of the string similarity review process, and that that process was duly followed in this case.

140. Finally, the panel notes that Booking.com’s claim – largely muted during the hearing – regarding alleged “discrimination” as regards the treatment of its application for .hotels also founders on the same ground. Booking.com acknowledges that the established string similarity review process was followed; and there is absolutely no evidence whatsoever that .hotels was treated any differently than any other applied-for gTLD string in this respect. The mere fact that the *result* of the string similarity review of .hotels differed from the results of the reviews of the vast majority of other applied-for strings does not suggest discriminatory treatment. In any event, the Panel cannot but note the obvious, which is that .hotels is not alone in having been placed in contention by the SSP. So too was .hoteis; and so too were .unicom and .unicorn. Moreover, and once again, it is recalled that Booking.com does not claim to challenge the merits of the string similarity review, that is, the determination that .hotels and .hoteis are so visually similar as to warrant placement in a contention set.

#### **D. Conclusion**

141. In launching this IRP, Booking.com no doubt realized that it faced an uphill battle. The very limited nature of IRP proceedings is such that any IRP applicant will face significant obstacles in establishing that the ICANN Board acted inconsistently with ICANN’s Articles of Incorporation or Bylaws. In fact, Booking.com acknowledges those obstacles, albeit inconsistently and at times indirectly.
142. Booking.com purports to challenge “the way in which the [string similarity review] process was established, implemented and supervised by (or under the authority of) the ICANN Board”; yet it also claims that it *does not challenge the validity or fairness of the string similarity review process as set out in the Guidebook*. It asks the Panel to overturn the SSP’s determination in this case and to substitute an alternate result, in part on the basis of its own “expert evidence” regarding similarity and the probability of user confusion as between .hotels and .hoteis; yet it claims that it *does not challenge the merits of the SSP determination and it acknowledges that the process set out in the Guidebook was duly followed* in the case of its application for .hotels.
143. In sum, Booking.com has failed to overcome the very obstacles that it recognizes exist.
144. The Panel finds that Booking.com has failed to identify any instance of Board action or inaction, including any action or inaction of ICANN staff or a third party (such as ICC, acting as the SSP), that could be considered to be inconsistent with ICANN’s Articles of Incorporation or Bylaws or with the policies and procedures established in the Guidebook. This includes the challenged actions of the Board (or any staff or third party) in relation to what Booking.com calls the implementation and supervision of the string similarity review process generally, as well as the challenged actions of the Board (or any staff or third party) in relation to the string similarity review of .hotels in particular.
145. More particularly, the Panel finds that the string similarity review performed in the case of .hotels was not inconsistent with the Articles or Bylaws or with what Booking.com refers to as the “applicable rules” as set out in the Guidebook.
146. To the extent that the Board’s adoption and implementation of specific elements of the new gTLD Program and Guidebook, including the string similarity review process, could

potentially be said to be inconsistent with the principles of transparency or fairness that underlie ICANN's Articles and Incorporation and Bylaws (which the Panel does not say is the case), the time to challenge such action has long since passed.

147. Booking.com's IRP Request must be denied.

## VII. THE PREVAILING PARTY; COSTS

148. Article IV, Section 3(18) of the Bylaws requires that the Panel "specifically designate the prevailing party." This designation is germane to the allocation of costs, given that Article IV, Section 3(18) provides that the "party not prevailing shall ordinarily be responsible for bearing all costs of the IRP Provider."
149. The same provision of the Bylaws also states that "in an extraordinary case the IRP Panel may in its declaration allocate up to half of the costs of the IRP Provider to the prevailing party based upon the circumstances, including a consideration of the reasonableness of the parties' positions and their contribution to the public interest. Each party to the IRP proceedings shall bear its own expenses."
150. Similarly, the Supplementary Procedures state, at Article 11:

*The IRP PANEL shall fix costs in its DECLARATION. The party not prevailing in an IRP shall ordinarily be responsible for bearing all costs of the proceedings, but under extraordinary circumstances the IRP PANEL may allocate up to half of the costs to the prevailing party, taking into account the circumstances of the case, including the reasonableness of the parties' positions and their contribution to the public interest.*

*In the event the Requestor has not availed itself, in good faith, of the cooperative engagement or conciliation process, and the requestor is not successful in the Independent Review, the IRP PANEL must award ICANN all reasonable fees and costs incurred by ICANN in the IRP, including legal fees.*


151. The "IRP Provider" is the ICDR, and, in accordance with the ICDR Rules, the costs to be allocated between the parties – what the Bylaws call the "costs of the IRP Provider", and the Supplementary Procedures call the "costs of the proceedings" – include the fees and expenses of the Panel members and of the ICDR (we refer to all of these costs as "**IRP costs**").
152. ICANN is undoubtedly the prevailing party in this case. That being said, the Panel considers that the nature and significance of the issues raised by Booking.com, and the contribution to the "public interest" of its submissions, are such that it is appropriate and reasonable that the IRP costs be shared equally by the parties. We consider that the extraordinary circumstances of case – in which some members of ICANN's New gTLD Program Committee have publicly declared that, in their view, the rules on the basis of which Booking.com's claims fail should be reconsidered by ICANN – warrants such a holding.
153. The Panel cannot grant Booking.com the relief that it seeks. A panel such as ours can only declare whether, on the facts as we find them, the challenged actions of ICANN are

or are not inconsistent with ICANN's Articles of Incorporation and Bylaws. We have found that the actions in question are not inconsistent with those instruments. The process established by ICANN under its Articles of Incorporation and Bylaws and set out in the Guidebook was followed, and the time to challenge that process (which Booking.com asserts is not its intention in these proceedings in any event) has long passed.

154. However, we can – and we do – acknowledge certain legitimate concerns regarding the string similarity review process raised by Booking.com, discussed above, which are evidently shared by a number of prominent and experienced ICANN NGPC members. And we can, and do, encourage ICANN to consider whether it wishes to address these issues in an appropriate manner and forum, for example, when drafting the Guidebook for round two of the New gTLD Program or, more immediately, in the exercise of its authority under Section 5.1 (Module 5-4) of the Guidebook (which it may choose to exercise at any time, in its discretion) to consider whether, notwithstanding the result of the string similarity review of .hotels and .hoteis, approval of both of Booking.com's and Despegar's proposed strings would be in the best interest of the Internet community.

FOR THE FOREGOING REASONS, the Panel hereby declares:

- (1) Booking.com's IRP Request is denied;
- (2) ICANN is the prevailing party;
- (3) In view of the circumstances, each party shall bear one-half of the costs of the IRP Provider, including the fees and expenses of the Panel members and the fees and expenses of the ICDR. As a result, the administrative fees and expenses of the ICDR, totaling US\$4,600.00, as well as the compensation and expenses of the Panelists totaling US\$163,010.05 are to be borne equally. Therefore, ICANN shall pay to Booking.com the amount of US\$2,300.00 representing that portion of said fees and expenses in excess of the apportioned costs previously incurred by Booking.com
- (4) This Final Declaration may be executed in any number of counterparts, each of which shall be deemed an original, and all of which together shall constitute the Final Declaration of this IRP Panel.

  
\_\_\_\_\_  
Hon. A. Howard Matz  
Date: March 2, 2015

\_\_\_\_\_  
David H. Bernstein  
Date:

\_\_\_\_\_  
Stephen L. Drymer,  
*Chair of the IRP Panel*  
Date:

I, Hon. A. Howard Matz, do hereby affirm upon my oath as Arbitrator that I am the individual described in and who executed this instrument, which is the Final Declaration of the IRP Panel.

March 2, 2015  
Date

  
Hon. A. Howard Matz

I, David H, Bernstein, do hereby affirm upon my oath as Arbitrator that I am the individual described in and who executed this instrument, which is the Final Declaration of the IRP Panel.

\_\_\_\_\_  
Date

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David H, Bernstein

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David H. Bernstein  
Date: March 2, 2015

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Chair of the IRP Panel  
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FOR THE FOREGOING REASONS, the Panel hereby declares:

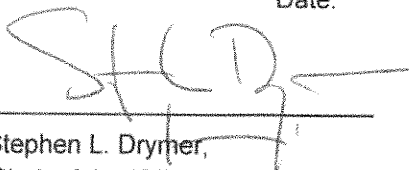
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\_\_\_\_\_  
Hon. A. Howard Matz

Date:

\_\_\_\_\_  
David H. Bernstein

Date:

  
\_\_\_\_\_  
Stephen L. Drymer,  
Chair of the IRP Panel

Date: 3 March 2015

I, Hon. A. Howard Matz, do hereby affirm upon my oath as Arbitrator that I am the individual described in and who executed this instrument, which is the Final Declaration of the IRP Panel.

\_\_\_\_\_  
Date

\_\_\_\_\_  
Hon. A. Howard Matz

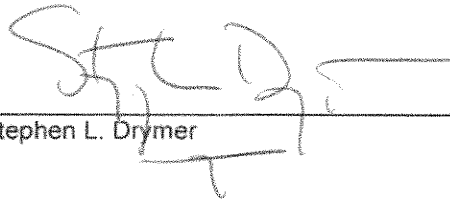
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\_\_\_\_\_  
Date

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David H, Bernstein

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3 March 2015  
Date

  
\_\_\_\_\_  
Stephen L. Drymer

# CORPORATIONS CODE

## SECTION 5210-5215

5210. Each corporation shall have a board of directors. Subject to the provisions of this part and any limitations in the articles or bylaws relating to action required to be approved by the members (Section 5034), or by a majority of all members (Section 5033), the activities and affairs of a corporation shall be conducted and all corporate powers shall be exercised by or under the direction of the board. The board may delegate the management of the activities of the corporation to any person or persons, management company, or committee however composed, provided that the activities and affairs of the corporation shall be managed and all corporate powers shall be exercised under the ultimate direction of the board.

5211. (a) Unless otherwise provided in the articles or in the bylaws, all of the following apply:

(1) Meetings of the board may be called by the chair of the board or the president or any vice president or the secretary or any two directors.

(2) Regular meetings of the board may be held without notice if the time and place of the meetings are fixed by the bylaws or the board. Special meetings of the board shall be held upon four days' notice by first-class mail or 48 hours' notice delivered personally or by telephone, including a voice messaging system or by electronic transmission by the corporation (Section 20). The articles or bylaws may not dispense with notice of a special meeting. A notice, or waiver of notice, need not specify the purpose of any regular or special meeting of the board.

(3) Notice of a meeting need not be given to a director who provides a waiver of notice or consent to holding the meeting or an approval of the minutes thereof in writing, whether before or after the meeting, or who attends the meeting without protesting, prior thereto or at its commencement, the lack of notice to that director. These waivers, consents and approvals shall be filed with the corporate records or made a part of the minutes of the meetings.

(4) A majority of the directors present, whether or not a quorum is present, may adjourn any meeting to another time and place. If the meeting is adjourned for more than 24 hours, notice of an adjournment to another time or place shall be given prior to the time of the adjourned meeting to the directors who were not present at the time of the adjournment.

(5) Meetings of the board may be held at a place within or without the state that has been designated in the notice of the meeting or, if not stated in the notice or there is no notice, designated in the bylaws or by resolution of the board.

(6) Directors may participate in a meeting through use of conference telephone, electronic video screen communication or electronic transmission by and to the corporation (Sections 20 and 21). Participation in a meeting through use of conference telephone or electronic video screen communication pursuant to this subdivision constitutes presence in person at that meeting as long as all

directors participating in the meeting are able to hear one another. Participation in a meeting through use of electronic transmission by and to the corporation, other than conference telephone and electronic video screen communication, pursuant to this subdivision constitutes presence in person at that meeting if both of the following apply:

(A) Each director participating in the meeting can communicate with all of the other directors concurrently.

(B) Each director is provided the means of participating in all matters before the board, including, without limitation, the capacity to propose, or to interpose an objection to, a specific action to be taken by the corporation.

(7) A majority of the number of directors authorized in or pursuant to the articles or bylaws constitutes a quorum of the board for the transaction of business. The articles or bylaws may require the presence of one or more specified directors in order to constitute a quorum of the board to transact business, as long as the death or nonexistence of a specified director or the death or nonexistence of the person or persons otherwise authorized to appoint or designate that director does not prevent the corporation from transacting business in the normal course of events. The articles or bylaws may not provide that a quorum shall be less than one-fifth the number of directors authorized in or pursuant to the articles or bylaws, or less than two, whichever is larger, unless the number of directors authorized in or pursuant to the articles or bylaws is one, in which case one director constitutes a quorum.

(8) Subject to the provisions of Sections 5212, 5233, 5234, 5235, and subdivision (e) of Section 5238, an act or decision done or made by a majority of the directors present at a meeting duly held at which a quorum is present is the act of the board. The articles or bylaws may not provide that a lesser vote than a majority of the directors present at a meeting is the act of the board. A meeting at which a quorum is initially present may continue to transact business notwithstanding the withdrawal of directors, if any action taken is approved by at least a majority of the required quorum for that meeting, or a greater number required by this division, the articles or the bylaws.

(b) An action required or permitted to be taken by the board may be taken without a meeting if all directors individually or collectively consent in writing to that action and if, subject to subdivision (a) of Section 5224, the number of directors then in office constitutes a quorum. The written consent or consents shall be filed with the minutes of the proceedings of the board. The action by written consent shall have the same force and effect as a unanimous vote of the directors. For purposes of this subdivision only, "all directors" does not include an "interested director" as defined in subdivision (a) of Section 5233 or a "common director" as described in subdivision (b) of Section 5234 who abstains in writing from providing consent, where (1) the facts described in paragraph (2) or (3) of subdivision (d) of Section 5233 are established or the provisions of paragraph (1) or (2) of subdivision (a) of Section 5234 are satisfied, as appropriate, at or prior to execution of the written consent or consents; (2) the establishment of those facts or satisfaction of those provisions, as applicable, is included in the written consent or consents executed by the noninterested or noncommon directors or in other records of the corporation; and (3) the noninterested or noncommon directors, as applicable, approve the action by a vote that is sufficient without counting the votes of the interested directors or common directors.

(c) Each director shall have one vote on each matter presented to the board of directors for action. No director may vote by proxy.

(d) The provisions of this section apply also to incorporators, to committees of the board, and to action by those incorporators or committees mutatis mutandis.

5212. (a) The board may, by resolution adopted by a majority of the number of directors then in office, provided that a quorum is present, create one or more committees, each consisting of two or more directors, to serve at the pleasure of the board. Appointments to such committees shall be by a majority vote of the directors then in office, unless the articles or bylaws require a majority vote of the number of directors authorized in or pursuant to the articles or bylaws. The bylaws may authorize one or more such committees, each consisting of two or more directors, and may provide that a specified officer or officers who are also directors of the corporation shall be a member or members of such committee or committees. The board may appoint one or more directors as alternate members of such committee, who may replace any absent member at any meeting of the committee. Such committee, to the extent provided in the resolution of the board or in the bylaws, shall have all the authority of the board, except with respect to:

(1) The approval of any action for which this part also requires approval of the members (Section 5034) or approval of a majority of all members (Section 5033), regardless of whether the corporation has members.

(2) The filling of vacancies on the board or in any committee which has the authority of the board.

(3) The fixing of compensation of the directors for serving on the board or on any committee.

(4) The amendment or repeal of bylaws or the adoption of new bylaws.

(5) The amendment or repeal of any resolution of the board which by its express terms is not so amendable or repealable.

(6) The appointment of committees of the board or the members thereof.

(7) The expenditure of corporate funds to support a nominee for director after there are more people nominated for director than can be elected.

(8) The approval of any self-dealing transaction except as provided in paragraph (3) of subdivision (d) of Section 5233.

(b) A committee exercising the authority of the board shall not include as members persons who are not directors. However, the board may create other committees that do not exercise the authority of the board and these other committees may include persons regardless of whether they are directors.

(c) Unless the bylaws otherwise provide, the board may delegate to any committee powers as authorized by Section 5210, but may not delegate the powers set forth in paragraphs (1) to (8), inclusive, of subdivision (a).

(d) If required by subdivision (e) of Section 12586 of the Government Code, the board shall appoint an audit committee in accordance with that subdivision and for the purposes set forth therein.

5213. (a) A corporation shall have a chair of the board, who may be given the title chair of the board, chairperson of the board, chairman of the board, or chairwoman of the board, or a president or both, a secretary, a treasurer or a chief financial officer or both, and any other officers with any titles and duties as shall be stated in the bylaws or determined by the board and as may be necessary to

enable it to sign instruments. The president, or if there is no president the chair of the board, is the general manager and chief executive officer of the corporation, unless otherwise provided in the articles or bylaws. Unless otherwise specified in the articles or the bylaws, if there is no chief financial officer, the treasurer is the chief financial officer of the corporation. Any number of offices may be held by the same person unless the articles or bylaws provide otherwise, except that no person serving as the secretary, the treasurer, or the chief financial officer may serve concurrently as the president or chair of the board. Any compensation of the president or chief executive officer and the chief financial officer or treasurer shall be determined in accordance with subdivision (g) of Section 12586 of the Government Code, if applicable.

(b) Except as otherwise provided by the articles or bylaws, officers shall be chosen by the board and serve at the pleasure of the board, subject to the rights, if any, of an officer under any contract of employment. Any officer may resign at any time upon written notice to the corporation without prejudice to the rights, if any, of the corporation under any contract to which the officer is a party.

(c) If the articles or bylaws provide for the election of any officers by the members, the term of office of the elected officer shall be one year unless the articles or bylaws provide for a different term which shall not exceed three years.

5214. Subject to the provisions of subdivision (a) of Section 5141 and Section 5142, any note, mortgage, evidence of indebtedness, contract, conveyance or other instrument in writing, and any assignment or endorsement thereof, executed or entered into between any corporation and any other person, when signed by any one of the chairman of the board, the president or any vice president and by any one of the secretary, any assistant secretary, the chief financial officer or any assistant treasurer of such corporation, is not invalidated as to the corporation by any lack of authority of the signing officers in the absence of actual knowledge on the part of the other person that the signing officers had no authority to execute the same.

5215. The original or a copy in writing or in any other form capable of being converted into clearly legible tangible form of the bylaws or of the minutes of any incorporators', members', directors', committee or other meeting or of any resolution adopted by the board or a committee thereof, or members, certified to be a true copy by a person purporting to be the secretary or an assistant secretary of the corporation, is prima facie evidence of the adoption of such bylaws or resolution or of the due holding of such meeting and of the matters stated therein.

**INTERNATIONAL CENTRE FOR DISPUTE RESOLUTION  
Independent Review Panel**

**CASE # 50 2013 001083**

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**DECLARATION ON THE IRP PROCEDURE**

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**In the matter of an Independent Review Process (IRP) pursuant to the Internet Corporation for Assigned Names and Number's (ICANN's) Bylaws, the *International Dispute Resolution Procedures (ICDR Rules)* of the International Centre for Dispute Resolution (ICDR), and the *Supplementary Procedures for ICANN Independent Review Process***

**Between: DotConnectAfrica Trust;**  
("Claimant" or "DCA Trust")

Represented by Mr. Arif H. Ali, Ms. Marguerite Walter and Ms. Erica Franzetti of Weil, Gotshal, Manges, LLP located at 1300 Eye Street, NW, Suite 900, Washington, DC 20005, U.S.A.

**And**

**Internet Corporation for Assigned Names and Numbers (ICANN);**  
("Respondent" or "ICANN")

Represented by Mr. Jeffrey A. LeVee of Jones Day, LLP located at 555 South Flower Street, Fiftieth Floor, Los Angeles, CA 90071, U.S.A.

Claimant and Respondent will together be referred to as "Parties".

**IRP Panel:**  
**Babak Barin, *Chair***  
**Prof. Catherine Kessedjian**  
**Hon. Richard C. Neal (Ret.)**

## **I. BACKGROUND**

- 1) DCA Trust is a non-profit organization established under the laws of the Republic of Mauritius on 15 July 2010 with its registry operation – DCA Registry Services (Kenya) Limited – as its principal place of business in Nairobi, Kenya. DCA Trust was formed with the charitable purpose of, among other things, advancing information technology education in Africa and providing a continental Internet domain name to provide access to internet services for the people of Africa and for the public good.
- 2) In March 2012, DCA Trust applied to ICANN for the delegation of the .AFRICA top-level domain name in its 2012 General Top-Level Domains (“gTLD”) Internet Expansion Program (the “New gTLD Program”), an internet resource available for delegation under that program.
- 3) ICANN is a non-profit corporation established under the laws of the State of California, U.S.A., on 30 September 1998 and headquartered in Marina del Rey, California. According to its Articles of Incorporation, ICANN was established for the benefit of the Internet community as a whole and is tasked with carrying out its activities in conformity with relevant principles of international law, international conventions, and local law.
- 4) On 4 June 2013, the ICANN Board New gTLD Program Committee (“NGPC”) posted a notice that it had decided not to accept DCA Trust’s application.
- 5) On 19 June 2013, DCA Trust filed a request for reconsideration by the ICANN Board Governance Committee (“BGC”), which denied the request on 1 August 2013.
- 6) On 19 August 2013, DCA Trust informed ICANN of its intention to seek relief before an Independent Review Panel under ICANN’s Bylaws. Between August and October 2013, DCA Trust and ICANN participated in a Cooperative Engagement Process (“CEP”) to try and resolve the issues relating to DCA Trust’s application. Despite several meetings, no resolution was reached.
- 7) On 24 October 2013, DCA Trust filed a Notice of Independent Review Process with the ICDR in accordance with Article IV, Section 3, of ICANN’s Bylaws.

## **II. SUMMARY OF THE PARTIES’ POSITIONS ON THE MERITS**

- 8) According to DCA Trust, the central dispute between it and ICANN in the Independent Review Process (“IRP”) invoked by DCA Trust in October 2013 and described in its Amended Notice of Independent Review Process submitted to ICANN on 10 January 2014 arises out of:



“(1) ICANN’s breaches of its Articles of Incorporation, Bylaws, international and local law, and other applicable rules in the administration of applications for the .AFRICA top-level domain name in its 2012 General Top-Level Domains (“gTLD”) Internet Expansion Program (the “New gTLD Program”); and (2) ICANN’s wrongful decision that DCA’s application for .AFRICA should not proceed [...]”<sup>1</sup>

- 9) According to DCA Trust, “ICANN’s administration of the New gTLD Program and its decision on DCA’s application were unfair, discriminatory, and lacked appropriate due diligence and care, in breach of ICANN’s Articles of Incorporation and Bylaws.”<sup>2</sup> DCA Trust also advanced that “ICANN’s violations materially affected DCA’s right to have its application processed in accordance with the rules and procedures laid out by ICANN for the New gTLD Program.”<sup>3</sup>
- 10) In its 10 February 2014 [sic]<sup>4</sup> Response to DCA Trust’s Amended Notice, ICANN submitted that in these proceedings, “DCA challenges the 4 June 2013 decision of the ICANN Board New gTLD Program Committee (“NGPC”), which has delegated authority from the ICANN Board to make decisions regarding the New gTLD. In that decision, the NGPC unanimously accepted advice from ICANN’s Governmental Advisory Committee (“GAC”) that DCA’s application for .AFRICA should not proceed. DCA argues that the NGPC should not have accepted the GAC’s advice. DCA also argues that ICANN’s subsequent decision to reject DCA’s Request for Reconsideration was improper.”<sup>5</sup>
- 11) ICANN argued that the challenged decisions of ICANN’s Board “were well within the Board’s discretion” and the Board “did exactly what it was supposed to do under its Bylaws, its Articles of Incorporation, and the Applicant Guidebook (“Guidebook”) that the Board adopted for implementing the New gTLD Program.”<sup>6</sup>
- 12) Specifically, ICANN also advanced that “ICANN properly investigated and rejected DCA’s assertion that two of ICANN’s Board members had conflicts of interest with regard to the .AFRICA applications, [...] numerous African countries issued “warnings” to ICANN regarding DCA’s application, a signal from those governments that they had serious concerns regarding DCA’s application; following the issuance of those warnings, the GAC issued “consensus advice” against DCA’s application; ICANN then accepted the GAC’s advice, which was entirely consistent with ICANN’s Bylaws and the

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<sup>1</sup> Claimant’s Amended Notice of Independent Review Process, *para.* 2.

<sup>2</sup> *Ibid.*

<sup>3</sup> *Ibid.*

<sup>4</sup> ICANN’s Response to Claimant’s Amended Notice contains a typographical error; it is dated “February 10, 2013” rather than 2014.

<sup>5</sup> ICANN’s Response to Claimant’s Amended Notice, *para.* 4. Underlining is from the original text.

<sup>6</sup> *Ibid.*, *para.* 5.

Guidebook; [and] ICANN properly denied DCA's Request for Reconsideration."<sup>7</sup>

13) In short, ICANN argued that in these proceedings, "the evidence establishes that the process worked exactly as it was supposed to work."<sup>8</sup>

14) In the merits part of these proceedings, the Panel will decide the above and other related issues raised by the Parties in their submissions.

### III. PROCEDURAL BACKGROUND LEADING TO THIS DECISION

15) On 24 April 2013, 12 May, 27 May and 4 June 2014 respectively, the Panel issued a Procedural Order No. 1, a Decision on Interim Measures of Protection, a list of questions for the Parties to brief in their 20 May 2014 memorials on the procedural and substantive issues identified in Procedural Order No. 1 ("12 May List of Questions"), a Procedural Order No. 2 and a Decision on ICANN's Request for Partial Reconsideration of certain portions of its Decision on Interim Measures of Protection. The Decision on Interim Measures of Protection and the Decision on ICANN's Request for Partial Reconsideration of certain portions of the Decision on Interim Measures of Protection have no bearing on this Declaration. Consequently, they do not require any particular consideration by the Panel in this Declaration.

16) In Procedural Order No. 1 and the 12 May List of Questions, based on the Parties' submissions, the Panel identified a number of questions relating to the future conduct of these proceedings, including the method of hearing of the merits of DCA Trust's amended Notice of Independent Review Process that required further briefing by the Parties. In Procedural Order No. 1, the Panel identified some of these issues as follows:

**B. Future conduct of the IRP proceedings, including the hearing of the merits of Claimant's Amended Notice of Independent Review Process, if required.**

**Issues:**

- a) Interpretation of the provisions of ICANN's Bylaws, the *International Dispute Resolution Procedures* of the ICDR, and the *Supplementary Procedures for ICANN Independent Review Process* (together the "IRP Procedure"), including whether or not there should be *viva voce* testimony permitted.
- b) Document request and exchange.
- c) Additional filings, including any memoranda and hearing exhibits (if needed and appropriate).

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<sup>7</sup> *Ibid.*

<sup>8</sup> ICANN's Response to Claimant's Amended Notice, *para.* 6. Underlining is from the original text.

- d) Consideration of method of hearing of the Parties, i.e., telephone, video or in-person and determination of a location for such a hearing, if necessary or appropriate, and consideration of any administrative issues relating to the hearing.

17) In that same Order, in light of: (a) the exceptional circumstances of this case; (b) the fact that some of the questions raised by the Parties implicated important issues of fairness, due process and equal treatment of the parties (“Outstanding Procedural Issues”); and (c) certain *primaie impressionis* or first impression issues that arose in relation to the IRP Procedure, the Panel requested the Parties to file two rounds of written memorials, including one that followed the 12 May List of Questions.

18) On 5 and 20 May 2014, the Parties filed their submissions with supporting material for consideration by the Panel.

#### **IV. ISSUES TO BE DECIDED BY THE PANEL**

19) Having read the Parties’ submissions and supporting material, and listened to their respective arguments by telephone, the Panel answers the following questions in this Declaration:

- 1) Does the Panel have the power to interpret and determine the IRP Procedure as it relates to the future conduct of these proceedings?
- 2) If so, what directions does the Panel give the Parties with respect to the Outstanding Procedural Issues?
- 3) Is the Panel's decision concerning the IRP Procedure and its future Declaration on the Merits in this proceeding binding?

#### **Summary of the Panel’s findings**

20) The Panel is of the view that it has the power to interpret and determine the IRP Procedure as it relates to the future conduct of these proceedings and consequently, it issues the procedural directions set out in paragraphs 58 to 61, 68 to 71 and 82 to 87 (below), which directions may be supplemented in a future procedural order. The Panel also concludes that this Declaration and its future Declaration on the Merits of this case are binding on the Parties.

## V. ANALYSIS OF THE ISSUES AND REASONS FOR THE DECISION

### 1) Can the Panel interpret and determine the IRP Procedure as it relates to the future conduct of these proceedings?

#### Interpretation and Future Conduct of the IRP Proceedings

##### DCA Trusts' Submissions

21) In its 5 May 2014 Submission on Procedural Issues ("DCA Trust First Memorial"), DCA Trust submitted, *inter alia*, that:

"[Under] California law and applicable federal law, this IRP qualifies as an arbitration. It has all the characteristics that California courts look to in order to determine whether a proceeding is an arbitration: 1) a third-party decision-maker; 2) a decision-maker selected by the parties; 3) a mechanism for assuring the neutrality of the decision-maker; 4) an opportunity for both parties to be heard; and 5) a binding decision[...]. Thus, the mere fact that ICANN has labeled this proceeding an independent review process rather than an arbitration (and the adjudicator of the dispute is called a Panel rather than a Tribunal) does not change the fact that the IRP – insofar as its procedural framework and the legal effects of its outcome are concerned – is an arbitration."<sup>9</sup>

22) According to DCA Trust, the IRP Panel is a neutral body appointed by the parties and the ICDR to hear disputes involving ICANN. Therefore, it "qualifies as a third-party decision-maker for the purposes of defining the IRP as an arbitration."<sup>10</sup> DCA Trust submits that, "ICANN's Bylaws contain its standing offer to arbitrate, through the IRP administered by the ICDR, disputes concerning Board actions alleged to be inconsistent with the Articles of Incorporation or the Bylaws."<sup>11</sup>

23) DCA Trust submits that, it "accepted ICANN's standing offer to arbitrate by submitting its Notice of Independent Review [...] to the ICDR on 24 October 2013 [...] when the two party-appointed panelists were unable to agree on a chairperson, the ICDR made the appointment pursuant to Article 6 of the ICDR Rules, amended and effective 1 June 2009. The Parties thus chose to submit their dispute to the IRP Panel for resolution, as with any other arbitration."<sup>12</sup>

24) According to DCA Trust, "the Supplementary Procedures provide that the IRP is to be comprised of 'neutral' [individuals] and provide that the panel shall be comprised of members of a standing IRP Panel or as selected by the

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<sup>9</sup> DCA Trust First Memorial, *para.* 4 and 5.

<sup>10</sup> *Ibid*, *para.* 8.

<sup>11</sup> *Ibid*, *para.* 9.

<sup>12</sup> *Ibid*.

parties under the ICDR Rules. The ICDR Rules [...] provide that panelists serving under the rules, ‘shall be impartial and independent’, and require them to disclose any circumstances giving rise to ‘justifiable doubts’ as to their impartiality and independence [...] The IRP therefore contains a mechanism for ensuring the neutrality of the decision-maker, just like any other arbitration.”<sup>13</sup>

25) DCA Trust further submitted that the “IRP affords both parties an opportunity to be heard, both in writing and orally” and the “governing instruments of the IRP – *i.e.*, the Bylaws, the ICDR Rules, and the Supplementary Procedures – confirm that the IRP is final and binding.” According to DCA Trust, the “IRP is the final accountability and review mechanism available to the parties materially affected by ICANN Board decisions. The IRP is also the only ICANN accountability mechanism conducted by an independent third-party decision-maker with the power to render a decision resolving the dispute and naming a prevailing party [...] The IRP represents a fundamentally different stage of review from those that precede it. Unlike reconsideration or cooperative engagement, the IRP is conducted pursuant to a set of independently developed international arbitration rules (as minimally modified) and administered by a provider of international arbitration services, not ICANN itself.”<sup>14</sup>

26) As explained in its 20 May 2014 Response to the Panel’s Questions on Procedural Issues (“DCA Trust Second Memorial”), according to DCA Trust, “the IRP is the ***sole forum*** in which an applicant for a new gTLD can seek independent, third-party review of Board actions. Remarkably, ICANN makes no reciprocal waivers and instead retains all of its rights against applicants in law and equity. ICANN cannot be correct that the IRP is a mere ‘corporate accountability mechanism’. Such a result would make ICANN – the caretaker of an immensely important (and valuable) global resource – effectively judgment-proof.”<sup>15</sup>

27) Finally DCA Trust submitted that:

“[It] is [...] critical to understand that ICANN created the IRP as an alternative to allowing disputes to be resolved by courts. By submitting its application for a gTLD, DCA agreed to eight pages of terms and conditions, including a nearly page-long string of waivers and releases. Among those conditions was the waiver of all of its rights to challenge ICANN’s decision on DCA’s application in court. For DCA and other gTLD applicants, the IRP is their only recourse; no other legal remedy is available. The very design of this process is evidence that the IRP is fundamentally unlike the forms of

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<sup>13</sup> *Ibid*, paras. 10, 11 and 12.

<sup>14</sup> *Ibid*, paras. 13, 16, 21 and 23.

<sup>15</sup> DCA Trust Second Memorial, *para.* 6. Bold and italics are from the original text.

administrative review that precede it and is meant to provide a final and binding resolution of disputes between ICANN and persons affected by its decisions.”<sup>16</sup>

### **ICANN’s Submissions**

28) In response, in its first memorial entitled ICANN’s Memorandum Regarding Procedural Issues filed on 5 May 2014 (“ICANN First Memorial”), ICANN argued, *inter alia*, that:

“[This] proceeding is *not* an arbitration. Rather, an IRP is a truly unique ‘Independent Review’ process established in ICANN’s Bylaws with the specific purpose of providing for ‘independent third-party review of Board actions alleged by an affected party to be inconsistent with the Articles of Incorporation or Bylaws’. Although ICANN is using the International Center [sic] for Dispute Resolution (‘ICDR’) to administer these proceedings, nothing in the Bylaws can be construed as converting these proceedings into an ‘arbitration’, and the Bylaws make clear that these proceedings are not to be deemed as the equivalent of an ‘international arbitration.’ Indeed, the word ‘arbitration’ does not appear in the relevant portion of the Bylaws, and as discussed below, the ICANN Board retains full authority to accept or reject the declaration of all IRP Panels [...] ICANN’s Board had the authority to, and did, adopt Bylaws establishing internal accountability mechanisms and defining the scope and form of those mechanisms. Cal. Corp. Code § 5150(a) (authorizing the board of a non-profit public benefit corporation to adopt and amend the corporation’s bylaws).”<sup>17</sup>

29) In its 20 May 2014 Further Memorandum Regarding Procedural Issues (“ICANN Second Memorial”), ICANN submitted that many of the questions that the Panel posed “are outside the scope of this Independent Review Proceeding [...] and the Panel’s mandate.”<sup>18</sup> According to ICANN:

“The Panel’s mandate is set forth in ICANN’s Bylaws, which limit the Panel to ‘comparing contested actions of the Board to the Articles of Incorporation and Bylaws, and [...] declaring whether the Board has acted consistently with the provisions of those Articles of Incorporation and Bylaws.’”<sup>19</sup>

### **The Panel’s Decision on its power to interpret and determine the IRP Procedure**

#### **(i) Mission and Core Values of ICANN**

30) ICANN is not an ordinary California non-profit organization. Rather, ICANN has a large international purpose and responsibility, to coordinate, at the overall level, the global Internet’s systems of unique identifiers, and in particular, to ensure the stable and secure operation of the Internet’s unique identifier systems.

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<sup>16</sup> DCA Trust First Memorial, *para.* 22.

<sup>17</sup> ICANN First Memorial, *paras.* 10 and 11. Bold and italics are from the original text.

<sup>18</sup> ICANN Second Memorial, *para.* 2.

<sup>19</sup> *Ibid.*

31) ICANN coordinates the allocation and assignment of the three sets of unique identifiers for the Internet. ICANN's special and important mission is reflected in the following provisions of its Articles of Incorporation:

3. This Corporation is a [non-profit] public benefit corporation and is not organized for the private gain of any person. It is organized under the California [Non-profit] Public Benefit Corporation Law for charitable and public purposes. The Corporation is *organized, and will be operated, exclusively for charitable, educational, and scientific purposes ...* In furtherance of the foregoing purposes, and in *recognition of the fact that the Internet is an international network of networks, owned by no single nation, individual or organization*, the Corporation shall, except as limited by Article 5 hereof, *pursue the charitable and public purposes of lessening the burdens of government and promoting the global public interest in the operational stability of the Internet* by (i) coordinating the assignment of Internet technical parameters as needed to maintain universal connectivity on the Internet; (ii) performing and overseeing functions related to the coordination of the Internet Protocol ("IP") address space; (iii) performing and overseeing functions related to the coordination of the Internet domain name system ("DNS"), including the development of policies for determining the circumstances under which new top-level domains are added to the DNS root system; (iv) overseeing operation of the authoritative Internet DNS root server system; and (v) engaging in any other related lawful activity in furtherance of items (i) through (iv).

4. The Corporation *shall operate for the benefit of the Internet community as a whole, carrying out its activities in conformity with relevant principles of international law and applicable international conventions and local law* and, to the extent appropriate and consistent with these Articles and its Bylaws, through *open and transparent processes* that enable competition and open entry in Internet-related markets. To this effect, the Corporation shall cooperate as appropriate with relevant international organizations. [Emphasis by way of italics is added]

32) In carrying out its mission, ICANN must be accountable to the global internet community for operating in a manner that is consistent with its Bylaws, and with due regard for its core values.

33) In performing its mission, among others, the following core values must guide the decisions and actions of ICANN: preserve and enhance the operational stability, security and global interoperability of the internet, employ open and transparent policy development mechanisms, make decisions by applying documented policies neutrally and objectively, with integrity and fairness and remain accountable to the internet community through mechanisms that enhance ICANN's effectiveness.

34) The core values of ICANN as described in its Bylaws are deliberately expressed in general terms, so as to provide useful and relevant guidance in the broadest possible range of circumstances. Because they are not narrowly prescriptive, the specific way in which they apply, individually and collectively, to each situation will necessarily depend on many factors that cannot be fully anticipated or enumerated.

## **(ii) Accountability of ICANN**

35) Consistent with its large and important international responsibilities, ICANN's Bylaws acknowledge a responsibility to the community and a need for a means of holding ICANN accountable for compliance with its mission and "core values." Thus, Article IV of ICANN's Bylaws, entitled "Accountability and Review," states:

"In carrying out its mission as set out in these Bylaws, ICANN should be accountable to the community for operating in a manner that is consistent with these Bylaws, and with due regard for the core values set forth in Article I of these Bylaws."

36) ICANN's Bylaws establish three accountability mechanisms: the Independent Review Process and two other avenues: Reconsideration Requests and the Ombudsman.

37) ICANN's BGC is the body designated to review and consider Reconsideration Requests. The Committee is empowered to make final decisions on certain matters, and recommendations to the Board of Directors on others. ICANN's Bylaws expressly provide that the Board of Directors "*shall not be bound to follow the recommendations of the BGC.*"

38) ICANN's Bylaws provide that the "charter of the Ombudsman shall be to act as a neutral dispute resolution practitioner for those matters for which the provisions of the Reconsideration Policy [...] or the Independent Review Policy have not been invoked." The Ombudsman's powers appear to be limited to "clarifying issues" and "using conflict resolution tools such as negotiation, facilitation, and 'shuttle diplomacy.'" The Ombudsman is specifically barred from "instituting, joining, or supporting in any way any legal actions challenging ICANN's structure, procedures, processes, or any conduct by the ICANN Board, staff, or constituent bodies."

39) The avenues of accountability for applicants that have disputes with ICANN do *not* include resort to the courts. Applications for gTLD delegations are governed by ICANN's Guidebook, which provides that applicants waive all right to resort to the courts:

"Applicant hereby releases ICANN [...] from any and all claims that arise out of, are based upon, or are in any way related to, any action or failure to act by ICANN [...] in connection with ICANN's review of this application, investigation, or verification, any characterization or description of applicant or the information in this application, any withdrawal of this application or the decision by ICANN to recommend or not to recommend, the approval of applicant's gTLD application. APPLICANT AGREES NOT TO CHALLENGE, IN COURT OR ANY OTHER JUDICIAL FORA, ANY FINAL DECISION MADE BY ICANN WITH RESPECT TO THE APPLICATION, AND IRREVOCABLY WAIVES ANY RIGHT TO SUE OR PROCEED IN COURT OR ANY OTHER JUDICIAL FORA ON THE BASIS



OF ANY OTHER LEGAL CLAIM AGAINST ICANN ON THE BASIS OF ANY OTHER LEGAL CLAIM.”<sup>20</sup>

40) Thus, assuming that the foregoing waiver of any and all judicial remedies is valid and enforceable, the ultimate “accountability” remedy for applicants is the IRP.

### **(iii) IRP Procedures**

41) The Bylaws of ICANN as amended on 11 April 2013, in Article IV (Accountability and Review), Section 3 (Independent Review of Board Actions), paragraph 1, require ICANN to put in place, in addition to the reconsideration process identified in Section 2, a separate process for independent third-party review of Board actions alleged by an affected party to be inconsistent with ICANN’s Articles of Incorporation or Bylaws.

42) Paragraphs 7 and 8 of Section 2 of the Bylaws, require all IRP proceedings to be administered by an international dispute resolution provider appointed by ICANN, and for that IRP Provider (“IRPP”) to, with the approval of the ICANN’s Board, establish operating rules and procedures, which shall implement and be consistent with Section 3.

43) In accordance with the above provisions, ICANN selected the ICDR, the international division of the American Arbitration Association, to be the IRPP.

44) With the input of the ICDR, ICANN prepared a set of Supplementary Procedures for ICANN IRP (“Supplementary Procedures”), to “supplement the [ICDR’s] International Arbitration Rules in accordance with the independent review procedures set forth in Article IV, Section 3 of the ICANN Bylaws.”

45) According to the Definitions part of the Supplementary Procedures, “Independent Review or IRP” refers to “the procedure that takes place upon filing of a request to review ICANN Board actions or inactions alleged to be inconsistent with ICANN’s Bylaws or Articles of Incorporation”, and “International Dispute Resolution Procedures or Rules” refers to the ICDR’s International Arbitration Rules (“ICDR Rules”) that will govern the process in combination with the Supplementary Rules.

46) The Preamble of the Supplementary Rules indicates that these “procedures supplement the [ICDR] Rules in accordance with the independent review procedures set forth in Article IV, Section 3 of the ICANN Bylaws” and Article

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<sup>20</sup> Applicant Guidebook, Terms and Conditions for Top Level Domain Applications, *para.* 6. Capital letters are from the original text.

2 of the Supplementary Procedures requires the ICDR to apply the Supplementary Procedures, *in addition* to the ICDR Rules, in all cases submitted to it in connection with Article IV, Section 3(4) of ICANN's Bylaws. In the event there is any inconsistency between the Supplementary Procedures and the ICDR Rules, ICANN requires the Supplementary Procedures to govern.

- 47)The online Oxford English Dictionary defines the word “supplement” as “a thing added to something else in order to complete or enhance it”. Supplement, therefore, means to complete, add to, extend or supply a deficiency. In this case, according to ICANN’s desire, the Supplementary Rules were designed to “add to” the ICDR Rules.
- 48)A key provision of the ICDR Rules, Article 16, under the heading “Conduct of Arbitration” confers upon the Panel the power to “conduct [proceedings] in whatever manner [the Panel] considers appropriate, provided that the parties are treated with equality and that each party has the right to be heard and is given a fair opportunity to present its case.”
- 49)Another key provision, Article 36 of the ICDR Rules, directs the Panel to “interpret and apply these Rules insofar as they relate to its powers and duties”. Like in all other ICDR proceedings, the details of exercise of such powers are left to the discretion of the Panel itself.
- 50)Nothing in the Supplementary Procedures either expressly or implicitly conflicts with or overrides the general and broad powers that Articles 16 and 36 of the ICDR Rules confer upon the Panel to interpret and determine the manner in which the IRP proceedings are to be conducted and to assure that each party is given a fair opportunity to present its case.
- 51)To the contrary, the Panel finds support in the “Independent Review Process Recommendations” filed by ICANN, which indicates that the Panel has the *discretion* to run the IRP proceedings in the manner it thinks appropriate. [Emphasis added].
- 52)Therefore, the Panel is of the view that it has the power to interpret and determine the IRP Procedure as it relates to the future conduct of these proceedings, and it does so here, with specificity in relation to the issues raised by the Parties as set out below.

## 2) What directions does the Panel give the Parties with respect to the Outstanding Procedural Issues?

### a) Document request and exchange

#### Parties' Submissions

- 53) In the DCA Trust First Memorial, DCA Trust seeks document production, since according to it, "information potentially dispositive of the outcome of these proceedings is in ICANN's possession, custody or control."<sup>21</sup> According to DCA Trust, in this case, "ICANN has submitted witness testimony that, among other things, purports to rely on secret documents that have not been provided." Given that these proceedings may be "DCA's only opportunity to present and have its claims decided by an independent decision-maker", DCA Trust argues "that further briefing on the merits should be allowed following any and all document production in these proceedings."<sup>22</sup>
- 54) According to DCA Trust, "by choosing the ICDR Rules, the Parties also chose the associated ICDR guidelines including the Guidelines for Arbitrators Concerning Exchanges of Information ("ICDR Guidelines"). The ICDR Guidelines provide that 'parties shall exchange, in advance of the hearing, all documents upon which each intends to rely' [...]"<sup>23</sup> DCA Trust submits that, "nothing in the Bylaws or Supplementary Procedures excludes such document production, leaving the ICDR Rules to cover the field."<sup>24</sup>
- 55) DCA Trust therefore, requests that the Panel issue a procedural order providing the Parties with an opportunity to request documents from one another, and to seek an order from the Panel compelling production of documents if necessary.
- 56) ICANN agrees with DCA Trust, that pursuant to the ICDR Guidelines, which it refers to as "Discovery Rules", "a party must request that a panel order the production of documents."<sup>25</sup> According to ICANN, "those documents must be 'reasonably believed to exist and to be relevant and material to the outcomes of the case,' and requests must contain 'a description of specific documents or classes of documents, along with an explanation of their materiality to the outcome of the case."<sup>26</sup> ICANN argues, however, that despite the requirement by the Supplementary Rules that, '**all necessary evidence** to demonstrate the requestor's claims that ICANN violated its Bylaws or Articles of Incorporation

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<sup>21</sup> DCA Trust First Memorial, *para.* 61.

<sup>22</sup> *Ibid*, *paras.* 61 and 66.

<sup>23</sup> *Ibid*, *para.* 67.

<sup>24</sup> *Ibid*.

<sup>25</sup> ICANN First Memorial, *para.* 28.

<sup>26</sup> *Ibid*.

should be part of the [initial written] submission’, DCA Trust has not to date “provided any indication as to what information it believes the documents it may request may contain and has made no showing that those documents could affect the outcome of the case.”<sup>27</sup>

57) ICANN further submits that, “while ICANN recognizes that the Panel may order the production of documents within the parameters set forth in the Discovery Rules, ICANN will object to any attempts by DCA to propound broad discovery of the sort permitted in American civil litigation.”<sup>28</sup> In support of its contention, ICANN refers to the ICDR Guidelines and states that those Guidelines have made it ‘clear that its Discovery Rules do not contemplate such broad discovery. The introduction of these rules states that their purpose is to promote ‘the goal of providing a simpler, less expensive and more expeditious form of dispute resolution than resort to national courts.’ According to ICANN, the ICDR Guidelines note that:

“One of the factors contributing to complexity, expense and delay in recent years has been the migration from court systems into arbitration of procedural devices that allow one party to a court proceeding access to information in the possession of the other, without full consideration of the differences between arbitration and litigation. The purpose of these guidelines is to make it clear to arbitrators that they have the authority, the responsibility and, in certain jurisdictions, the mandatory duty to manage arbitration proceedings so as to achieve the goal of providing a simpler, less expensive, and more expeditious process.”<sup>29</sup>

### **The Panel’s directions concerning document request and exchange**

58) Seeing that the Parties are both in agreement that some form of documentary exchange is permitted under the IRP Procedure, and considering that Articles 16 and 19 of the ICDR Rules respectively specify, *inter alia*, that, “[s]ubject to these Rules the [Panel] may conduct [these proceedings] in whatever manner it considers appropriate, provided that the parties are treated with equality and that each party has the right to be heard and is given a fair opportunity to present its case” and “at any time during the proceedings, the tribunal may order parties to produce other documents, exhibits or other evidence it deems necessary or appropriate”, the Panel concludes that some document production is necessary to allow DCA Trust to present its case.

59) The Panel is not aware of any international dispute resolution rules, which prevent the parties to benefit from some form of document production. Denying document production would be especially unfair in the circumstances of this case given ICANN’s reliance on internal confidential documents, as advanced by DCA Trust. In any event, ICANN’s espoused goals

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<sup>27</sup> *Ibid*, para. 29. Bold and italics are from the original text.

<sup>28</sup> *Ibid*, para. 30.

<sup>29</sup> ICDR Guidelines for Arbitrators on Exchanges of Information, Introduction.

of accountability and transparency would be disserved by a regime that truncates the usual and traditional means of developing and presenting a claim.

60)The Panel, therefore, orders a reasonable documentary exchange in these proceedings with a view to maintaining efficiency and economy, and invites the Parties to agree by or before 29 August 2014, on a form, method and schedule of exchange of documents between them. If the Parties are unable to agree on such a documentary exchange process, the Panel will intervene and, with the input of the Parties, provide further guidance.

61)In this last regard, the Panel directs the Parties attention to paragraph 6 of the ICDR Guidelines, and advises, that it is very “receptive to creative solutions for achieving exchanges of information in ways that avoid costs and delay, consistent with the principles of due process expressed in these Guidelines.”

#### **b) Additional filings, including memoranda and hearing exhibits**

#### **Parties’ Submissions**

62)In the DCA Trust First Memorial, DCA Trust submits that:

“[The] plain language of the Supplementary Procedures pertaining to written submissions clearly demonstrates that claimants in IRPs are not limited to a single written submission incorporating all evidence, as argued by ICANN. Section 5 of the Supplementary Procedures states that ‘initial written submissions of the parties shall not exceed 25 pages.’ The word ‘initial’ confirms that there may be subsequent submissions, subject to the discretion of the Panel as to how many additional written submissions and what page limits should apply.”<sup>30</sup>

63)DCA Trust also submits that, “Section 5 of the Supplementary Procedures [...] provides that ‘[a]ll necessary evidence to demonstrate the requestor’s claims that ICANN violated its Bylaws or Articles of Incorporation should be part of the submission.’ Use of the word ‘should’—and not ‘shall’—confirms that it is desirable, but not required that all necessary evidence be included with the Notice of Independent Review. Plainly, the Supplementary Procedures do not preclude a claimant from adducing additional evidence nor would it make any sense if they did given that claimants may, subject to the Panel’s discretion, submit document requests.”<sup>31</sup>

64)According to DCA Trust, in addition, “section 5 of the Supplementary Procedures provides that ‘the Panel may request additional written submissions from the party seeking review, the Board, the Supporting

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<sup>30</sup> DCA Trust First Memorial, *para.* 57.

<sup>31</sup> *Ibid*, *para.* 58.

Organizations, or from other parties.’ Thus, the Supplementary Procedures clearly contemplate that additional written submissions may be necessary to give each party a fair opportunity to present its case.”<sup>32</sup>

65) In response, ICANN submits that, DCA Trust “has no automatic right to additional briefing under the Supplementary Procedures.”<sup>33</sup> According to ICANN, “paragraph 5 of the Supplementary Procedures, which governs written statements, provides:

The initial written submissions of the parties shall not exceed 25 pages each in argument, double-spaced and in 12-point font. ***All necessary evidence to demonstrate the requestor’s claims that ICANN violated its Bylaws or Articles of Incorporation should be part of the submission.*** Evidence will not be included when calculating the page limit. The parties may submit expert evidence in writing, and there shall be one right of reply to that expert evidence. ***The IRP Panel may request additional written submissions from the party seeking review,*** the Board, the Supporting Organizations, or from other parties.” [Bold and italics are ICANN’s]

ICANN adds:

“This section clearly provides that DCA [Trust’s] opportunity to provide briefing and evidence in this matter has concluded, subject only to a request for additional briefing from the Panel. DCA has emphasized that the rule references the ‘initial’ written submission, but the word ‘initial’ refers to the fact that the Panel ‘may request additional written submissions,’ not that DCA [Trust] has some ‘right’ to a second submission. There is no Supplementary Rule that even suggests the possibility of a second submission as a matter of right. The fact that DCA [Trust] has twice failed to submit evidence in support of its claims is not justification for allowing DCA [Trust] a third attempt.”<sup>34</sup>

66) ICANN further notes, that in its 20 April 2014 letter to the Panel, ICANN already submitted that, “DCA [Trust’s] argument that it submitted its papers ‘on the understanding that opportunities would be available to make further submissions’ is false. ICANN stated in an email to DCA [Trust’s] counsel on 9 January 2014—prior to the submission of DCA [Trust’s] Amended Notice—that the Supplementary [Procedures] bar the filing of supplemental submissions absent a request from the Panel.”<sup>35</sup>

67) According to ICANN:

“[The] decision as to whether to allow supplemental briefing is within the Panel’s discretion, and ICANN urges the Panel to decline to permit supplemental briefing for two reasons. First, despite having months to consider how DCA [Trust] might respond to ICANN’s presentation on the merits, DCA [Trust] has never even attempted to explain

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<sup>32</sup> *Ibid*, para. 59.

<sup>33</sup> ICANN First Memorial, para. 24.

<sup>34</sup> *Ibid*.

<sup>35</sup> *Ibid*, para. 25.

what it could say in additional briefing that would refute the materials in ICANN's presentation. [...] The fact that DCA is unable to identify supplemental witnesses six months after filing its Notice of IRP is strong indication that further briefing would not be helpful in this case. Second, as ICANN has explained on multiple occasions, DCA [Trust] has delayed these proceedings substantially, and further briefing would compound that delay [...] as ICANN noted in its letter of 20 April 2014, despite DCA [Trust's] attempts to frame this case as implicating issues 'reach[ing] far beyond the respective rights of the parties as concerns the delegation of .AFRICA,' the issues in this case are in fact extremely limited in scope. This Panel is authorized only to address whether ICANN violated its Bylaws or Articles of Incorporation *in its handling of DCA's Application for .AFRICA*. The parties have had the opportunity to submit briefs and evidence regarding that issue. DCA [Trust] has given no indication that it has further dispositive arguments to make or evidence to present. The Panel should resist DCA's attempt to delay these proceedings even further via additional briefing."<sup>36</sup>

### **The Panel's directions concerning additional filings**

- 68) As with document production, in the face of Article 16 of the ICDR Rules, the Panel is of the view that both Parties ought to benefit from additional filings. In this instance again, while it is possible as ICANN explains, that the drafters of the Supplementary Procedures may have desired to preclude the introduction of additional evidence not submitted with an initial statement of claim, the Panel is of the view that such a result would be inconsistent with ICANN's core values and the Panel's obligation to treat the parties fairly and afford both sides a reasonable opportunity to present their case.
- 69) Again, every set of dispute resolution rules, and every court process that the Panel is aware of, allows a claimant to supplement its presentation as its case proceeds to a hearing. The goal of a fair opportunity to present one's case is in harmony with ICANN's goals of accountability, transparency, and fairness.
- 70) The Panel is aware of and fully embraces the fact that ICANN tried to curtail unnecessary time and costs in the IRP process. However, this may not be done at the cost of a fair process for both parties, particularly in light of the fact that the IRP is the exclusive dispute resolution mechanism provided to applicants.
- 71) Therefore, the Panel will allow the Parties to benefit from additional filings and supplemental briefing going forward. The Panel invites the Parties in this regard to agree on a reasonable exchange timetable. If the Parties are unable to agree on the scope and length of such additional filings and supplemental briefing, the Panel will intervene and, with the input of the Parties, provide further guidance.

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<sup>36</sup> *Ibid*, paras. 26 and 27.

## **c) Method of Hearing and Testimony**

### **Parties' Submissions**

72) In the DCA Trust First Memorial, DCA Trust submitted that:

“[The] parties agree that a hearing on the merits is appropriate in this IRP. DCA [Trust] respectfully requests that the Panel schedule a hearing on the merits after document discovery has concluded and the parties have had the opportunity to file memorials on the merits. Although the Panel clearly has the authority to conduct a hearing in-person, in the interest of saving time and minimizing costs, DCA [Trust] would agree to a video hearing, as stated during the April 22 hearing on procedural matters.”<sup>37</sup>

73) In response, ICANN submitted that, “during the 22 April 2014 Call, ICANN agreed that this IRP is one in which a telephonic or video conference would be helpful and offered to facilitate a video conference.”<sup>38</sup> In addition, in the ICANN First Memorial, ICANN argued that according to Article IV, Section 3.12 of the Bylaws and paragraph 4 of the Supplementary Procedures, the IRP should conduct its proceedings by email and otherwise via Internet to the maximum extent feasible and in the extraordinary event that an in-person hearing is deemed necessary by the panel, the in-person hearing shall be limited to argument only.

74) ICANN also advanced, that:

“[It] does not believe [...] that this IRP is sufficiently ‘extraordinary’ so as to justify an in-person hearing, which would dramatically increase the costs for the parties. As discussed above, the issues in this IRP are straightforward – limited to whether ICANN’s Board acted consistent with its Bylaws and Articles of Incorporation in relation to DCA’s application for. AFRICA. – and can, easily [...], be resolved following a telephonic oral argument with counsel and the Panel.”<sup>39</sup>

75) In the DCA Trust First Memorial, DCA Trust also argued that, in “April 2013, ICANN amended its Bylaws to limit telephonic or in-person hearings to ‘argument only.’ At some point after the *ICM* Panel’s 2009 decision in *ICM v. ICANN*, ICANN also revised the Supplementary Procedures to limit hearings to ‘argument only.’ Accordingly, and as ICANN argued at the procedural hearing, ICANN’s revised Bylaws and Supplementary Procedures suggest that there is to be no cross-examination of witnesses at the hearing. However, insofar as neither the Supplementary Procedures nor the Bylaws expressly exclude cross-examination, this provision remains ambiguous.”<sup>40</sup>

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<sup>37</sup> DCA Trust First Memorial, *para.* 63.

<sup>38</sup> ICANN First Memorial, *para.* 36.

<sup>39</sup> *Ibid*, *para.* 36.

<sup>40</sup> DCA Trust First Memorial, *para.* 64.



76)DCA Trust submitted that:

“[Regardless] of whether the parties themselves may examine witnesses at the hearing, it is clear that the Panel may do so. Article 16(1) provides that the Panel ‘may conduct the arbitration in whatever manner it considers appropriate, provided that the parties are treated with equality and that each party has the right to be heard and is given a fair opportunity to present its case.’ It is, moreover, customary in international arbitration for tribunal members to question witnesses themselves – often extensively – in order to test their evidence or clarify facts that are in dispute. In this case, ICANN has submitted witness testimony that, among other things, purports to rely on secret documents that have not been provided. As long as those documents are withheld from DCA [Trust], it is particularly important for that witness testimony to be fully tested by the Panel, if not by the parties. Particularly in light of the important issues at stake in this matter and the general due process concerns raised when parties cannot test the evidence presented against them, DCA [Trust] strongly urges the Panel to take full advantage of its opportunity to question witnesses. Such questioning will in no way slow down the proceedings, which DCA [Trust] agrees are to be expedited – but not at the cost of the parties’ right to be heard, and the Panel’s right to obtain the information it needs to render its decision.”<sup>41</sup>

77)In response, ICANN submitted that:

“[Both] the Supplementary Procedures and ICANN’s Bylaws unequivocally and unambiguously prohibit live witness testimony in conjunction with any IRP.” Paragraph 4 of the Supplementary Procedures, which according to ICANN governs the “Conduct of the Independent Review”, demonstrates this point. According to ICANN, “indeed, two separate phrases of Paragraph 4 explicitly prohibit live testimony: (1) the phrase limiting the in-person hearing (and similarly telephonic hearings) to ‘argument only,’ and (2) the phrase stating that ‘all evidence, including witness statements, must be submitted in advance.’ The former explicitly limits hearings to the argument of counsel, excluding the presentation of any evidence, including any witness testimony. The latter reiterates the point that *all evidence, including witness testimony*, is to be presented in writing and prior to the hearing. Each phrase unambiguously excludes live testimony from IRP hearings. Taken together, the phrases constitute irrefutable evidence that the Supplementary Procedures establish a truncated hearing procedure.”<sup>42</sup>

78)ICANN added:

“[Paragraph] 4 of the Supplementary Procedures is based on the exact same and unambiguous language in Article IV, Section 3.12 of the Bylaws, which provides that ‘[i]n the unlikely event that a telephonic or in-person hearing is convened, **the hearing shall be limited to argument only; all evidence, including witness statements, must be submitted in writing in advance**.’” [...] While DCA [Trust] may prefer a different procedure, the Bylaws and the Supplementary Procedures could not be any clearer in this regard. Despite the Bylaws’ and Supplementary Procedures’ clear and unambiguous prohibition of live witness testimony, DCA [Trust] attempts to argue that the Panel should instead be guided by Article 16 of the ICDR Rules, which states that subject to the ICDR Rules, ‘the tribunal may conduct the arbitration in whatever manner it considers appropriate, provided that the parties are treated with equality and that each

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<sup>41</sup> *Ibid*, paras. 65 and 66.

<sup>42</sup> ICANN First Memorial, paras. 15 and 16.

party has the right to be heard and is given a fair opportunity to present its case.’ However, as discussed above, the Supplementary Procedures provide that ‘[i]n the event there is any inconsistency between these Supplementary Procedures and [ICDR’s International Arbitration Rules], these Supplementary Procedures will govern,’ and the Bylaws require that the ICDR Rules ‘be consistent’ with the Bylaws. As such, the Panel **does not have discretion** to order live witness testimony in the face of the Bylaws’ and Supplementary Procedures’ clear and unambiguous prohibition of such testimony.”<sup>43</sup>

79) ICANN further submitted:

“[During] the 22 April Call, DCA vaguely alluded to ‘due process’ and ‘constitutional’ concerns with prohibiting cross-examination. As ICANN did after public consultation, and after the *ICM* IRP, ICANN has the right to establish the rules for these procedures, rules that DCA agreed to abide by when it filed its Request for IRP. First, ‘constitutional’ protections do not apply with respect to a *corporate accountability mechanism*. Second, ‘due process’ considerations (though inapplicable to corporate accountability mechanisms) were already considered as part of the design of the revised IRP. And the United States Supreme Court has repeatedly affirmed the right of parties to tailor unique rules for dispute resolution processes, including even *binding arbitration proceedings* (which an IRP is not). The Supreme Court has specifically noted that ‘[t]he point of affording parties discretion in designing arbitration processes is to allow for efficient, streamlined procedures tailored to the type of dispute. . . . And the informality of arbitral proceedings is itself desirable, reducing the cost and increasing the speed of dispute resolution’.”<sup>44</sup>

80) According to ICANN:

“[The] U.S. Supreme Court has explicitly held that the right to tailor unique procedural rules includes the right to dispense with certain procedures common in civil trials, including the right to cross-examine witnesses [...] Similarly, international arbitration norms recognize the right of parties to tailor their own, unique arbitral procedures. ***‘Party autonomy is the guiding principle in determining the procedure to be followed in international arbitration.’*** It is a principle that is endorsed not only in national laws, but by international arbitral institutions worldwide, as well as by international instruments such as the New York Convention and the Model Law.”<sup>45</sup>

81) In short, ICANN advanced that:

“[Even] if this were a formal ‘arbitration’, ICANN would be entitled to limit the nature of these proceedings so as to preclude live witness testimony. The fact that this proceeding is not an arbitration further reconfirms ICANN’s right to establish the rules that govern these proceedings [...] DCA [Trust] argues that it will be prejudiced if cross-examination of witnesses is not permitted. However, the procedures give both parties equal opportunity to present their evidence—the inability of either party to examine witnesses at the hearing would affect both the Claimant and ICANN equally. In this instance, DCA [Trust] did not submit witness testimony with its Amended Notice (as clearly it should have). However, were DCA [Trust] to present any written witness statements in support of its position, ICANN would not be entitled to cross examine

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<sup>43</sup> *Ibid*, paras. 17 and 18. Bold and italics are from the original text.

<sup>44</sup> *Ibid*, para. 19.

<sup>45</sup> *Ibid*, paras. 20 and 21. Bold and italics are from the original text.

those witnesses, just as DCA [Trust] is not entitled to cross examine ICANN's witnesses. Of course, the parties are free to argue to the IRP Panel that witness testimony should be viewed in light of the fact that the rules do not permit cross-examination."<sup>46</sup>

### **The Panel's directions on method of hearing and testimony**

- 82) The considerations and discussions under the prior headings addressing document exchange and additional filings apply to the hearing and testimony issues raised in this IRP proceeding as well.
- 83) At this juncture, the Panel is of the preliminary view that at a minimum a video hearing should be held. The Parties appear to be in agreement. However, the Panel does not wish to close the door to the possibility of an in-person hearing and live examination of witnesses, should the Panel consider that such a method is more appropriate under the particular circumstances of this case after the Parties have completed their document exchange and the filing of any additional materials.
- 84) While the Supplementary Procedures appear to limit both telephonic and in-person hearings to "argument only", the Panel is of the view that this approach is fundamentally inconsistent with the requirements in ICANN's Bylaws for accountability and for decision making with objectivity and fairness.
- 85) Analysis of the propriety of ICANN's decisions in this case will depend at least in part on evidence about the intentions and conduct of ICANN's top personnel. ICANN should not be allowed to rely on written statements of these officers and employees attesting to the propriety of their actions without an appropriate opportunity in the IRP process for DCA Trust to challenge and test the veracity of such statements.
- 86) The Panel, therefore, reserves its decision to order an in-person hearing and live testimony pending a further examination of the representations that will be proffered by each side, including the filing of any additional evidence which this Decision permits. The Panel also permits both Parties at the hearing to challenge and test the veracity of statements made by witnesses.
- 87) Having said this, the Panel acknowledges the Parties' desire that the IRP proceedings be as efficient and economical as feasible, consistent with the overall objectives of a fair and independent proceeding. The Panel will certainly bear this desire and goal in mind as these proceedings advance further.

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<sup>46</sup> *Ibid*, paras. 22 and 23.

### 3) Is the Panel's Decision on the IRP Procedure and its future Declaration on the Merits in this proceeding binding?

#### DCA Trust's Submissions

88) In addition to the submissions set out in the earlier part of this Decision, DCA Trust argues that, the language used in the Bylaws to describe the IRP process is demonstrative that it is intended to be a binding process. When the language in the Bylaws for reconsideration is compared to that describing the IRP, DCA Trust explains:

“[It] is clear that the declaration of an IRP is intended to be final and binding [...] For example, the Bylaws provide that the [ICANN] [Board Governance Committee] BGC ‘shall act on a Reconsideration Request on the basis of the written public record’ and ‘shall make a final determination or recommendation.’ The Bylaws even expressly state that **‘the Board shall not be bound to follow the recommendations’** of the BGC. By contrast, the IRP Panel makes **‘declarations’** — defined by ICANN in its Supplementary Procedures as ‘decisions/opinions’— that **‘are final and have precedential value.’** The IRP Panel ‘shall specifically designate the prevailing party’ and may allocate the costs of the IRP Provider to one or both parties. Moreover, nowhere in ICANN’s Bylaws or the Supplementary Procedures does ICANN state that the Board shall not be bound by the declaration of the IRP. If that is what ICANN intended, then it certainly could have stated it plainly in the Bylaws, as it did with reconsideration. The fact that it did not do so is telling.”<sup>47</sup>

89) In light of the foregoing, DCA Trust advances:

“[The] IRP process is an arbitration in all but name. It is a dispute resolution procedure administered by an international arbitration service provider, in which the decision-makers are neutral third parties chosen by the parties to the dispute. There are mechanisms in place to assure the neutrality of the decision-makers and the right of each party to be heard. The IRP Panel is vested with adjudicative authority that is equivalent to that of any other arbitral tribunal: it renders decisions on the dispute based on the evidence and arguments submitted by the parties, and its decisions are binding and have *res judicata* and precedential value. The procedures appropriate and customary in international arbitration are thus equally appropriate in this IRP. But in any event, and as discussed below, the applicable rules authorize the Panel to conduct this IRP in the manner it deems appropriate regardless of whether it determines that the IRP qualifies as an arbitration.”<sup>48</sup>

#### ICANN's Submissions

90) In response, ICANN submits that:

“[The] provisions of Article IV, Section 3 of the ICANN Bylaws, which govern the Independent Review process and these proceedings, make clear that the declaration of the Panel will not be binding on ICANN. Section 3.11 gives the IRP panels the authority

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<sup>47</sup> DCA Trust First Memorial, *paras.* 33, 34 and 35. Bold and italics are from the original text.

<sup>48</sup> *Ibid.* *para.* 44.

to ‘declare whether an action or inaction of the Board was inconsistent with the Articles of Incorporation or Bylaws’ and ‘recommend that the Board stay any action or decision, or that the Board take any interim action, until such time as the Board reviews and acts upon the opinion of the IRP.’ Section 3.21 provides that ‘[w]here feasible, the Board shall consider the IRP Panel declaration at the Board’s next meeting.’ Section 3 never refers to the IRP panel’s declaration as a ‘decision’ or ‘determination.’ It does refer to the ‘Board’s subsequent action on [the IRP panel’s] declaration [...]’ That language makes clear that the IRP’s declarations are advisory and not binding on the Board. Pursuant to the Bylaws, the Board has the discretion to consider an IRP panel’s declaration and take whatever action it deems appropriate.”<sup>49</sup>

#### 91) According to ICANN:

“[This] issue was addressed extensively in the *ICM* IRP, a decision that has precedential value to this Panel. The *ICM* Panel specifically considered the argument that the IRP proceedings were ‘arbitral and not advisory in character,’ and unanimously concluded that its declaration was ‘not binding, but rather advisory in effect.’ At the time that the *ICM* Panel rendered its declaration, Article IV, Section 3 of ICANN’s Bylaws provided that ‘IRP shall be operated by an international arbitration provider appointed from time to time by ICANN...using arbitrators . . . nominated by that provider.’ *ICM* unsuccessfully attempted to rely on that language in arguing that the IRP constituted an arbitration, and that the IRP panel’s declaration was binding on ICANN. Following that IRP, that language was removed from the Bylaws with the April 2013 Bylaws amendments, further confirming that, under the Bylaws, an IRP panel’s declaration is not binding on the Board.”<sup>50</sup>

#### 92) ICANN also submits that:

“[The] lengthy drafting history of ICANN’s independent review process confirms that IRP panel declarations are not binding. Specifically, the Draft Principles for Independent Review, drafted in 1999, state that ‘the ICANN Board should retain ultimate authority over ICANN’s affairs – after all, it is the Board ... that will be chosen by (and is directly accountable to) the membership and supporting organizations.’ And when, in 2001, the Committee on ICANN Evolution and Reform (‘ERC’) recommended the creation of an independent review process, it called for the creation of ‘a process to require non-binding arbitration by an international arbitration body to review any allegation that the Board has acted in conflict with ICANN’s Bylaws.’ The individuals who actively participated in the process also agreed that the review process would not be binding. As one participant stated: IRP ‘decisions will be nonbinding, because the Board will retain final decision-making authority’.”<sup>51</sup>

#### 93) According to ICANN:

“[The] only IRP Panel ever to issue a declaration, the *ICM* IRP Panel, unanimously rejected the assertion that IRP Panel declarations are binding and recognized that an IRP panel’s declaration ‘is not binding, but rather advisory in effect.’ Nothing has occurred since the issuance of the *ICM* IRP Panel’s declaration that changes the fact that IRP Panel declarations are not binding. To the contrary, in April 2013, following the

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<sup>49</sup> ICANN First Memorial, *para.* 33,

<sup>50</sup> *Ibid*, *para.* 34,

<sup>51</sup> ICANN Second Memorial, *para.* 5,

*ICM* IRP, in order to clarify even further that IRPs are not binding, all references in the Bylaws to the term ‘arbitration’ were removed as part of the Bylaws revisions. ICM had argued in the IRP that the use of the word ‘arbitration’ in the portion of the Bylaws related to Independent Review indicated that IRPs were binding, and while the *ICM* IRP Panel rejected that argument, to avoid any lingering doubt, ICANN removed the word ‘arbitration’ in conjunction with the amendments to the Bylaws.”<sup>52</sup>

94) ICANN further submits that:

“[The] amendments to the Bylaws, which occurred following a community process on the proposed IRP revisions, added, among other things, a sentence stating that ‘declarations of the IRP Panel, and the Board’s subsequent action on those declarations, are final and have precedential value.’ DCA argues that this new language, which does not actually use the word ‘binding,’ nevertheless provides that IRP Panel declarations are binding, trumping years of drafting history, the sworn testimony of those who participated in the drafting process, the plain text of the Bylaws, and the reasoned declaration of a prior IRP panel. DCA is wrong.”<sup>53</sup>

95) According to ICANN:

“[The] language DCA references was added to ICANN’s Bylaws to meet recommendations made by ICANN’s Accountability Structures Expert Panel (‘ASEP’). The ASEP was comprised of three world-renowned experts on issues of corporate governance, accountability, and international dispute resolution, and was charged with evaluating ICANN’s accountability mechanisms, including the Independent Review process. The ASEP recommended, *inter alia*, that an IRP should not be permitted to proceed on the same issues as presented in a prior IRP. The ASEP’s recommendations in this regard were raised in light of the second IRP constituted under ICANN’s Bylaws, where the claimant presented claims that would have required the IRP Panel to [re-evaluate] the declaration of the IRP Panel in the *ICM* IRP. To prevent claimants from challenging a prior IRP Panel declaration, the ASEP recommended that ‘[t]he declarations of the IRP, and ICANN’s subsequent actions on those declarations, should have precedential value.’ The ASEP’s recommendations in this regard did not convert IRP Panel declarations into binding decisions.”<sup>54</sup>

96) Moreover, ICANN argues:

“[One] of the important considerations underlying the ASEP’s work was the fact that ICANN, while it operates internationally, is a California non-profit public benefit corporation subject to the statutory law of California as determined by United States courts. That law requires that ICANN’s Board retain the ultimate responsibility for decision-making. As a result, the ASEP’s recommendations were premised on the understanding that the declaration of the IRP Panel is not ‘binding’ on the Board. In any event, a declaration clearly can be both non-binding and precedential.”<sup>55</sup>

97) In short, ICANN argues that the IRP is *not* binding. According to ICANN, “not only is there no language in the Bylaws stating that IRP Panel declarations

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<sup>52</sup> *Ibid*, para. 6.

<sup>53</sup> *Ibid*, para. 7.

<sup>54</sup> *Ibid*, paras. 8 and 9.

<sup>55</sup> *Ibid*, paras. 9 and 10.

are binding on ICANN, there is no language stating that an IRP Panel even may determine if its advisory Declarations are binding.”<sup>56</sup> According to ICANN, words such as “arbitration” and “arbitrator” were removed from the Bylaws to ensure that the IRP Panel’s declarations do not have the force of normal commercial arbitration. ICANN also argues that DCA Trust, “fails to point to a *single piece of evidence* in all of the drafting history of the Bylaws or any of the amendments to indicate that ICANN intended, through its 2013 amendments, to convert a non-binding procedure into a binding one.”<sup>57</sup> Finally, ICANN submits that “it is not within the scope of this Panel’s authority to declare whether IRP Panel declarations are binding on ICANN’s Board...the Panel does not have the authority to re-write ICANN’s Bylaws or the rules applicable to this proceeding. The Panel’s mandate is strictly limited to ‘comparing contested actions of the Board [and whether it] has acted consistently with the provisions of those Articles of Incorporation and Bylaws, and [...] declaring whether the Board has acted consistently with the provisions of those Articles of Incorporation and Bylaws’.”<sup>58</sup>

### **The Panel’s Decision on Binding or Advisory nature of IRP decisions, opinions and declarations**

98) Various provisions of ICANN’s Bylaws and the Supplementary Procedures support the conclusion that the Panel’s decisions, opinions and declarations are binding. There is certainly nothing in the Supplementary Rules that renders the decisions, opinions and declarations of the Panel either advisory or non-binding.<sup>59</sup>

99) In paragraph 1, the Supplementary Procedures define “Declaration” as the “decisions and/or opinions of the IRP Panel”. In paragraph 9, the Supplementary Procedures require any Declaration of a three-member IRP Panel to be signed by the majority and in paragraph 10, under the heading “Form and Effect of an IRP Declaration”, they require Declarations to be in writing, based on documentation, supporting materials and arguments submitted by the parties. The Supplementary Procedures also require the Declaration to “specifically designate the prevailing party”.<sup>60</sup>

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<sup>56</sup> ICANN letter of 2 June 2014 addressed to the Panel.

<sup>57</sup> *Ibid.* Italics are from the original decision.

<sup>58</sup> *Ibid.*

<sup>59</sup> The Reconsideration process established in the Bylaws expressly provides that ICANN’s “Board *shall not be bound to follow* the recommendations” of the BGC for action on requests for reconsideration. No similar language in the Bylaws or Supplementary Procedures limits the effect of the Panel’s IRP decisions, opinions and declarations to an advisory or non-binding effect. It would have been easy for ICANN to clearly state somewhere that the IRP’s decisions, opinions or declarations are “advisory”—this word appears in the Reconsideration Process.

<sup>60</sup> Moreover, the word “Declaration” in the common law legal tradition is often synonymous with a binding decision. According to Black’s Law Dictionary (7<sup>th</sup> Edition 1999) at page 846, a “declaratory

- 100) Section 10 of the Supplementary Procedures, resembles Article 27 of the ICDR Rules. Whereas Article 27 refers to “Awards”, section 10 refers to “Declarations”. Section 10 of the Supplementary Procedures, however, is silent on whether Declarations made by the IRP Panel are “final and binding” on the parties.
- 101) As explained earlier, as per Article IV, Section 3, paragraph 8 of the Bylaws, the Board of Directors of ICANN has given its approval to the ICDR to establish a set of operating rules and procedures for the conduct of the IRP set out in section 3. The operating rules and procedures established by the ICDR are the ICDR Rules as referred to in the preamble of the Supplementary Procedures. These Rules have been supplemented<sup>61</sup> with the Supplementary Procedures.
- 102) This is clear from two different parts of the Supplementary Procedures. First, in the preamble, where the Supplementary Procedures state that: “These procedures supplement the International Centre for Dispute Resolution’s International Arbitration Rules in accordance with the independent review procedures set forth in Article IV, Section 3 of the ICANN Bylaws”.
- 103) And second, under section 2 entitled (Scope), that states that the “ICDR will apply these Supplementary Procedures, in addition to the INTERNATIONAL DISPUTE RESOLUTION PROCEDURES, in all cases submitted to the ICDR in connection with the Article IV, Section 3(4) of the ICANN Bylaws”. It is therefore clear that ICANN intended the operating rules and procedures for the independent review to be an international set of arbitration rules supplemented by a particular set of additional rules.
- 104) There is also nothing inconsistent between section 10 of the Supplementary Procedures and Article 27 of the ICDR Rules.
- 105) One of the hallmarks of international arbitration is the binding and final nature of the decisions made by the adjudicators. Binding arbitration is the essence of what the ICDR Rules, the ICDR itself and its parent, the American Arbitration Association, offer. The selection of the ICDR Rules as the baseline

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judgment” is, “a binding adjudication that establishes the rights and other legal obligations of the parties without providing for or ordering enforcement”.

<sup>61</sup> As explained by the Panel before, the word “supplement” means to complete, add to, extend or supply a deficiency. The Supplementary Procedures, therefore, *supplement* (not replace or supersede) the ICDR Rules. As also indicated by the Panel before, in the event there is any inconsistency between the Supplementary Procedures and the ICDR Rules, ICANN requires the Supplementary Procedures to govern.



set of procedures for IRP's, therefore, points to a binding adjudicative process.

106) Furthermore, the process adopted in the Supplementary Procedures is an adversarial one where counsel for the parties present competing evidence and arguments, and a panel decides who prevails, when and in what circumstances. The panelists who adjudicate the parties' claims are also selected from among experienced arbitrators, whose usual charter is to make binding decisions.

107) The above is further supported by the language and spirit of section 11 of ICANN's Bylaws. Pursuant to that section, the IRP Panel has the authority to summarily dismiss requests brought without standing, lacking in substance, or that are frivolous or vexatious. Surely, such a decision, opinion or declaration on the part of the Panel would not be considered advisory.

108) Moreover, even if it could be argued that ICANN's Bylaws and Supplementary Procedures are ambiguous on the question of whether or not a decision, opinion or declaration of the IRP Panel is binding, in the Panel's view, this ambiguity would weigh against ICANN's position. The relationship between ICANN and the applicant is clearly an adhesive one. There is no evidence that the terms of the application are negotiable, or that applicants are able to negotiate changes in the IRP.

109) In such a situation, the rule of *contra proferentem* applies. As the drafter and architect of the IRP Procedure, it was open to ICANN and clearly within its power to adopt a procedure that expressly and clearly announced that the decisions, opinions and declarations of IRP Panels were advisory only. ICANN did not adopt such a procedure.

110) ICANN points to the extensive public and expert input that preceded the formulation of the Supplementary Procedures. The Panel would have expected, were a mere advisory decision, opinion or declaration the objective of the IRP, that this intent be clearly articulated somewhere in the Bylaws or the Supplementary Procedures. In the Panel's view, this could have easily been done.

111) The force of the foregoing textual and construction considerations as pointing to the binding effect of the Panel's decisions and declarations are reinforced by two factors: 1) the exclusive nature of the IRP whereby the non-binding argument would be clearly in contradiction with such a factor<sup>62</sup>;

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<sup>62</sup> If the waiver of judicial remedies ICANN obtains from applicants is enforceable, and the IRP process is non-binding, as ICANN contends, then that process leaves TLD applicants and the Internet community with no compulsory remedy of any kind. This is, to put it mildly, a highly watered down notion of "accountability". Nor is such a process "independent", as the ultimate decision maker,

and, 2) the special, unique, and publicly important function of ICANN. As explained before, ICANN is not an ordinary private non-profit entity deciding for its own sake who it wishes to conduct business with, and who it does not. ICANN rather, is the steward of a highly valuable and important international resource.

112) Even in ordinary private transactions, with no international or public interest at stake, contractual waivers that purport to give up *all* remedies are forbidden. Typically, this discussion is found in the Uniform Commercial Code Official Comment to section 2719, which deals with “Contractual modification or limitation of remedy.” That Comment states:

“Under this section parties are left free to shape their remedies to their particular requirements and reasonable agreements limiting or modifying remedies are to be given effect. However, *it is the very essence of a sales contract that at least minimum adequate remedies be available.* If the parties intend to conclude a contract for sale within this Article *they must accept the legal consequence that there be at least a fair quantum of remedy for breach of the obligations or duties outlined in the contract.*” [Panel’s emphasis by way of italics added]

113) The need for a minimum adequate remedy is indisputably more important where, as in this case, the party arguing that there is no compulsory remedy is the party entrusted with a special, internationally important and valuable operation.

114) The need for a compulsory remedy is concretely shown by ICANN’s longstanding failure to implement the provision of the Bylaws and Supplementary Procedures requiring the creation of a standing panel. ICANN has offered no explanation for this failure, which evidences that a self-policing regime at ICANN is insufficient. The failure to create a standing panel has consequences, as this case shows, delaying the processing of DCA Trust’s claim, and also prejudicing the interest of a competing .AFRICA applicant.

115) Moreover, assuming for the sake of argument that it is acceptable for ICANN to adopt a remedial scheme with no teeth, the Panel is of the opinion that, at a minimum, the IRP should forthrightly explain and acknowledge that the process is merely advisory. This would at least let parties know before embarking on a potentially expensive process that a victory before the IRP panel may be ignored by ICANN. And, a straightforward acknowledgment that the IRP process is intended to be merely advisory might lead to a legislative or executive initiative to create a truly independent compulsory process. The Panel seriously doubts that the Senators questioning former ICANN President Stuart Lynn in 2002 would have been satisfied had they

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ICANN, is also a party to the dispute and directly interested in the outcome. Nor is the process “neutral,” as ICANN’s “core values” call for in its Bylaws.

understood that a) ICANN had imposed on all applicants a waiver of all judicial remedies, *and* b) the IRP process touted by ICANN as the “ultimate guarantor” of ICANN accountability was only an advisory process, the benefit of which accrued only to ICANN.<sup>63</sup>

### **ICM Case**

116)The Parties in their submissions have discussed the impact on this Decision of the conclusions reached by the IRP panel in the matter of *ICM v. ICANN* (“*ICM Case*”). Although this Panel is of the opinion that the decision in the *ICM Case* should have no influence on the present proceedings, it discusses that matter for the sake of completeness.

117)In the *ICM Case*, another IRP panel examined the question centrally addressed in this part of this Decision: whether declarations and/or decisions by an IRP panel are binding, or merely advisory. The *ICM Case* panel concluded that its decision was advisory.<sup>64</sup>

118)In doing so, the *ICM Case* panel noted that the IRP used an “international arbitration provider” and “arbitrators nominated by that provider,” that the ICDR Rules were to “govern the arbitration”, and that “arbitration connotes a binding process.” These aspects of the IRP, the panel observed, were “suggestive of an arbitral process that produces a binding award.”<sup>65</sup> But, the panel continued, “there are other indicia that cut the other way, and more deeply.” The panel pointed to language in the Interim Measures section of the Supplementary Procedures empowering the panel to “recommend” rather than order interim measures, and to language requiring the ICANN Board to “consider” the IRP declaration at its next meeting, indicating, in the panel’s view, the lack of binding effect of the Declaration.

119)The *ICM Case* panel specifically observed that “the relaxed temporal proviso to do no more than ‘consider’ the IRP declaration, and to do so at the next meeting of the Board ‘where feasible’, emphasized that it is not binding. If the IRP’s declaration were binding, there would be nothing to consider but rather a determination or decision to implement in a timely manner. The Supplementary Procedures adopted for IRP, in the article on ‘Form and Effect of an IRP Declaration’, significantly omit provision of Article 27 of the ICDR Rules specifying that an award ‘shall be final and binding on the parties’. Moreover, the preparatory work of the IRP provisions...confirms that the

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<sup>63</sup> See in this regard the Memorandum of Jack Goldsmith dated 29 July 2010 at <https://cyber.law.harvard.edu/pubrelease/icann/pdfs/Jack%20Goldsmith%20on%20ICANN-final.pdf>, referred to in footnote 58 of DCA Trust’s Second Memorial.

<sup>64</sup> *ICM Case*, footnote 30. The panel’s brief discussion on this issue appears in *paras.* 132-134 of the *ICM Decision*.

<sup>65</sup> *Ibid*, *para.* 132.

intention of the drafters of the IRP process was to put in place a process that produced declarations that would not be binding and that left ultimate decision-making authority in the hands of the Board.”<sup>66</sup>

120) Following the issuance of the *ICM* Case Declaration, ICANN amended its Bylaws, and related Supplementary Procedures governing IRPs, removing most, but not all, references to “arbitration”, and adding that the “declarations of the IRP Panel, and the Board’s subsequent action on those declarations, are final and have precedential value.”

### **Difference between this IRP and the *ICM* Case**

121) According to DCA Trust, the panel in the *ICM* Matter, “based its decision that its declaration would not be binding, ‘but rather advisory in effect,’ on specific language in both a ***different*** set of Bylaws and a ***different*** set of Supplementary Procedures than those that apply in this dispute...one crucial difference in the Bylaws applicable during the *ICM* was the absence of the language describing panel declarations as ‘final and precedential’.”<sup>67</sup> The Panel agrees.

122) Section 3(21) of the 11 April 2013 ICANN Bylaws now provides: “Where feasible, the Board shall consider the IRP Panel declaration at the Board’s next meeting. The declarations of the IRP Panel, and the Board’s subsequent action on those declarations, are final and have precedential value.” At the time the *ICM* Matter was decided, section 3(15) of Article IV of ICANN’s Bylaws did not contain the second sentence of section 3(21).

123) As explained in the DCA Trust First Memorial:

“[In] finding that the IRP was advisory, the *ICM* Panel also relied on the fact that the Bylaws gave the IRP [panel] the authority to ‘declare,’ rather than ‘decide’ or ‘determine,’ whether an action or inaction of the Board was inconsistent with the Articles of Incorporation or the Bylaws. However, the *ICM* Panel did not address the fact that the Supplementary Procedures, which govern the process in combination with the ICDR Rules, defined ‘declaration’ as ‘decisions/opinions of the IRP’. If a ‘declaration’ is a ‘decision’, then surely a panel with the authority to ‘declare’ has the authority to ‘decide’.”<sup>68</sup>

The Panel agrees with DCA Trust.

124) Moreover, as explained by DCA Trust:

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<sup>66</sup> *Ibid*, para. 133.

<sup>67</sup> DCA Trust First Memorial, para. 36. Bold and italics are from the original text.

<sup>68</sup> *Ibid*, para. 39.

“[The] *ICM* Panel [...] found it significant that the Supplementary Procedures adopted for the IRP omitted Article 27 of the ICDR Rules – which specifies that an award ‘shall be final and binding on the parties.’ On that basis, the *ICM* Panel concluded that Article 27 did not apply. ICANN’s Supplementary Rules, however, were – and continue to be – silent on the effect of an award. In the event there is inconsistency between the Supplementary Procedures and the ICDR Rules, then the Supplementary Procedures govern; but there is nothing in the applicable rules suggesting that an **omission** of an ICDR Rule means that it does not apply. Indeed, the very same Supplementary Procedures provide that ‘the ICDR’s International Arbitration Rules [...] will govern the process **in combination** with these Supplementary Procedures. Furthermore, it is only in the event there is ‘any inconsistency’ between the Supplementary Procedures and the ICDR Rules that the Supplementary Procedures govern.”<sup>69</sup>

Again, the Panel agrees with DCA Trust.

125) With respect, therefore, this Panel disagrees with the panel in the *ICM* Case that the decisions and declarations of the IRP panel are not binding. In reaching that conclusion, in addition to failing to make the observations set out above, the *ICM* panel did not address the issue of the applicant’s waiver of all judicial remedies, it did not examine the application of the *contra proferentem* doctrine, and it did not examine ICANN’s commitment to accountability and fair and transparent processes in its Articles of Incorporation and Bylaws.

126) ICANN argues that the panel’s decision in the *ICM* Case that declarations are not binding is dispositive of the question. ICANN relies on the provision in the Bylaws, quoted above, (3(21)) to the effect that declarations “have precedential value.” Like certain other terms in the IRP and Supplementary Procedures, the Panel is of the view that this phrase is ambiguous. Legal precedent may be either binding or persuasive.<sup>70</sup> The Bylaws do not indicate which kind of precedent is intended.

127) *Stare decisis* is the legal doctrine, which gives binding precedential effect, typically to earlier decisions on a settled point of law, decided by a higher court. The doctrine is not mandatory, as illustrated by the practice in common law jurisdictions of overruling earlier precedents deemed unwise or unworkable. In the present case, there is no “settled” law in the usual sense of a body of cases approved by a court of ultimate resort, but instead, a single decision by one panel on a controversial point, which this Panel, with respect, considers to be unconvincing.

128) Therefore, the Panel is of the view that the ruling in the *ICM* Case is *not* persuasive and binding upon it.

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<sup>69</sup> *Ibid*, para. 40. Bold and italics are from the original text.

<sup>70</sup> Black’s Law Dictionary, (7<sup>th</sup> Edition 1999), p. 1195.

## **VI. DECLARATION OF THE PANEL**

129)Based on the foregoing and the language and content of the IRP Procedure, the Panel is of the view that it has the power to interpret and determine the IRP Procedure as it relates to the future conduct of these proceedings.

130)Based on the foregoing and the language and content of the IRP Procedure, the Panel issues the following procedural directions:

(i) The Panel orders a reasonable documentary exchange in these proceedings with a view to maintaining efficacy and economy, and invites the Parties to agree by or before 29 August 2014, on a form, method and schedule of exchange of documents between them;

(ii) The Panel permits the Parties to benefit from additional filings and supplemental briefing going forward and invites the Parties to agree on a reasonable exchange timetable going forward;

(iii) The Panel allows a video hearing as per the agreement of the Parties, but reserves its decision to order an in-person hearing and live testimony pending a further examination of the representations that will be proffered by each side, including the filing of any additional evidence which this Decision permits; and

(iv) The Panel permits both Parties at the hearing to challenge and test the veracity of statements made by witnesses.

If the Parties are unable to agree on a reasonable documentary exchange process or to agree on the scope and length of additional filings and supplemental briefing, the Panel will intervene and, with the input of the Parties, provide further guidance.

131)Based on the foregoing and the language and content of the IRP Procedure, the Panel concludes that this Declaration and its future Declaration on the Merits of this case are binding on the Parties.

132)The Panel reserves its views with respect to any other issues raised by the Parties for determination at the next stage of these proceedings. At that time, the Panel will consider the Parties' respective arguments in those regards.

133)The Panel reserves its decision on the issue of costs relating to this stage of the proceeding until the hearing of the merits.

This Declaration may be executed in any number of counterparts, each of which shall be deemed an original, and all of which together shall constitute the Declaration of this Panel.

This Declaration on the IRP Procedure has thirty-three (33) pages.

Thursday, 14 August 2014

Place of the IRP, Los Angeles, California.



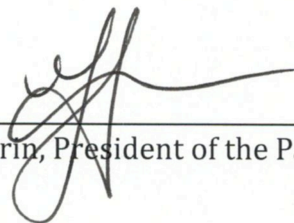
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Professor Catherine Kessedjian



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Hon. Richard C. Neal



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Babak Barin, President of the Panel

# CODE OF CIVIL PROCEDURE

## SECTION 1297.311-1297.318

1297.311. An arbitral award shall be made in writing and shall be signed by the members of the arbitral tribunal.

1297.312. For the purposes of Section 1297.311, in arbitral proceedings with more than one arbitrator, the signatures of the majority of all the members of the arbitral tribunal shall be sufficient so long as the reason for any omitted signature is stated.

1297.313. The arbitral award shall state the reasons upon which it is based, unless the parties have agreed that no reasons are to be given, or the award is an arbitral award on agreed terms under Article 3 (commencing with Section 1297.301) of this chapter.

1297.314. The arbitral award shall state its date and the place of arbitration as determined in accordance with Article 3 (commencing with Section 1297.201) of Chapter 5 and the award shall be deemed to have been made at that place.

1297.315. After the arbitral award is made, a signed copy shall be delivered to each party.

1297.316. The arbitral tribunal may, at any time during the arbitral proceedings, make an interim arbitral award on any matter with respect to which it may make a final arbitral award. The interim award may be enforced in the same manner as a final arbitral award.

1297.317. Unless otherwise agreed by the parties, the arbitral tribunal may award interest.

1297.318. (a) Unless otherwise agreed by the parties, the costs of an arbitration shall be at the discretion of the arbitral tribunal.

(b) In making an order for costs, the arbitral tribunal may include as costs any of the following:

- (1) The fees and expenses of the arbitrators and expert witnesses.
- (2) Legal fees and expenses.
- (3) Any administration fees of the institution supervising the



arbitration, if any.

(4) Any other expenses incurred in connection with the arbitral proceedings.

(c) In making an order for costs, the arbitral tribunal may specify any of the following:

- (1) The party entitled to costs.
  - (2) The party who shall pay the costs.
  - (3) The amount of costs or method of determining that amount.
  - (4) The manner in which the costs shall be paid.
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Legitimate Expectations in  
Administrative Law

SØREN J. SCHØNBERG  
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OXFORD  
UNIVERSITY PRESS

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## Chapter 2

### *Procedural Protection of Legitimate Expectations*

#### 1 Introduction

It was argued in Chapter 1 that public law should, primarily for reasons of fairness and trust in administration, protect legitimate expectations created by administrative decisions, representations, and conduct. In this chapter I will examine how principles of administrative procedure contribute towards meeting those requirements. The connection between procedures and expectations may be explained as follows.

First, procedures may reduce the risk that expectations will *actually* be disappointed in a way which causes unfairness or mistrust in government, because they affect the outcomes of administrative decision-making processes.<sup>1</sup> If persons affected by administrative action are given advance notice, they may adapt their expectations and act so as to avoid or limit loss caused by reliance upon previous administrative representations and conduct. If affected persons are consulted or heard, their expectations and reliance can be brought to the administration's attention, and arguments against action which will disappoint those expectations may be presented. If decisions which affect expectations are followed by reasons, the administration will be forced to consider the justification for disappointing those expectations.

Second, procedures may reduce the *feeling* of unfairness and mistrust which a person whose expectations are disappointed often experiences. For if the holder of an expectation is granted a notification, a say in the process, and a justification for why his expectation cannot be upheld, the administration acknowledges that its action affects his autonomy and personal dignity.<sup>2</sup>

It will now, with these general comments in mind, be considered to what extent legitimate expectations are subject to procedural protection in English,<sup>3</sup>

<sup>1</sup> Although it remains uncertain *how* effective procedures are at affecting outcomes. See D. J. Galligan, *Due Process and Fair Procedures* (Oxford, 1996), 360-1.

<sup>2</sup> See J. L. Mashaw, *Due Process in the Administrative State* (New Haven, 1985), 104-55; R. M. Dworkin, *A Matter of Principle* (Oxford, 1985), 79-84; T. R. S. Allan, 'Procedural Fairness and the Duty of Respect' (1998) OJLS 497. Compare Galligan, above n. 1, 75-82, 122-7.

<sup>3</sup> See generally R. Baldwin and D. Horne, 'Expectations in a Joyless Landscape' (1986) MLR 685; G. Ganz, 'Legitimate Expectation', in C. Harlow (ed.), *Public Law and Politics* (London, 1986), 145; P. Elias, 'Legitimate Expectations and Judicial Review', in J. L. Jowell and D. Oliver (eds.), *New Directions in Judicial Review* (London, 1988); C. F. Forsyth, 'The Provenance and Protection of Legitimate Expectations' (1988) CLJ 238; R. E. Riggs, 'Legitimate Expectations and Procedural Fairness in English Law' (1988) AJCL 395; P. P. Craig, 'Legitimate Expectations: A Conceptual Analysis' (1992) LQR 79; R. Singh, 'Making Legitimate Use of Legitimate Expectations' (1994) NLJ 1215; De Smith 417-30; R. Singh and K. Steyn, 'Legitimate Expectations in 1996: Where Now' (1996) JR 17; B. Schwehr, 'A Study in Fairness in the Field of Community Care' (1997) JSWFL 159, 247.

French,<sup>4</sup> and EC law.<sup>5</sup> The discussion will be structured as follows. First, a comparative overview of administrative procedures in English, French, and EC law will be given. Second, I will analyse the procedural protections which apply when administrative authorities revoke decisions or go back on informal representations (Situations 1–4). Due to the limited space available only the most important aspects of fair procedures will be discussed (namely notice, hearing, and reasons).<sup>6</sup> Finally, the results of the comparative survey will be summed up and proposals for reform of English law will be presented.

## 2 Procedural Fairness in English, French, and EC Law: A Comparative Overview

Administrative procedure has traditionally played a more important role in the common law than in Continental legal systems. While the British courts had by the seventeenth century devised principles of 'natural justice' to control administrative power, the French courts have traditionally relied more upon substantive principles of judicial review and damages liability for this purpose.<sup>7</sup> A number of historical, ideological, and socio-legal factors may explain this difference. Two explanations are particularly important for our purposes.<sup>8</sup>

<sup>4</sup> See generally R. Odent, 'Les droits de la défense', EDCE 1953, 55; 'De la décision Trompiero-Gravier à la décision Garysas', EDCE 1962, 43; M. Waline 'Audi Alterem Partem', in *Livre Jubilaire du Conseil d'État du Grand-Duché de Luxembourg* (Luxembourg, 1957), 495; R. Hostiou, *Procédures et formes de l'acte administratif unilatéral en droit français* (Paris, 1974), ch. 2; D. K. Allen, 'Audi Alterem Partem in France' (1980) PL 288; LGA 350–4; B. Genevois, 'Principes généraux du droit', in F. Gazier, R. Drago and A. Dupie (eds.), *Encyclopédie Dalloz: Répertoire de contentieux administratif* (Paris, 1996), nos. 350–92; C. Eude-Guias in *JC Fasc.* 107–20; Chapus 1020–54; H. Zeghib, 'Principe du contradictoire et procédure administrative non contentieuse', RDP 1998, 467.

<sup>5</sup> See generally C.-D. Ehlermann and D. Oldekop, 'Due Process in Administrative Procedure', in *Reports to the 8th E. I. D. E. Congress*, vol. III (1978), 11.1–11.20; V. Korah, 'The Rights of Defence in Administrative Proceedings Under Community Law' (1980) CLP 73; O. Due, 'Le respect des droits de la défense dans le droit administratif communautaire', CDE 1987, 383; D. Curtin, 'Constitutionalism in the European Community: The Right to Fair Procedures in Administrative Law', in J. O'Reilly (ed.), *Human Rights and Constitutional Law: Essays in Honour of Brian Walsh* (Dublin, 1992), 293; Schwarze 1320–71; K. Lenaerts and J. Vanhamme, 'Procedural Right of Private Parties in the Community Administrative Process' (1997) CMLRev 531; H. P. Nehl, *Principles of Administrative Procedure in EC Law* (Oxford, 1999), 70–99; T. Tridimas, *The General Principles of EC Law* (Oxford, 1999), 244–75.

<sup>6</sup> Thus, the right to be granted adequate time to prepare answers, access to files, opportunity to make oral representations, opportunity to call and cross-examine witnesses and opponents, legal representation, and the right to have a decision decided without bias will not be discussed.

<sup>7</sup> It is debated in France to what extent French procedural principles differ from their English counterparts. See Waline, above n. 4, J. Lemasurier, 'Vers une démocratie administrative: du refus d'informer au droit d'être informé', RDP 1980, 1239, 1245. Compare Barthelemy in *JC Fasc.* 590–1 nos. 20–2; G. Vedel and P. Delvolvé, *Droit Administratif*, 12th edn. (Paris, 1992), 472.

<sup>8</sup> See also Tridimas, above n. 5, 245 noting the connection between the Diceyan *ultra vires* doctrine and the preference for procedural rather than substantive judicial control of administrative action.

First, administrative procedures are largely the product of case law. In England, to a large extent, they have been developed by analogy with the principle which has since ancient times a strong adversarial, formal, and technically exacting degree, viewed as an ideal for administrative procedures. These principles were less influential in France. France's system of the separate division of administrative and judicial courts, traced back to the seventeenth century, with administrative courts, headed by the Conseil d'État, operating on a *contradictoire*,<sup>9</sup> which encapsulates the principle, but it is overall more inquisitorial, in contrast to English judicial procedures<sup>13</sup> (and administrative procedures).<sup>14</sup> This difference between the two systems is the result of the development of different administrative procedures.

Second, the rationale for procedural protection is different in practice.<sup>15</sup> In France, the value of procedural protection is seen as a contribution to correct outcomes. That is, procedural protection is seen as instrumental.<sup>16</sup> Thus, a decision will be annulled *only* by a reviewing court if there is a difference to the substantive decision.

<sup>9</sup> On the historical background, see Galligani.

<sup>10</sup> See e.g. H. W. R. Wade, 'Law, Opinion and Politics', in *The Principles of Politics* (Oxford, 1966), 1–10; J. J. Jowell and L. Oliver (eds.), *The Changing Constitution* (Oxford, 1992), above n. 1, 240–7. Compare N. Lacey, 'The Administrative Law Paradigm', in K. Hawkins (ed.), *The Uses of Administrative Law* (Oxford, 1995), 1–10.

<sup>11</sup> See J. Mestre, *Introduction historique au droit administratif* (Paris, 1992), Excessive judicial interference by the ordinary courts led to an almost total exclusion of judicial review from 16–24/8 1790, repeated in the Constitution of 1791, the present form developed to fill the vacuum created by the Revolution. See Merryman, 'The French Deviation' (1997) *Administrative Law and Theory* d'être et du maintien de la juridiction administrative en France et européenne européenne Verwaltungsgeschichte 55.

<sup>12</sup> See R. Chapus, *Droit du contentieux administratif* (Paris, 1992), above n. 4.

<sup>13</sup> See J. S. Bell, 'Reflections on the Procedure of Administrative Law', in *Administrative Law and Theory* (eds.), *Droit sans frontières: Essays in Honour of J. S. Bell* (Oxford, 1992), Allison ch. 10; Brown and Bell ch. 5.

<sup>14</sup> See R. Chapus, 'De l'office du juge: contentieux administratif', *JC Fasc.* 1977–78 EDCE, 11.

<sup>15</sup> See Fratacci *conclusions* CE 22/3–96 *Soit le droit administratif* *notion de droits acquis en droit administratif*.

<sup>17</sup> e.g. CE 5/11–52 *Le Moigne* Rec 487. See also J. S. Bell, 'Règles en droit administratif français' (1993) *Administrative Law and Theory* this approach, Hubert *conclusions* CE 3/2–96.

<sup>18</sup> See footnote 2.

be structured as follows. First, a comparison of procedures in English, French, and EC law will be presented. Second, procedural protections which apply to administrative decisions or go back to informal representations or go back on informal representations will be presented. Third, the most limited space available only the most important procedural protections will be discussed (namely notice, hearing, and review). Finally, a comparative survey will be summed up and conclusions will be presented.

## English, French, and EC Law:

### Overview

English law played a more important role in the development of administrative law systems. While the British courts had by the late 19th century developed a sense of 'natural justice' to control administrative action, they have traditionally relied more upon common law principles of tort and damages liability for this purpose.<sup>7</sup> The socio-legal factors may explain this difference. The following are particularly important for our purposes.<sup>8</sup>

First, administrative procedures reflect judicial procedures because they are largely the product of case law. In Britain, administrative procedures have to a large extent been developed by analogies from the *audi alterem partem* principle which has since ancient times applied in ordinary court proceedings.<sup>9</sup> This adversarial, formal, and technically elaborate procedure was, and is still to some degree, viewed as an ideal for administrative decision-making.<sup>10</sup> Similar analogies were less influential in France. French administrative law is largely the work of the separate division of administrative courts, the origins of which may be traced back to the seventeenth century.<sup>11</sup> The procedure in the administrative courts, headed by the Conseil d'État, is subject to a principle of 'contradiction' (*contradictoire*),<sup>12</sup> which encapsulates the basic idea of *audi alterem partem*, but it is overall more inquisitorial, informal, and based on written evidence than English judicial procedures<sup>13</sup> (and also more so than French private law court procedures).<sup>14</sup> This difference between judicial procedures may explain the development of different administrative procedures in Britain and in France.

Second, the rationale for procedural rights affects their scope and content in practice.<sup>15</sup> In France, the value of procedures is generally seen to be their contribution to correct outcomes. That is, their rationale is almost exclusively seen as instrumental.<sup>16</sup> Thus, a decision vitiated by a procedural error will in France *only* be annulled by a reviewing court if it appears that the error made an actual difference to the substantive decision made.<sup>17</sup> By contrast, legal writers<sup>18</sup>—and

<sup>7</sup> See, e.g., H. W. R. Wade, 'Law, Opinion and Administration' (1962) LQR 188, 192; J. R. Lucas, *The Principles of Politics* (Oxford, 1966), 196–9; J. L. Jowell, 'The Rule of Law Today', in J. L. Jowell and L. Oliver (eds.), *The Changing Constitution*, 3rd edn. (London, 1994) 69; Galligan, above n. 1, 240–7. Compare N. Lacey, 'The Jurisprudence of Discretion: Escaping the Legal Paradigm', in K. Hawkins (ed.), *The Uses of Discretion* (Oxford, 1992), 371–6.

<sup>8</sup> See J. Mestre, *Introduction historique au droit administratif français* (Paris, 1985), 99–103. Excessive judicial interference by the ordinary French courts (*Parlements*) prior to the 1789 Revolution led to an almost total exclusion of judicial competence over administrative matters (Law of 16–24/8 1790, repeated in the Constitution of 1791, Art 203). The administrative courts in their present form developed to fill the vacuum created by this exclusion. See Allison 138–46; J. H. Merryman, 'The French Deviation' (1997) AJCL 109; C. Duval, 'Les Justifications de la raison d'être et du maintien de la juridiction administrative en France au 19e siècle' (1998) Jahrbuch für europäische Verwaltungsgeschichte 55.

<sup>9</sup> See R. Chapus, *Droit du contentieux administratif*, 6th edn. (Paris, 1996), 676–84; Zeghib, above n. 4.

<sup>10</sup> See J. S. Bell, 'Reflections on the Procedure of the Conseil d'État', in G. Hand and J. McBride (eds.), *Droit sans frontières: Essays in Honour of L. Neville Brown* (Birmingham, 1991), 211; Allison ch. 10; Brown and Bell ch. 5.

<sup>11</sup> See R. Chapus, 'De l'office du juge: contentieux administratif et nouvelle procédure civile', 1977–78 EDCE, 11.

<sup>12</sup> See generally Craig 402–3.

<sup>13</sup> See Fratacci *conclusions* CE 22/3–96 *Société NRJSA* RDP 1996, 1768; C. Yannakopoulos, *La notion de droits acquis en droit administratif français* (Paris, 1997), 376–7; Chapus 1033.

<sup>14</sup> e.g. CE 5/11–52 *Le Moigne* Rec 487. See J. Moreau, 'Les conséquences des illégalités procédurales en droit administratif français' (1993) ERPL, special edn. 85, 90–1; and for recent criticism of this approach, Hubert *conclusions* CE 3/2–99 *Montagnac* AJDA 1999, 631.

<sup>15</sup> See footnote 2.

<sup>9</sup> On the historical background, see Galligan, above n. 1, 161–86.

<sup>10</sup> See e.g. H. W. R. Wade, 'Law, Opinion and Administration' (1962) LQR 188, 192; J. R. Lucas, *The Principles of Politics* (Oxford, 1966), 196–9; J. L. Jowell, 'The Rule of Law Today', in J. L. Jowell and L. Oliver (eds.), *The Changing Constitution*, 3rd edn. (London, 1994) 69; Galligan, above n. 1, 240–7. Compare N. Lacey, 'The Jurisprudence of Discretion: Escaping the Legal Paradigm', in K. Hawkins (ed.), *The Uses of Discretion* (Oxford, 1992), 371–6.

<sup>11</sup> See J. Mestre, *Introduction historique au droit administratif français* (Paris, 1985), 99–103. Excessive judicial interference by the ordinary French courts (*Parlements*) prior to the 1789 Revolution led to an almost total exclusion of judicial competence over administrative matters (Law of 16–24/8 1790, repeated in the Constitution of 1791, Art 203). The administrative courts in their present form developed to fill the vacuum created by this exclusion. See Allison 138–46; J. H. Merryman, 'The French Deviation' (1997) AJCL 109; C. Duval, 'Les Justifications de la raison d'être et du maintien de la juridiction administrative en France au 19e siècle' (1998) Jahrbuch für europäische Verwaltungsgeschichte 55.

<sup>12</sup> See R. Chapus, *Droit du contentieux administratif*, 6th edn. (Paris, 1996), 676–84; Zeghib, above n. 4.

<sup>13</sup> See J. S. Bell, 'Reflections on the Procedure of the Conseil d'État', in G. Hand and J. McBride (eds.), *Droit sans frontières: Essays in Honour of L. Neville Brown* (Birmingham, 1991), 211; Allison ch. 10; Brown and Bell ch. 5.

<sup>14</sup> See R. Chapus, 'De l'office du juge: contentieux administratif et nouvelle procédure civile', 1977–78 EDCE, 11.

<sup>15</sup> See generally Craig 402–3.

<sup>16</sup> See Fratacci *conclusions* CE 22/3–96 *Société NRJSA* RDP 1996, 1768; C. Yannakopoulos, *La notion de droits acquis en droit administratif français* (Paris, 1997), 376–7; Chapus 1033.

<sup>17</sup> e.g. CE 5/11–52 *Le Moigne* Rec 487. See J. Moreau, 'Les conséquences des illégalités procédurales en droit administratif français' (1993) ERPL, special edn. 85, 90–1; and for recent criticism of this approach, Hubert *conclusions* CE 3/2–99 *Montagnac* AJDA 1999, 631.

<sup>18</sup> See footnote 2.

increasingly also the courts—in common law countries have adopted non-instrumental rationales for procedures.<sup>19</sup> Procedures are seen to promote democratic participation, dignity, and autonomy as well as legally correct outcomes. Consequently, decisions vitiated by a procedural error will normally be quashed in judicial review proceedings without it being necessary to show a causal link between procedure and substance.<sup>20</sup> The recognition of non-instrumental rationales in Britain may explain why the scope of procedural rights is still wider than in France.<sup>21</sup>

The difference between the English and the French courts' approach to judicial control of administration has diminished somewhat over the last twenty years. The British courts have begun to develop more refined and searching substantive principles of review, and procedural protection has since 1978 been extended in France by legislative codes concerning hearings, reasons, and access to files.<sup>22</sup> However, important differences remain both in the conceptualization and substance of procedural rights. To understand these differences, and their significance for the protection of legitimate expectations, it is necessary to be clear about three basic features of English, French, and EC law: what are the sources, the scope, and the content of such rights?

#### (A) The Sources of Procedural Protection

The sources of procedural protection are largely similar in English, French, and EC law, although the practical importance of different sources vary.<sup>23</sup> General principles based on case law remain, in all three systems, the primary source. In English law, procedural protection derives from the two pillars of natural justice (*audi alteram partem* and *nemo iudex in re sua*)<sup>24</sup> now known simply as the principle of procedural fairness.<sup>25</sup> In French and EC law, the functionally equiv-

<sup>19</sup> e.g. *R v Home Secretary, ex p Doody* [1994] 1 AC 531. For further examples, see G. Richardson, 'The Legal Regulation of Process', in G. Richardson and H. Genn (eds.), *Administrative Law and Government Action* (Oxford, 1994); D. Woodhouse, *In Pursuit of Good Administration: Ministers, Civil Servants and Judges* (Oxford, 1997), 161–7.

<sup>20</sup> *John v Rees* [1970] Ch 345, 402; *R v Chief Constable of North Wales Police force, ex p Evans* [1982] 1 WLR 1155, 1160–1; *R v Chief Constable of the Thames Valley Police Force, ex p Cotton* [1990] IRLR 344. See Craig 420–1.

<sup>21</sup> It remains somewhat unclear to what extent the CFI and ECJ see the right to be heard as serving non-instrumental values. Decisions are only annulled if the failure to grant a procedural entitlement 'might have influenced' the outcome. See Cases C-142/87 *Belgium v Commission* [1990] ECR I-959; T-30/91 *Solvay v Commission* [1995] ECR II-1775 para 68; T-290/97 *Dordtselaan v Commission*, 18/1–2000 para 47; Nehl, above n. 5, 97–8; Tridimas, above n. 5, 244–5, 259–62.

<sup>22</sup> See Zeghib, above n. 4, 478 and further below.

<sup>23</sup> See on sources in English law Galligan, above n. 1, 291–313; in French law Chapus 27–58; in EC law Lenaerts and Vanhamme, above n. 5.

<sup>24</sup> Or, the right to be heard and to have a decision made without bias. The latter is not discussed in this book. See generally Galligan, above n. 1, 437–47.

<sup>25</sup> It is not entirely clear whether natural justice and procedural fairness are synonymous terms (Wade 515) or whether natural justice connotes a higher level of protection applicable in a more restricted area than fairness (Craig 409–12; Galligan, above n. 1, 186).

alent principles are known and impartiality (*impartialité*) originates in nineteenth-century measures against public employees from the 1930s<sup>29</sup> broadened finally in 1944 by the famous principle of defence rights also. From the 1974 case from 1974 the ECJ case which is binding upon all the secondary measures.<sup>32</sup>

General principles of procedural protection in areas such as licensing. The growing practice both in England and France is to require some form of hearing in which the community interest is taken into account. Legislative provisions of procedural protection. The requirement of a hearing<sup>36</sup> and a general requirement that the authority must give reasons for legal acts. The requirement of statutory procedural requirements.

<sup>26</sup> This principle is in French law known as the principle of *contradictoire*. The latter principle is subject to the principle of *contradictoire*. See M. Basset, 'Le principe dit de *contradictoire*' (Paris, 1967), 217–45; Chapus 1040–1.

<sup>27</sup> Impartiality is not discussed in French law. See e.g. CE 19/6–1839 *Ledochowski* (1966) 1040–1. See also Waline, above n. 4, 500–4.

<sup>30</sup> CE 5/5–44 *Trompier-Gravier* (1966) 1040–1. See also Mailou D 1946 III 52.

<sup>31</sup> Cases 32/62 *Alvis v Council* [1968] ECR I-1039; *Van Eick v Commission* [1968] ECR I-1039.

<sup>32</sup> Case 17/74 *Transocean Marine Insurance v Commission* [1991] ECR I-1997 para 60.

<sup>33</sup> See A. P. Le Sueur, 'Legal Duties of the Commission' (1968) 486–91.

<sup>34</sup> e.g. staff discipline: Art 25(1) of the Staff Regulations; Competition law: Art 8 of Regulation 4064/89; Art 11–15 Regulation 8, 21 Regulation 3284/94. Trade mark law: Art 7 Regulation 1168/86. Agricultural grants under the EAGGF: Art 7 of Regulation 1168/86.

<sup>35</sup> e.g. financial grants under the EAGGF: Art 7 of Regulation 1168/86.

<sup>36</sup> Art 88(2), 226(1). See also A. P. Le Sueur, 'Legal Duties of the Commission' (1968) 486–91.

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alent principles are known as the rights of the defence (*droits de la défense*)<sup>26</sup>  
 and impartiality (*impartialité*).<sup>27</sup> The French principle of *droits de la défense*  
 originates in nineteenth-century legislation and case law concerning disciplinary  
 measures against public employees.<sup>28</sup> Procedural rules developed in this area  
 were from the 1930s<sup>29</sup> broadened into a general unwritten principle established  
 finally in 1944 by the famous case of *Ms Trompier-Gravier*.<sup>30</sup> The EC law prin-  
 ciple of defence rights also emerged in employment cases,<sup>31</sup> but in the *TMPA*  
 case from 1974 the ECJ confirmed its status as a generally applicable norm  
 which is binding upon all the EC institutions and valid at a higher level than all  
 secondary measures.<sup>32</sup>

General principles of procedural fairness are supplemented by specific statu-  
 tory procedures in areas such as immigration, social welfare, planning, and  
 licensing. The growing practical importance of such procedures has been noted  
 both in England and France.<sup>33</sup> A survey of EC legislation reveals a similar pic-  
 ture; some form of hearing provisions apply in many,<sup>34</sup> but not all of the areas  
 in which the community institutions exercise direct administrative authority.<sup>35</sup>  
 Legislative provisions of more general application are also important sources of  
 procedural protection. The EC Treaty contains a few references to the right to  
 a hearing<sup>36</sup> and a general rule in Art 253 that all the Community institutions  
 must give reasons for legally binding measures.<sup>37</sup> In Britain and in France,  
 statutory procedural requirements apply to appeal tribunals and public

<sup>26</sup> This principle is in French law supplemented by the principle of *parallélisme des formes et procédures*. The latter principle is subject to numerous exceptions and its practical relevance is limited. See M. Basset, 'Le principe dit de "l'acte contraire" en droit administratif français', Doctoral thesis (Paris, 1967), 217-45; Chapus 1040-2.

<sup>27</sup> Impartiality is not discussed in this book. See generally Hostiou, above n. 4, 265-8.

<sup>28</sup> e.g. CE 19/6-1839 *Ledochowski* Rec 452. Art 65 of the Law of 22/4-1905 fuelled the develop-  
 ment by providing a right for civil servants to comment on the file in disciplinary proceedings. See  
 Waline, above n. 4, 500-4.

<sup>29</sup> CE 27/11-30 *Ribeyrolles* Rec 76.  
<sup>30</sup> CE 5/5-44 *Trompier-Gravier* Rec 133 confirmed by CE 26/10-45 *Aramu* Rec 213; CE 22/5-46  
*Mailou* D 1946 III 52.

<sup>31</sup> Cases 32/62 *Alvis v Council* [1963] ECR 49; 26/63 *Pistoij v Commission* [1964] ECR 2071; 35/67  
*Van Eick v Commission* [1968] ECR 329.

<sup>32</sup> Case 17/74 *Transocean Marine Paint Association v Commission* [1974] ECR 1063. See also  
 Cases 85/76 *Hoffmann-La Roche v Commission* [1979] ECR 461 para 9-11; C-49/88 *Al-Jubail*  
*Fertilizer v Commission* [1991] ECR I-3187 para 17; T-260/94 *Air Inter v Commission* [1997] ECR  
 II-997 para 60.

<sup>33</sup> See A. P. Le Sueur, 'Legal Duties to Give Reasons' (1999) CLP 150, 161-6; Zeghib, above n. 4,  
 486-91.

<sup>34</sup> e.g. staff discipline: Art 25(1), 26, 87 and Annex IX Regulation 259/68 (hereafter: 'EU Staff  
 Regulations'). Competition law: Art 19 Regulation 17/62; Art 2 Regulation 99/63. Mergers Art 18  
 Regulation 4064/89; Art 11-15 Regulation 2367/90. Anti-dumping: Art 6, 20 Regulation 384/96; Art  
 8, 21 Regulation 3284/94. Trade marks: Art 5, 56(1) Regulation 40/94; Regulation 2100/94. Invest-  
 ment aids: Art 7 Regulation 1168/86; Art 7 Regulation 1116/88, Art 44(1) Regulation 4028/86. Finan-  
 cial grants under the EAGGF: Art 7 Regulation 99/64, Art 22(2) Regulation 17/64.

<sup>35</sup> e.g. financial grants under the ESF Regulations 2052/88 and 4255/88, see text at footnote 144.

<sup>36</sup> Art 88(2), 226(1). See also Art 36(1), 46(2), 54(4), 66(5), 88(1) ECSC; Art 5(2), 46(2), 141  
 EURATOM.  
<sup>37</sup> See also Art 15 ECSC; Art 162 EURATOM.



enquiries.<sup>38</sup> More importantly, the French Law of 11 July 1979 grants the right to reasons for all 'unfavourable' administrative decisions made by both state and local authorities,<sup>39</sup> and an administrative decree<sup>40</sup> from 1983 grants a right to notice and hearing for those affected by unfavourable decisions made by state administrative bodies.<sup>41</sup>

### (B) The Scope of General Principles of Procedural Fairness

Different legal systems delineate the *scope* of procedural fairness or 'defence rights' by reference to criteria, which differ widely both in linguistic and conceptual terms. Despite these differences, it is clear that three questions arise in all legal systems. First, what *types of interests* deserve procedural protection? Second, how *intensively* must such interests be affected to attract protection? Third, what *additional conditions* must be fulfilled for protections to apply? The answers to these questions in English, French, and EC law may be set out as follows.

#### I What Types of Interests?

The first question is what *types of interests* are protected by procedural principles. There are similarities, but also important differences, between English, French, and EC law in this respect. The English courts distinguish between rights and interests. Traditionally, it was assumed that a decision which takes away a legal right must comply with procedural fairness.<sup>42</sup> However, the concept of rights was never clearly defined,<sup>43</sup> and it is now accepted that a decision which affects an interest of a substantial, as opposed to trivial, kind must also comply with procedural fairness.<sup>44</sup> The French courts never distinguished between rights and other interests in the context of administrative procedures, and French writers do not attempt to discern precisely what interests are actually protected. A decision which affects the *situation* of a person adversely

<sup>38</sup> Tribunals and Inquiries Act 1992, s 10; Decree of 23/11-58; Decree of 14/5-76; Law of 12/7-83 completed by Decree of 25/4-85. See L. N. Brown, 'Tribunal Adjudication in Britain: Model Rules of Procedure' (1993) ERPL, special edn. 287; J.-C. Helin and R. Hostiou, *Droit des enquêtes publiques* (Paris, 1993).

<sup>39</sup> Law no 79-587 of 11/7-79, JO 1979, 1711 as amended by Law no 86-76 of 17/1-86, JO 1986, 888.

<sup>40</sup> French administrative rule-making takes a number of forms, such as *décret*, *règlement*, and *ordonnance*. Following Brown and Bell 11 this book uses the term 'decree' as a shorthand way of referring to all of these.

<sup>41</sup> Art 8, Decree (*Ordonnance*) no 83-1025, 28/11-83, JO 1983, 3492. This provision is shortly to be codified by primary legislation. See Art 22, *Projet de loi relatif aux droits des citoyens dans leurs relations avec les administrations* available at <http://www.legifrance.gouv.fr/citoyen/actualite/preparation/citoyen.htm>.

<sup>42</sup> *Cooper v Wandsworth Board of Works* (1863) 14 CB (NS) 180; *Ridge v Baldwin* [1964] AC 40.

<sup>43</sup> Craig 413. See also Wade 555 (equating livelihood with rights); De Smith 410-11 (distinguishing livelihood from rights).

<sup>44</sup> *Bushell v Secretary of State for the Environment* [1981] AC 75. Similarly De Smith 410-11.

must, it is said, comply with the principle, but not distinguish between rights and interests on the ground that the EC rights of the individual are 'the interests of a person adversely'.<sup>45</sup>

A reading of case law and secondly, the rights protected by the French and the EC principles are significantly different from the 'rights of procedural fairness' in Britain.<sup>46</sup> There is a certain overlap under all of the different concepts, but they include, in particular, property,<sup>47</sup> livelihood,<sup>50</sup> and reputation.<sup>51</sup> Thus, a decision which affects interests with a certain intensity (see below) and some form of hearing under English law is a growing recognition that procedural fairness has serious financial implications, although not for the addressee.<sup>52</sup> So far, the scope of the principles is quite similar.

There is, however, one very important difference between English and EC law. The English courts accept that *legitimate expectations* must comply with procedural fairness, but are distinct from rights and interests. As discussed below, based on some administrative law principles, representation rather than the expectation

<sup>45</sup> Cases C-142/87 *Belgium v Commission* [1988] ECR II-1361; *Jubail Fertilizer v Commission* [1991] ECR II-1361; *Netherlands v Commission* [1992] ECR I-555; *Commission v Netherlands* [1994] ECR I-2885 para 39 (fisheries); *Commission v France* [1994] ECR II-1177 para 42 (ESF); T-305-307/94 *Limburgse v Commission*, 20/4-99 para 260.

<sup>46</sup> See notably Hostiou, above n. 4, with note 10; *Cooper v Wandsworth Board of Works* (1863) 14 CB (NS) 180; *ex p Fanneran* (1996) 8 Admin LR 351.

<sup>47</sup> *Hopkins v Smethwick Local Board of Health* [1952] 1 QB 740; *R v Home Secretary* [1992] 1 QB 740.

<sup>48</sup> *Bagge's Case* (1615) 11 Co Re93b; *Abbott v British Railways Board* [1976] AC 255; *Rec 304*; Cases 46/87 and 227/88 *Hoechst C. v Commission* [1989] ECR 3283.


<sup>49</sup> *R v Barnsley MBC, ex p Hook* [1976] All ER 699; CE 5/5-44 *Trompier-Gravier R v Commission* [1994] ECR I-2885.

<sup>50</sup> *McInnes v Onslow-Fane* [1978] 1 WLR 1211-56; *Chapon* Rec 473; Case T-346/94 *Franco v Commission* [1994] ECR II-1361.

<sup>51</sup> *R v Secretary of State for Transport, ex p British Airways* [1992] QB 513; *for Health, ex p US Tobacco* [1992] QB 353; *Commission v Lisrestal* [1992] ECR I-959 para 46; C-32/95P *Commission v Lisrestal* [1995] ECR I-1361.

<sup>52</sup> *Schmidt v Secretary of State for Home Affairs* [1962] AC 513; *ex p Baker* [1995] 1 All ER 73, 88-9.



 KeyCite Yellow Flag - Negative Treatment  
 Distinguished by *O'Byrne v. Santa Monica-UCLA Medical Center*, Cal.App. 2 Dist., December 20, 2001  
 45 Cal.App.3d 507, 119 Cal.Rptr. 507

STANFORD W. ASCHERMAN, Plaintiff and  
 Appellant,

v.

SAINT FRANCIS MEMORIAL HOSPITAL et al.,  
 Defendants and Respondents

Civ. No. 32791.

Court of Appeal, First District, Division 2, California.  
 February 24, 1975.

### SUMMARY

The trial court denied the petition of a licensed physician for a writ of mandate that would have compelled a private hospital to consider his application for staff privileges. The court upheld a hospital by-law permitting summary rejection of such an application, without a right to hearing, solely on the basis of failure of the applicant to include three letters of reference from active members of the hospital staff. Though the hospital received 22 letters of reference from physicians who were not on its staff, it returned the doctor's application without consideration for the sole reason that it did not have the three letters from staff members. (Superior Court of the City and County of San Francisco, No. 625990, Ira A. Brown, Jr., Judge.)

The Court of Appeal reversed with directions to the trial court to issue an injunction compelling the hospital to reconsider the physician's application pursuant to fair procedure standards. The court noted recent decisions to the effect that private hospitals are to be governed by the same criteria as public hospitals, and it held that the by-law precluding consideration of the application violated the minimal common law standards of a fair procedure. It was pointed out that the by-law, in preventing the application from being considered and rejected, denied the applicant the benefit of another by-law providing for hearing procedures for rejected applications. (Opinion by Taylor, P. J., with Rouse, J., concurring. Separate concurring and dissenting opinion by Kane, J.)

### HEADNOTES

### Classified to California Digest of Official Reports

(1)

Healing Arts and Institutions § 5--Hospitals--Applications for Staff Membership.

In a proceeding in mandamus by a licensed practicing physician who sought to compel a private hospital to consider his application for staff privileges, the trial court erred in upholding a hospital by-law permitting summary rejection of such an application, without a right to hearing, solely on the basis of failure of the applicant to include three letters of reference from active members of the hospital staff. Denial of staff membership effectively impairs a physician's right to practice his profession whether or not any economic hardship results, and, while there may be a rational connection between endorsement by staff members and the assurance of professional and ethical qualifications of physicians for the common good of the hospital and its patients, it is not sufficient to permit rejection of an application for staff membership solely for failure to procure such endorsements, without a concurrent right in the applicant to challenge such summary action by an appropriate consideration and hearing as to his actual qualifications.

[See **Cal.Jur.2d**, Hospitals and Asylums, § 8; **Am.Jur.2d**, Hospitals and Asylums, § 8 et seq.]

### COUNSEL

Jerome Berg for Plaintiff and Appellant.  
 Chickering & Gregory, John Philip Coghlan, William L. Ferdon and Walter M. Frank for Defendants and Respondents.

### TAYLOR, P. J.

Plaintiff, a licensed and practicing physician, appeals from a judgment denying his petition for a writ of mandate to compel the respondent, Saint Francis Memorial Hospital, to consider his application for staff privileges. He contends that the trial court erred in upholding a by-law which permits summary rejection of an application \*509 for staff membership, without a right to hearing, solely on the basis that such application fails to include three letters of reference from active members of the hospital staff. On the basis of *Pinsker v. Pacific Coast Society of Orthodontists* (1974) 12 Cal.3d 541 [116 Cal.Rptr. 245, 526 P.2d 253], and *Ascherman v. San Francisco Medical Society*, 39 Cal.App.3d 623 [114 Cal.Rptr. 681], we have concluded that his contention is well taken and that the judgment must be reversed.

The court found the pertinent facts as follows: The hospital is a privately owned medical hospital and not a public entity but is the recipient of funds made available under the Hill-Burton Act.<sup>1</sup> On August 20, 1970, the physician submitted an application for admission to the medical staff. His application was returned without consideration for the sole reason that it did not have three letters<sup>2</sup> from members of the hospital's active staff as required by its applicable by-law (set forth in full below).<sup>3</sup>

- 1 Pursuant to the Hill-Burton Act, [42 United States Code Annotated section 291](#), the federal government makes grants to public and private hospitals for construction costs.
- 2 The hospital received 22 letters of reference from physicians who were not on its staff.
- 3 Article III, section 4(a) of the hospital's by-laws provides: "Application for original membership on the Medical Staff shall be presented to the Medical Advisory Board in writing, on the prescribed form which shall state the qualifications and references of the applicant, and shall recite facts to show that the applicant possesses the qualifications specified in Section 2 of Article III hereof, and such other information as may be required from time to time by the Medical Advisory Board. The applicant shall also signify his agreement to abide by the By-Laws, Rules and Regulations of the medical Staff, and to the California Medical Association Guiding Principles for Physician-Hospital Relationships. The application shall be signed by the applicant. *Three members of the Active Staff must submit letters of reference on behalf of the applicant.* No member of the Board of Trustees shall sponsor an applicant for Medical Staff membership. If acceptable for membership, the applicant shall show evidence that he has obtained malpractice insurance in amounts sufficient to meet the minimum requirements of the Board of Trustees." (Italics supplied.)

The physician has been practicing in San Francisco since 1959 and has a busy practice, with about 50 percent of his patients treated in hospitals in San Mateo County. He enjoys full staff privileges at one hospital in San Francisco, and three others located respectively in Redwood City, Burlingame and San Mateo. He was formerly a staff member of the recently closed Callison Memorial Hospital in San Francisco, and currently has an application pending for admittance to another San Francisco hospital. He estimated that in 1970, his gross

annual income was \$80,000-\$90,000 and made no showing of a substantial, significant or irreparable injury to his practice as the result of his inability to use the hospital. On the contrary, he admitted that his purpose in making the application was to find a hospital a little closer to his home office in order to make life a bit easier for himself. \*510

As to the by-law here in question, the court found in accord with the allegations of the answer that the hospital reasonably relies upon the authors of the letters of reference submitted pursuant to the by-law provision in question for vital information concerning an applicant, including but not limited to information regarding his character, reputation, skill and ability to work with others. The hospital does not have a power of subpoena over persons writing letters of reference regarding an applicant, nor any other such similar power, and must rely upon the candor of the authors of the letters of reference for information vital to consideration of an applicant. Members of the active medical staff of the hospital may be expected to and will exercise much more care and exhibit far more concern than nonmembers over applicants for membership to the medical staff. These active staff members may be expected to be and will be more candid and cooperative than nonmembers as to applicants since sensitive topics are at issue in the consideration of applications.

The court also found that the purpose and intent of the by-law provision and the purpose and intent of the hospital in adopting it was reasonable for the protection of the hospital, its medical staff and patients, as well as specifically to ensure and obtain vital information regarding applicants for membership to the medical staff. The hospital had a valid and substantial interest in acquiring knowledge concerning the background of an applicant, and specifically information regarding his character, reputation, skill, and ability to work with others.

The court concluded that as a private institution, the hospital was free to establish its own rules, regulations and qualifications for medical staff membership, so long as these were not unreasonable or applied in a discriminatory manner, and that the by-law in question was not unreasonable and had not been applied in a discriminatory manner.

The physician's main contention on appeal is that respondent is a "public" institution and, therefore, cannot have a by-law like the one in issue that arbitrarily and unreasonably restricts staff memberships. Neither the parties nor the court below had the benefit of our state

Supreme Court's recent decision in *Pinsker v. Pacific Coast Society of Orthodontists*, *supra*, hereafter *Pinsker II*.

*Pinsker II* flowed from the court's earlier holding that an applicant for membership in a professional society had a judicially enforceable right to have his application considered in a manner comporting with the \*511 fundamentals of due process (*Pinsker v. Pacific Coast Soc. of Orthodontists*, 1 Cal.3d 160, 166 [81 Cal.Rptr. 623, 460 P.2d 495], hereafter *Pinsker I*).

In *Pinsker II*, the state Supreme Court cited *Martino v. Concord Community Hosp. Dist.*, 233 Cal.App.2d 51 [43 Cal.Rptr. 255], and *Wyatt v. Tahoe Forest Hospital Dist.*, 174 Cal.App.2d 709 [345 P.2d 93], to hold (at p. 554) that because of the fiduciary responsibilities arising out of "public service" functions, membership decisions of professional associations, like those of the hospital staffs involved in *Martino* and *Wyatt*, *supra*, must be rendered pursuant to minimal requisites of fair procedures required by established common law principles.<sup>4</sup> The court specifically noted (fn. 12, p. 554) that while the defendants in both *Wyatt* and *Martino* were public entities, neither decision relied on this factor but on the fact that denial of membership would effectively impair the applicant's right "to fully practice his profession," citing *Wyatt* and *Rosner v. Eden Township Hospital Dist.*, 58 Cal.2d 592, 598 [25 Cal.Rptr. 551, 375 P.2d 431].

4 The court indicated (fn. 7, p. 550) that since the decision was based on common law rather than constitutional principles, the appropriate language was "fair procedure" rather than "due process."

<sup>[11]</sup> Before applying the test of *Pinsker II* to the instant case, we must deal with the question of whether here, as in *Pinsker*, denial of membership would effectively impair the physician's right "to fully practice his profession." Although the trial court found that the physician had made no showing of "economic necessity" here, *Pinsker I* indicates that "economic necessity" for membership is not the criterion. As to the trial court's finding that other San Francisco hospitals were available, this court (Division One) recently indicated in *Ascherman v. San Francisco Medical Society*, 39 Cal.App.3d 623, footnote 9 at page 650 [114 Cal.Rptr. 681], (approved in *Pinsker II*, fn. 8, pp. 550-551), the mere existence of other hospitals may not be a sufficient safety valve to prevent deprivation of substantial economic advantage with the advent of comprehensive health planning. We conclude, therefore, that denial of staff membership would effectively impair the physician's right to fully practice

his profession. In *Pinsker II*, the court also relied on its decision in *Willis v. Santa Ana etc. Hospital Assn.*, 58 Cal.2d 806, 810 [26 Cal.Rptr. 640, 376 P.2d 568], which held that private hospitals are under the same constraints as public ones to protect against arbitrary exclusion from membership. The court said at page 550: "... whenever a private association is legally required to refrain from arbitrary action, the association's action must be both substantively rational and procedurally \*512 fair." The court then rejected an argument that procedural fairness was restricted to expulsion cases and concluded that a fair procedure requires that before the denial of an application, an applicant be notified of the reason for the rejection and given a fair opportunity to defend himself.

We turn, therefore, to the question of whether the by-law here in question was substantially rational and procedurally fair. Article II, section 1 of the hospital by-laws provided that its purpose was: "To insure that all patients admitted to the hospital or treated in the out-patient department, receive the best possible care."

The trial court found that, because of the greater frankness to be expected from staff members than nonmembers, there was a rational connection between the endorsement by staff members and the assurance of professional and ethical qualifications of the physicians for the common good of the hospital and its patients. While we may not quarrel with that proposition in the abstract, we do not agree that such "rational connection" is sufficient to permit rejection of one's application for staff membership solely because of his failure to procure such endorsements without a concurrent right in the applicant to challenge such summary action by an appropriate consideration and hearing as to his actual qualifications. For one thing, there is too great a danger that the necessary endorsements may be arbitrarily and discriminatorily withheld. Precisely because of this threshold exclusion effect of the by-law, we think the instant situation requires criteria analogous to the constitutional ones used for "public hospitals." We are supported in this conclusion by the federal cases holding that, when a private hospital accepts federal funds for construction or operation, discrimination against physicians may constitute a violation of the Fourteenth Amendment (see *Sams v. Ohio Valley General Hospital Association* (4th Cir. 1969) 413 F.2d 826, 828-830; and *Citta v. Delaware Valley Hospital* (E.D. Pa. 1970) 313 F.Supp. 301, 306-310; and note, *Eaton v. Grubbs* (4th Cir. 1964) 329 F.2d 710, 713-715; and *Simkins v. Moses H. Cone Memorial Hospital* (4th Cir. 1963) 323 F.2d 959-969, cert. den. (1964) 376 U.S. 938 [11 L.Ed.2d 659, 84 S.Ct. 793]). In addition, our Supreme Court's holding in *Pinsker II* approved the elimination of the public/private distinction along the lines used by this

court in *Ascherman v. San Francisco Medical Society*, 39 Cal.App.3d 623, 645 [114 Cal.Rptr. 681], quoted with approval from *Silver v. Castle Memorial Hospital* (1972) 53 Hawaii 475 [497 P.2d 564] (cert. den. (1972) 409 U.S. 1048 [34 L.Ed.2d 500, 93 S.Ct. 517], and reh. den. (1973) 409 U.S. 1131 [35 L.Ed.2d 264, 93 S.Ct. 936]) as follows: “There the court, although acknowledging that the hospital involved had more than a nominal governmental involvement in \*513 the form of funding, noted: ‘... if the proposition that any hospital occupies a fiduciary trust relationship between itself, its staff and the public it seeks to serve is accepted, then the rationale for any distinction between public, “quasi public” and truly private breaks down and becomes meaningless, especially if the hospital’s patients are considered to be of primary concern.’ (53 Hawaii at p. 482 [497 P.2d at p. 570].)”

In *Ascherman*, *supra*, this court (Division One) also reviewed the criteria established by the Legislature, pursuant to the Local Hospital District Law (*Health & Saf. Code, div. 23, § 32000 et seq.*), as well as the recent additions to the Business and Professions Code, and concluded that “... the Legislature intended private hospitals to be governed by *the same criteria as public hospitals.*” (Italics added.)

By-law provisions, substantially identical to that here in issue, were rejected in *Foster v. Mobile County Hospital Board*, 398 F.2d 227, and *Hamilton County Hospital v. Andrews* (1949) 227 Ind. 217 [84 N.E.2d 469]. The Indiana court said at page 472: “The present rules, however, provide that the hospital can appoint new members to its staff only upon recommendation of its staff. It would seem by this rule, recommendation to membership may be rejected by the board, but that no one shall be made a member of the staff without such recommendation. This is an unreasonable requirement, ...”

The trial court’s reasoning overlooked this aspect of the by-law as its conclusion of rationality was based on the potential use of the letters from staff members in relation to an application considered on its merits, “regarding his character, reputation, skill and ability to work with others.”<sup>5</sup>

5 As to this finding, we note that in *Rosner v. Eden Township Hospital Dist.*, 58 Cal.2d 592, at page 599 [25 Cal.Rptr. 551, 375 P.2d 431], our Supreme Court held that inability to get along with some doctors or hospital personnel was not a sufficient ground for exclusion as to a “public” hospital.

The by-law has the inherent grave danger that members of the active staff may seek to exclude certain applicants because they are of a certain race, religion, ancestry, because they have testified against them in malpractice suits, or simply because they do not like them; or what if an applicant simply does not know three members of the staff of a particular hospital whose facilities he needs to practice his profession?

The hospital relies on *Kronen v. Pacific Coast Society of Orthodontists*, 237 Cal.App.2d 289 [46 Cal.Rptr. 808], decided by this court (Division \*514 One) in 1965. In that case, two sponsors of the plaintiff, who had originally recommended him for membership in a professional society, for reasons set forth in the record, withdrew their recommendations from this second application. The court held that the plaintiff was entitled to judicial review as to whether this withdrawal was arbitrary or wrongfully accomplished, and on the basis of the evidence in the record, affirmed the trial court’s conclusion that there had been no wrongful or arbitrary withdrawal. *Kronen* was subsequently cited with approval, as a basis for the decision in *Pinsker I. Kronen*, however, unlike the instant case, did not involve a threshold rejection without a consideration of the application on its merits.

Even assuming substantive rationality here, the effect of the by-law was to prevent the physician’s application from being considered and rejected. Thus, he never had the benefit of article III, section 7 of the by-laws which provides for hearing procedures for rejected applications.<sup>6</sup> While the physician was notified of the reason for the hospital’s refusal to consider his application (the failure to have the requisite number of letters from staff members), he was not given a fair opportunity to defend himself. The fact that the physician was able to obtain a large number of letters from physicians not on the active staff of the hospital would indicate that he might well have met the required professional qualifications for staff membership.

6 Respondents’ attorney conceded, and in fact adamantly contended at oral argument, that article III, section 7 was inapplicable where an application was never received for processing because of the physician’s failure to obtain the three required letters from staff members pursuant to article III, section 4(a). We agree that a reading of the entirety of article III clearly confirms the propriety of this contention.

We conclude that the by-law in the instant case that served to preclude consideration of the physician’s application also violated the minimal common law standards of a fair procedure.



The judgment is reversed and the trial court is directed to issue an injunction compelling the hospital to reconsider the application pursuant to a fair procedure, as outlined in *Pinsker II*.

Rouse, J., concurred.

**KANE, J.,**

Concurring and Dissenting.

For reasons which shall appear, I agree that a remand to the trial court is appropriate. I cannot, however, subscribe to the conclusion that the questioned by-law is either unreasonable per se or violative of “minimal common law standards of a fair \*515 procedure.” On the contrary, in my opinion the requirement of obtaining letters of reference from three members of the active staff is entirely reasonable and sensible, is rationally connected to the essential and critical purposes of a professional and ethical private hospital and does no violence whatever to standards of fair procedure. I therefore respectfully dissent.

The majority bootstraps its contrary conclusion by means of indulging in rank speculation, viz: “There is too great a danger that the necessary endorsements *may* be arbitrarily and discriminatorily withheld.” And later: “The by-law has the inherent grave danger that members of the active staff *may* seek to exclude certain applicants because they are of a certain race, religion, ancestry, because they have testified against them in malpractice suits, or simply because they do not like them;” (italics added).

There is absolutely no evidence whatever in this record to suggest that any such “inherent grave danger” has actually occurred, or that it is reasonably likely to occur. Indeed, plaintiff makes no allegation that his claimed inability to obtain the necessary recommendations is due to any such arbitrary or discriminatory motivation.

Bearing in mind that we are dealing with common law - not constitutional - standards of “fair procedure” (*Pinsker v. Pacific Coast Society of Orthodontists* (1974) 12 Cal.3d 541, 550, fn. 7 [116 Cal.Rptr. 245, 526 P.2d 253]), we should not allow our decision to be formulated by “due process” considerations which are not only inapplicable (*Pinsker II*, p. 550, fn. 7, *supra*) but, in my opinion, inappropriate to the situation and the parties at bench.

First of all there can be no dispute with the fact that a private hospital, the purpose of which is to insure that all patients admitted - or treated - receive the best possible care, is free to establish its own rules, regulations and qualifications for medical staff membership, so long as they are not unreasonable or applied in a discriminatory manner. Here, defendants’ own by-laws contained such an expression of purpose, and the trial court found that a rational connection exists between the endorsement of staff members and the insurance of professional and ethical qualifications of the physicians for the common good of the hospital and its patients. That finding, in my view, is conclusively persuasive. \*516

At a time when the standards of professional conduct and service are subject to aggressive consumer assault and when hospitals and physicians are exposed to increasing horizons of liability - often predicated upon principles of vicarious or imputed liability - courts should not unduly interfere with the legitimate and ostensible good-faith efforts of private hospitals and physicians to protect themselves.

No enterprise is more important than one which undertakes the responsibility of rendering medical care to the sick, sore, lame, and disabled members of society. It seems to me to be patently elementary that in order to discharge such an onerous and awesome duty, the hospital should be clothed with broad discretionary authority to establish reasonable standards for staff admission.

The majority’s concern that the necessary endorsements *may* be withheld is premised on the erroneous assumption that an applicant such as appellant is left entirely without a remedy in the event he is unable to obtain the three letters of recommendation.

Thus, the majority asserts that “he was not given a fair opportunity to defend himself.” But the record shows without contradiction that the by-laws of defendants *do* provide for a hearing.<sup>1</sup>

1 In addition, and independently of the by-laws, appellant is now entitled to a hearing under the holding of *Pinsker II*, a case which the majority correctly notes was decided *after* the proceedings in the court below. It is clear to me, therefore, that respondent’s by-laws providing for a hearing procedure in all cases is simply an express recognition of the procedural right later articulated by the court in *Pinsker II*.

Thus, article III, section 7 (a), in pertinent part provides: “In all cases in which any applicant has been denied

membership, the applicant shall be notified promptly by registered or certified mail. He may, within 30 days of receipt of notice of such denial, request in writing a hearing by the Medical Advisory Board and such hearing shall be held within 60 days after receipt of the request. ... Failure to request a hearing after the prescribed time constitutes a waiver of the applicant's right to a hearing."

Admittedly, defendants failed to give written notice *that plaintiff was entitled to request a hearing*. In my opinion it should have done so. At the same time, the concept of common law standards of fair procedure should not be traveled on a one-way street. Plaintiff makes no showing - not even an allegation - that he ever requested a hearing of any kind. In my opinion, he should have done so.

Although it may be argued that since the application here was \*517 "returned" rather than "denied," that the hearing by-law quoted above does not apply, I find such a contention to be altogether technical, substituting form for substance. The gravamen of plaintiff's dispute is (as was conceded at oral argument before this court) simply that plaintiff has been denied the right to staff privileges at defendant hospital. As can be seen from even a cursory reading of article III, section 7(a), the provision for a hearing is all inclusive and applies "In *all* cases ..." (italics added).

In my view, the solution to the instant controversy is a simple one and the facts of this case do not warrant the far-reaching consequences of the majority's holding, i.e., that a by-law requirement such as here contested is violative of minimal common law standards of fair procedure.

If, in fact, plaintiff's inability to obtain the necessary three signatures of active staff members is due to some discriminatory factor, such evidence can be acquired and established in the hearing permitted by defendants' by-laws. If plaintiff's application is then denied, he has the clear right of judicial review (*Kronen v. Pacific Coast Society of Orthodontists* (1965) 237 Cal.App.2d 289 [46 Cal.Rptr. 808]).

In a further effort to support its position that the by-law provision is unlawful per se, the majority pose this question: "what if an applicant simply does not know three members of the staff ...?"

The short answer is that he should take steps to get acquainted with those physicians. One would be hopelessly naive to conclude that this would be an onerous or unreasonable burden for a physician to bear. In

the case at bench, for example, as the majority points out, plaintiff has been practicing in San Francisco since 1959, and did submit a large number of letters from other physicians. To suggest that Doctor Ascherman will be unable to comply with the by-law because he does not know - and cannot reasonably be expected to arrange to meet - the active staff members simply overlooks the realities and practicalities of professional life which are matters of such common knowledge that a court should not hesitate to acknowledge them promptly.

Finally, I do not believe that either *Pinsker II* or *Ascherman v. San Francisco Medical Society* (1974) 39 Cal.App.3d 623 [114 Cal.Rptr. 681] compel the conclusion that the by-law in question is unreasonable on its face. \*518

Each of these cases is distinguishable from the case at bench. *Pinsker II*, for example, involved membership in a professional association, as contrasted with admission to hospital staff privileges. The core of the holding in *Pinsker II*, as I read it, is that Dr. Pinsker was denied membership (1) without being notified of the reason for the rejection and (2) without being given a fair hearing "to defend himself." In the case at bench Dr. Ascherman was notified of the reason for his rejection. Thus, the only defect in the procedure below is the absence of a hearing neither requested by plaintiff nor offered by defendants.


*Ascherman v. San Francisco Medical Society, supra*, does not stand for the proposition that a hospital by-law requiring recommendation by active staff members is inherently violative of due process, or even of common law principles of fair procedure. In that case, the trial court instructed the jury that hospitals were *not* required to afford the plaintiff a hearing at all in connection with a denial of, or expulsion from, staff privileges. Needless to say, that is clearly contrary to established law. In addition, as I have pointed out before, not only is plaintiff entitled to such a hearing in this case by operation of law, but defendants' own by-laws explicitly provide for it.

I would therefore reverse the judgment with directions to the trial court to issue an injunction ordering defendants to advise plaintiff of his right to request a hearing in accordance with article III, section 7 (a), of defendants' by-laws and, upon receipt of a timely request for such hearing from plaintiff, to consider the matter pursuant to a fair procedure as described in *Pinsker II*. \*519



Laguna Royale Owners Assn. v. Darger, 119 Cal.App.3d 670 (1981)

174 Cal.Rptr. 136

 KeyCite Yellow Flag - Negative Treatment  
**Distinguished by** [O'Connor v. Resort Custom Builders, Inc.](#), Mich., February 25, 1999  
 119 Cal.App.3d 670, 174 Cal.Rptr. 136

LAGUNA ROYALE OWNERS ASSOCIATION,  
 Plaintiff and Respondent,

v.

STANFORD P. DARGER et al., Defendants and  
 Appellants.

Civ. No. 21950.

Court of Appeal, Fourth District, Division 2,  
 California.  
 May 28, 1981.

### SUMMARY

The owners of a leasehold condominium in a community apartment complex purported to assign three one quarter undivided interests in the property to three other couples without the approval of the owners' association. The association instituted an action to obtain a declaration that the assignments were invalid because they were made in violation of a provision of the instrument by which the owners acquired the property prohibiting assignment or transfer of interests in the property without the consent and approval of the association's predecessor in interest. Following a court trial judgment was rendered in favor of the association invalidating the assignments. (Superior Court of Orange County, No. 252781, James F. Judge, Judge.)

The Court of Appeal reversed with directions to enter judgment for defendants. The court rejected the association's contention that its right to give or withhold approval or consent was absolute, and also rejected defendants' contention that the association's claimed right to approve or disapprove transfers was an invalid restraint on alienation. The court held that in exercising its power to approve or disapprove transfers or assignments the association must act reasonably, exercising its power in a fair and nondiscriminatory manner and withholding approval only for a reason or reasons rationally related to the protection, preservation and proper operation of the property and the purposes of the association as set forth in its operating instruments. The court held the restriction on transfers, thus limited, did not violate defendants' constitutional rights of association and was not invalid as an unreasonable restraint on alienation. Moreover, the court held that in view of provisions of the association's

bylaws which permitted rental of an apartment unit for a period of time more than 90 days, under which the owners could effect the same use of the property as proposed by the assignment, the association's refusal to consent to the transfers was unreasonable as a matter of law. (Opinion by Kaufman, J., with McDaniel, J., concurring. Separate dissenting opinion by Gardner, P. J.)

### HEADNOTES

#### Classified to California Digest of Official Reports

(<sup>1a</sup>, <sup>1b</sup>, <sup>1c</sup>)

Condominiums and Cooperative Apartments § 2--  
 Condominiums--Restrictions on Transfers--Validity.

A provision in a condominium agreement prohibiting an owner of a unit from assigning or transferring an interest in the property without the consent and approval of the condominium owner's association did not give the association the absolute right to withhold approval or consent. Neither was the right to approve or disapprove transfers an invalid restraint on alienation as being repugnant to the conveyance of a fee. In exercising its power to approve or disapprove transfers or assignments, the association was required to act reasonably, exercising its power in a fair and nondiscriminatory manner and withholding approval only for a reason or reasons rationally related to the protection, preservation and proper operation of the property and the purposes of the association as set forth in its governing instruments. [Civ. Code, § 1355](#), pertaining to condominiums, expressly authorizes the recordation of a declaration of project restrictions, and reasonable restrictions on the alienation of condominiums are consistent with [Civ. Code, § 711](#). The right of the association reasonably to restrict assignments or transfers does not violate the constitutional rights of owners to associate freely with persons of their own choosing.

[See [Cal.Jur.3d, Condominiums and Cooperative Apartments, § 5](#); [Am.Jur.2d, Condominiums and Cooperative Apartments, § 40](#).]

(<sup>2a</sup>, <sup>2b</sup>)

Condominiums and Cooperative Apartments §  
 2--Condominiums-- Restrictions on  
 Transfers--Reasonableness.

Under a provision in a condominium agreement



prohibiting an owner of a unit from assigning or transferring any interest in the property without the consent and approval of the condominium owners' association, the association's refusal to consent to an owner's assignment of three one quarter undivided interests in the property to three other couples was unreasonable as a matter of law, where the association's bylaws permitted the rental of an apartment unit for a period of more than 90 days and the owners therefore could effect the same use of the property as contemplated by the assignment by simply leasing to each couple for a period of 90 days each year.

<sup>(3)</sup>  
Constitutional Law § 54--First Amendment and Other Fundamental Rights of Citizens--Scope and Nature--Freedom of Association and Assembly--Restrictions.

The constitutionally guaranteed right of freedom of association, like most other constitutionally protected rights, is not absolute but is subject to reasonable restriction in the interests of the general welfare.

<sup>(4)</sup>  
Constitutional Law § 67--Property--Restrictions.  
Property rights are subject to reasonable regulation to promote the general welfare.

<sup>(5)</sup>  
Condominiums and Cooperative Apartments § 2--Condominiums--Agreement--Terms--Construction.

As used in a provision of a condominium agreement restricting the use of units to residential purposes, any ambiguity or uncertainty in the meaning of the term "single family residential use" was required to be resolved most favorably to free alienation.

COUNSEL

Layman, Hanson, Jones & Voss, Rondell B. Hanson and Steven H. Sunshine for Defendants and Appellants.  
Feldsott & Lee, Feldsott, Lee & Van Gemert and Martin L. Lee for Plaintiff and Respondent. \*673

KAUFMAN, J.

Defendants Stanford P. Darger and Darlene B. Darger (the Dargers) were the owners of a leasehold condominium<sup>1</sup> in Laguna Royale, a 78-unit community apartment complex on the ocean front in South Laguna Beach. The Dargers purported to assign three one-quarter undivided interests in the property to three other couples: Wendell P. Paxton and Daila D. Paxton, Keith I.

Gustaveson and Elsie Gustaveson, and Keith C. Brown and Geneva B. Brown (collectively the other defendants) without the approval of Laguna Royale Owners Association (Association). Association instituted this action to obtain a declaration that the assignments from the Dargers to defendants were invalid because they were made in violation of a provision of the instrument by which the Dargers acquired the property, prohibiting assignment or transfer of interests in the property without the consent and approval of Association's predecessor in interest. Following trial to the court judgment was rendered in favor of Association invalidating the assignments from the Dargers to the other defendants. Defendants appeal.

1 A "condominium" is defined in [Civil Code section 783](#), which reads in part as follows: "A condominium is an estate in real property consisting of an undivided interest in common in a portion of a parcel of real property together with a separate interest in space in a residential, industrial or commercial building on such real property, such as an apartment, office or store ... [¶] Such estate may, with respect to the duration of its enjoyment, be either (1) an estate of inheritance or perpetual estate, (2) an estate for life, or (3) an estate for years, such as a leasehold or a subleasehold." (For a general discussion of condominiums, see Hanna, *Cal. Condominium Handbook* (1975); Comment, *Community Apartments: Condominium or Stock Cooperative?* (1962) 50 Cal.L.Rev. 299; Comment, *Fee in Condominium* (1964) 37 So.Cal.L.Rev. 82.)

**Facts**

The Laguna Royale development is built on land leased by the developer from the landowner in a 99-year ground lease executed in 1961. As the units were completed, the developer sold each one by executing a subassignment and occupancy agreement with the purchaser. This document conveyed an undivided 1/78 interest in the leasehold estate for a term of 99 years, a right to exclusive use of a designated unit and one or more garage spaces and a right to joint use of common areas and facilities; it also contained certain restrictions. The restriction pertinent to this action is paragraph 7, which provides in relevant part: "7. Subassignee [the purchaser] shall not assign or otherwise transfer this agreement, \*674 ... nor shall subassignee sublet ... without the consent of and approval of Lessee ...."<sup>2</sup>

2 In full, paragraph 7 reads: "Subassignee shall not assign or otherwise transfer this agreement, or any right or interest herein, or in or to any of the buildings and

improvements on the leased premises nor shall subassignee sublet said premises or any part thereof without the consent and approval of Lessee, and no assignment or transfer, whether voluntary or involuntary, by operation of law, under legal process or proceedings, by assignment for benefit of creditors, by receivership, in bankruptcy, or otherwise, and no such subletting shall be valid or effective without such consent and approval. Should Lessee consent to any such assignment, transfer or subletting, none of the restrictions of this article shall be thereby waived and the same shall apply to each successive encumbrance, assignment, transfer or subletting hereunder and shall be severally binding upon each and every assignee, transferee, subtenant and other successor in interest of subassignee. [¶] The death of subassignee shall not be deemed to effect a transfer of this agreement within the meaning of this paragraph, but the right of the successors in interest of subassignee to use and occupy the subject premises shall be subject to approval of lessee as in the case of a voluntary assignment by subassignee."

Upon the sale of all units and completion of the project, the developer entered into an "Assignment Agreement" with the Association, transferring and assigning to the Association all the developer's rights, powers and duties under the subassignment and occupancy agreements, including inter alia the "right to approve or disapprove assignments or transfers of interests in Laguna Royale pursuant to Paragraph 7 of the Subassignment and Occupancy Agreements."

In 1965, Ramona G. Sutton acquired unit 41, consisting of some 3,000 square feet, by a subassignment and occupancy agreement with the developer. In 1973 the Dargers purchased unit 41 from the executrix of Mrs. Sutton's estate.<sup>3</sup> As owner of a unit in the project, the Dargers automatically became members of the Association and were bound by the Association's bylaws.<sup>4</sup>  
**\*675**

3 The transfer was accomplished through an assignment and assumption agreement, not disputed by the parties or in issue on appeal.

4 Article II, section 2 of the bylaws provides: "Section 2. *Ownership*. [¶] A person shall be considered to become an owner of a unit for purposes of membership in the Association upon recordation of a Subassignment and Occupancy Agreement that has been approved by the Board of Governors, by which the person acquires an undivided 1/78th interest in the leasehold covering Laguna Royale, plus the exclusive right to use and

occupy an apartment to be used as a residence.

Article VII of the bylaws provides: "Section 1. *By-Laws a contract*. [¶] These By-Laws shall constitute a binding contract among the owners of units in Laguna Royale .... Section 2. *Assigns*. [¶] These By-Laws shall inure to the benefit of and be binding upon the heirs, grantees, successors, assigns, ... who agree to be bound by these By-Laws."

The Dargers reside in Salt Lake City, Utah, where Mr. Darger became a vice president of a large banking chain not long after the Dargers acquired their unit at Laguna Royale. The responsibilities of Mr. Darger's new position made it difficult for them to get away, and they attempted unsuccessfully to lease their unit through real estate agents in Laguna Beach. On October 30, 1973, Mr. Darger wrote to Mr. Yount, then chairman of the board of governors of the Association, in which he stated in part: "It has been suggested that we might sell shares in our apartment to two or three other couples here. These associates would be aware of the restrictions regarding children under 16 living there, as well as the restrictions regarding pets, and would submit themselves to the regular investigation of the Board given prospective purchasers and lessees. I would expect that the apartment will remain vacant most of the time, as now, and not more than one of the families will occupy the apartment at one time."

By letter dated November 12, 1973, Mr. Yount responded in relevant part: "Following receipt of your letter of October 30, 1973 regarding the possibility of selling shares in your apartment #41, we discussed the matter at the regular meeting of the Board of Governors held on November 10, 1973. [¶] Prior to the meeting we had referred the letter to our attorney, Mr. James Ralston Smith, for Laguna Royale Owner's Association for his opinion. We received his opinion prior to the meeting and this is quoted as follows: 'As to the request of Mr. Darger, as owner of apartment #41, to sell undivided interests in that apartment to other parties, it is my opinion that if such other parties otherwise qualified and indicate no intended use of the apartment other than single family owner's use, there would be no legal basis to refuse such transfers. However, State law restricts more than four (4) transfers of undivided interests, without qualifying as a subdivision.'"

The letter then indicated that a number of members of the board of governors had voiced some objections to multiple ownership of a unit and then stated: "The Board of Governors is quite sympathetic with your problem of being unable to lease your apartment; however, because of the reasons given above, it is our opinion that the

multiple ownership would not be beneficial to the other unit owners. We believe that our opinion is shared by the majority of the unit owners of Laguna Royale. [¶] Even in view of the Boards' [sic] opinion, we would have no alternative except to approve the transfer which you suggested, providing you would comply with the legal opinion of Mr. Smith." \*676

Thereafter Mr. Darger discussed the possibility of joint ownership with some of his associates in Salt Lake City and in late 1974 or early 1975 he reached a point where he believed he was ready to proceed. He made an appointment with John Russell Henry, then chairman of the board of governors of the Association, and met with him for the purpose of going over the agreement that Mr. Darger's Salt Lake City attorney had prepared, to make sure that everything that the board might want to be in the agreement was included from the beginning. Mr. Darger agreed in writing to pay the fees incurred by the board in having the board's attorney review the instrument.

The document prepared by Mr. Darger's attorney contemplated five owners,<sup>5</sup> and the board's attorney indicated both to the board and Mr. Darger personally that, in his opinion, ownership of undivided interests in the unit by more than four persons would violate California subdivision laws. Thereafter, in a letter dated November 25, 1975, to Mr. Henry, Mr. Darger stated that because of a possible violation of the subdivision laws and for other reasons, "we plan for a total of four shares, including my own."

5 Apparently title to the unit would have been transferred to a trustee for the benefit of the five beneficial owners.

Subsequently Mr. Darger received from Mr. Henry a letter dated January 12, 1976, which read in part: "The matter of multiple ownership of Apt. 41 has been studied in depth and detail with our own attorney, and the ultimate decision being that to do so would be contrary to recorded Lease, Subassignment and Occupancy agreement. In this connection you are respectfully requested to refer to Paragraphs 4<sup>6</sup> and 7 of such Agreement which limit use of units solely to residential purposes, without exception, and require written consent by your Board of Governors for any assignment thereof."

6 Paragraph 4 of the subassignment and occupancy agreement reads: "The premises covered hereby shall be used solely for residential purposes, and no sign of any kind shall be displayed in or upon any portions of said building. Subassignee shall not use or suffer or permit any person to use said premises, or any portion

thereof, for any purpose tending to injure the reputation thereof, or to disturb the neighborhood or occupants of adjoining property, or to constitute a nuisance, or in violation of any public law, ordinance or regulation."

A few days later Mr. Darger received from Mr. Henry another letter dated January 16, 1976, that read in part: "The Board has determined \*677 that the transfer as you requested would create and impose an undue, unreasonable burden and disadvantage on the other owners' and residents' enjoyment of their apartments and the common facilities. Further, your requested transfer would be contrary to and in conflict with the close community living nature of Laguna Royale and would be contrary to the single family character of the private residential purpose to which all apartments are restricted under the recorded Master Lease and the Subassignment and Occupancy Agreement, as well as the By-Laws and House Rules, by which all owners are bound."

On February 23, 1976, Mr. Darger sent a formal letter request for approval to transfer unit 41 from the Dargers to themselves and the other defendants on condition that "the three new couples subsequently receiv[e] individual approvals after a 'Request For Approval Of Sale Or Lease' form has been filed with the Board for each, and each has submitted to a personal interview by the Board for its consideration." The letter further requested that if approval was not given, "the Board specify its reasons for denial and indicate how the request made herein differs from the situation of the owners of at least two other units where there is multiple ownership between more than one party who have no family or corporate relationship, [and] in light of the written and verbal approvals for such a transfer of apartment #41 that have been extended by the Board to us over the past two and one half years."

By a letter from its attorney to the Dargers dated March 16, 1976, Association advised the Dargers that it would not consent to the requested transfer. It was denied that written and verbal approvals had been given the Dargers in the past, and it was stated in relevant part: "The reason the Association will not consent to your requested transfer is that the Board feels it is obligated to protect and preserve the private single family residential character of Laguna Royale, together with the use and quiet enjoyment of all apartment owners of their respective apartments and the common facilities, taking into consideration the close community living circumstances of Laguna Royale. [¶] The Board feels strongly about its power of consent to assignments and other transfers of leasehold interests and considers the protection and preservation of that power to be critical in maintaining the character of Laguna Royale

for the benefit of all owners as a whole. A four family ownership of a single apartment, with the guests of each owner potentially involved, would compound the use of the apartment and common facilities well beyond the normal and usual private single family residential character to the detriment of other owners and would frustrate effective \*678 controls over general security, guest occupants and rule compliance, as has been the case in the past. [¶] Provision 7 of the Subassignment and Occupancy Agreement, under which all apartment leasehold interests are held, requires the unqualified consent to any transfer. Provision 10 of said agreement provides for the termination of the leasehold interest in the event of a violation of Provision 7, or other breach .... [¶] No apartments in Laguna Royale are held by multiple families in the manner that you have requested. In any event, any consents given by the Association to transfers in the past cannot be regarded as setting any precedent or in any way limiting or impairing the power of the Association to refuse its consent to any present or future transfer. In this regard, the language of Provision 7 of the Subassignment and Occupancy Agreement provides that consent given to any particular transfer shall not operate as a waiver for any other transfer.“

After consultation with legal counsel the Dargers proceeded nevertheless, and on June 11 they executed instruments purporting to assign undivided one-fourth interests in the property to themselves and the other three couples. The instruments were recorded on June 30, and on July 3, 1976, the Dargers informed Association by letter of the transfers inclosing on Association's forms a separate "Request For Approval Of Sale Or Lease" and financial statement prepared and executed by each of the other couples. These papers show that the other defendants all reside in Salt Lake City, Utah. Each executed request form contains a warranty by the purchaser that if the application is approved no child under 16 years of age "will make residency at this property" and an agreement that the purchaser "will abide by and conform to the terms and conditions of the master lease, ... all amendments described in the Subassignment and Occupancy Agreement ... and the By-Laws of the Laguna Royale Owners ... Association.“

After unsuccessfully demanding that the other defendants retransfer their purported interests to the Dargers, the Association filed this action.

At trial the testimony confirmed that no more than one family of defendants used the property at a time and, although the matter was not examined in detail, answers to questions by one or more defendants indicated that thirteen-week periods had been agreed upon for exclusive

use by each of the four families. It was also indicated that for substantial periods during the year, no use at all was being made of the unit. The evidence also showed that a number of Laguna Royale units were \*679 owned by several unrelated persons, but that in each case the owners used the unit "as a family.“

No formal findings were made. However, in its notice of intended decision the court stated in relevant part: "The Court concludes that the Subassignment and Occupancy Agreement, ... is in law a sublease. ... Therefore, [Civil Code Section 711](#) does not apply to void the requirement that consent be given to the transfer of defendant Darger's interest. The provisions of [Title 10 of the Administrative Code, Section 2792.25](#), as cited in *Ritchey v. Villa Nueva Condominiums* [(1978)] [81 CA \(3\) 688](#), only govern the restrictions of condominiums by laws, and not restrictions that may exist because of leasehold interests. The plaintiff association had the right to approve any transfer of defendant Darger's interest. The Court finds that the plaintiff association acted reasonably in refusing to grant consent to the proposed transfer by Darger to the other defendants. Plaintiff is entitled to a declaration that the assignments by Darger to the other defendants are invalid. Plaintiff is awarded attorney fees in the amount of \$2500.“

Judgment was entered accordingly.

#### *Contentions, Issues and Discussion*

Defendants contend paragraph 7 of the subassignment and occupancy agreement prohibiting assignments or transfers without the consent of Association is invalid because it is in violation of their constitutional rights to associate with persons of their choosing ([U.S. Const., 1st Amend.](#); [Cal. Const., art. I, § 1](#)), because it constitutes an unlawful restraint on alienation ([Civ. Code, § 711](#)), and because it does not comply with a regulation of the Real Estate Commissioner ([Cal. Admin. Code, tit. 10, § 2792.25](#)). Failing those, defendants contend finally that if by its finding that Association acted reasonably in refusing to approve the transfers, the court meant to indicate that Association had the duty to act reasonably in withholding consent and did so, that determination is not supported by substantial evidence and is contrary to law.

Association contends that the prohibition against transfer or assignment without its consent is not invalid on any of the bases urged by defendants. It argues primarily that its right to withhold approval or consent is absolute, that in exercising its power it is not required to adhere to a standard of reasonableness but may withhold approval or consent for any reason or for no reason at all. Secondly,



it argues \*680 that the evidence supports the finding it acted reasonably in disapproving the transfers to the other defendants.

<sup>(1a)</sup>We reject Association's contention that its right to give or withhold approval or consent is absolute. We likewise reject defendants' contention that the claimed right to approve or disapprove transfers is an invalid restraint on alienation because it is repugnant to the conveyance of a fee. We hold that in exercising its power to approve or disapprove transfers or assignments Association must act reasonably, exercising its power in a fair and nondiscriminatory manner and withholding approval only for a reason or reasons rationally related to the protection, preservation and proper operation of the property and the purposes of Association as set forth in its governing instruments. We hold that the restriction on transfer contained in paragraph 7 of the subassignment and occupancy agreement (hereafter simply paragraph 7), thus limited, does not violate defendants' constitutional rights of association and is not invalid as an unreasonable restraint on alienation. <sup>(2a)</sup>However, we conclude that in view of the present provisions of Association's bylaws, its refusal to consent to the transfers to defendants was unreasonable as a matter of law. Accordingly, we reverse the judgment with directions to enter judgment for defendants. Having so concluded and disposed of the appeal it is unnecessary for us to decide whether the Real Estate Commissioner's regulation, which was not in effect when the subassignment and occupancy agreement here involved was executed, could validly be applied to paragraph 7 or whether, if applied, it would invalidate the provisions of paragraph 7.

As indicated, the initial positions of the parties are at opposite extremes. Association contends that the subassignment and occupancy agreement constitutes a sublease and that under the law applicable to leasehold interests, when a lease contains a provision permitting subletting only upon consent of the lessor, the lessor is under no obligation to give consent and, in fact, may withhold consent arbitrarily. (See, e.g., *Richard v. Degen & Brody, Inc.* (1960) 181 Cal.App.2d 289, 298-299 [5 Cal.Rptr. 263]; 4 Miller & Starr, Current Law of Cal. Real Estate, § 27:92, pp. 415-416; see also cases cited in Annot. (1953), 31 A.L.R.2d 831.) Defendants on the other hand contend that the subassignment and occupancy agreement conveys, in essence, a fee,<sup>7</sup> and that \*681 under California law when a fee simple interest is granted, any restriction on the subsequent conveyance of the grantee's interest contained in the original grant is repugnant to the interest conveyed and is therefore void. (See, e.g., *Murray v. Green* (1883) 64 Cal. 363, 367 [28 P. 118]; *Title Guarantee & Trust Co. v. Garrett* (1919) 42

Cal.App. 152, 155 [183 P. 470]; see also 3 Witkin, Summary of Cal. Law (8th ed. 1973) Real Property, § 314, p. 2023.)

7 It is unclear to us how the subassignment and occupancy agreement could convey a fee interest when the entire interest in the land underlying the development is only a 99-year ground lease. It would appear that defendants' argument more appropriately ought to be that once consent was given pursuant to the subassignment and occupancy agreement to the transfer from the estate of Ramona Sutton to the Dargers, the rule in *Dumpor's Case* (1578) 76 Eng.Rep. 1110, became applicable and that thereafter no consent to any further assignment was required. (See 3 Witkin, Summary of Cal. Law (8th ed. 1973) Real Property, § 491, p. 2170.)

<sup>(1b)</sup>We reject the extreme contentions of both parties; the rules of law they propose, borrowed from the law of landlord and tenant developed during the feudal period in English history (see *Green v. Superior Court* (1974) 10 Cal.3d 616, 622 [111 Cal.Rptr. 704, 517 P.2d 1168]), are entirely inappropriate tools for use in affecting an accommodation of the competing interests involved in the use and transfer of a condominium. Even assuming the continued vitality of the rule that a lessor may arbitrarily withhold consent to a sublease (but see Note, *Effect of Leasehold Provision Requiring the Lessor's Consent to Assignment* (1970) 21 Hastings L.J. 516), there is little or no similarity in the relationship between a condominium owner and his fellow owners and that between lessor and lessee or sublessor and sublessee. Even when the right to the underlying land is no more than an undivided interest in a ground lease or sublease, ownership of a condominium constitutes a statutorily recognized estate in real property (see Civ. Code, § 783 [see fn. 1, ante]), and in our society the right freely to use and dispose of one's property is a valued and protected right. (U.S. Const., Amends. 5 and 14; Cal. Const., art. I, § 7, subd. (a); see 5 Witkin, Summary of Cal. Law (8th ed. 1974) Constitutional Law, § 273, p. 3563.) Ownership and use of condominiums is an increasingly significant form of "home ownership" which has evolved in recent years to meet the desire of our people to own their own dwelling place, in the face of heavy concentrations of population in urban areas, the limited availability of housing, and, thus, the impossibly inflated cost of individual homes in such areas.

On the other hand condominium living involves a certain closeness to and with one's neighbors, and, as stated in *Hidden Harbour Estates, Inc. v. Norman* (Fla.App. 1975) 309 So.2d 180, 181-182: "[I]nherent in the

condominium concept is the principle that to promote the health, \*682 happiness, and peace of mind of the majority of the unit owners since they are living in such close proximity and using facilities in common, each unit owner must give up a certain degree of freedom of choice which he might otherwise enjoy in separate, privately owned property.“ (See also *White Egret Condominium v. Franklin* (Fla. 1979) 379 So.2d 346, 350; *Seagate Condominium Association, Inc. v. Duffy* (Fla.App. 1976) 330 So.2d 484, 486.) Thus, it is essential to successful condominium living and the maintenance of the value of these increasingly significant property interests that the owners as a group have the authority to regulate reasonably the use and alienation of the condominiums.

Happily, there is no impediment to our adoption of such a rule; indeed, the existing law suggests such a rule. In the only California appellate decision of which we are aware dealing with the problem of restraints on alienation of a condominium, *Ritchey v. Villa Nueva Condominium Assn., supra.*, 81 Cal.App.3d 688, 695 [146 Cal.Rptr. 695], the court upheld as a reasonable restriction on an owner’s right to sell his unit to families with children, a duly adopted amendment to the condominium bylaws restricting occupancy to persons 18 years and over. And, of course, *Civil Code section 1355* pertaining to condominiums expressly authorizes the recordation of a declaration of project restrictions and subsequent amendments thereto, ”which restrictions shall be enforceable equitable servitudes where reasonable, and shall inure to and bind all owners of condominiums in the project.“

Reasonable restrictions on the alienation of condominiums are entirely consistent with *Civil Code section 711* in which the California law on unlawful restraints on alienation has its origins.<sup>8</sup> The day has long since passed when the rule in California was that all restraints on alienation were unlawful under the statute; it is now the settled law in this jurisdiction that only unreasonable restraints on alienation are invalid. ( *Wellenkamp v. Bank of America* (1978) 21 Cal.3d 943, 948-949 [148 Cal.Rptr. 379, 582 P.2d 970]; *La Sala v. American Sav. & Loan Assn.* (1971) 5 Cal.3d 864, 878-879 [97 Cal.Rptr. 849, 489 P.2d 1113]; *Coast Bank v. Minderhout* (1964) 61 Cal.2d 311, 316 [38 Cal.Rptr. 505, 392 P.2d 265], overruled to the extent inconsistent in *Wellenkamp v. Bank of America, supra.*, 21 Cal.3d at p. 953.) \*683

8 *Civil Code section 711* reads: ”Conditions restraining alienation, when repugnant to the interest created, are void.“

Nor does the right of Association reasonably to approve or disapprove the assignment or transfer of the Dargers’ ownership interest violate defendants’ constitutional right to associate freely with persons of their choosing. Preliminarily, there is considerable doubt of whether the actions of Association constitute state action so as to bring into play the constitutional guarantees. (Cf. *Moose Lodge No. 107 v. Irvis* (1972) 407 U.S. 163, 173 [32 L.Ed.2d 627, 637, 92 S.Ct. 1965]; *Newby v. Alto Riviera Apartments* (1976) 60 Cal.App.3d 288, 293-295 [131 Cal.Rptr. 547]; see generally 5 Witkin, *Summary of Cal. Law* (8th ed. 1974) *Constitutional Law*, § 338, pp. 3631-3632.) <sup>(3)</sup>In any event, however, the constitutionally guaranteed freedom of association, like most other constitutionally protected rights, is not absolute but is subject to reasonable restriction in the interests of the general welfare. ( *Village of Belle Terre v. Boraas* (1974) 416 U.S. 1, 9 [39 L.Ed.2d 797, 804, 94 S.Ct. 1536, 1541]; *White Egret Condominium v. Franklin, supra.*, 379 So.2d at pp. 349-351.) Moreover, it may be persuasively argued that if any constitutional right is at issue it is the due process right of an owner of property to use and dispose of it as he chooses. (See generally 5 Witkin, *Summary of Cal. Law* (8th ed. 1974) *Constitutional Law*, § 273, p. 3563.) <sup>(4)</sup> And, of course, property rights are subject to reasonable regulation to promote the general welfare. ( *Home Building & Loan Assn. v. Blaisdell* (1934) 290 U.S. 398, 428, 434-436 [78 L.Ed. 413, 423, 426-428, 54 S.Ct. 231]; *Sonoma County Organization of Public Employees v. County of Sonoma* (1979) 23 Cal.3d 296, 305 [152 Cal.Rptr. 903, 591 P.2d 1]; *In re Marriage of Bouquet* (1976) 16 Cal.3d 583, 592 [128 Cal.Rptr. 427, 546 P.2d 1371].) Finally, any determination of the validity or invalidity of Association’s right to approve or disapprove assignments or transfers of the Dargers’ interest will of necessity impinge upon someone’s constitutional freedom of association. A determination that the power granted the Association is invalid would adversely affect the constitutional right of association of the remaining owners at least as much as a contrary determination would affect the same right of the Dargers. (Cf. *Presbytery of Riverside v. Community Church of Palm Springs* (1979) 89 Cal.App.3d 910, 925 [152 Cal.Rptr. 854].)

Having concluded that a reasonable restriction on the right of alienation of a condominium is lawful, we must now determine whether Association’s refusal to approve the transfer of the Dargers’ interest to the other defendants was reasonable in the circumstances of the case at bench. <sup>(1c)</sup>The criteria for testing the reasonableness of an exercise of such a power by an owners’ association are (1) whether the reason \*684 for

withholding approval is rationally related to the protection, preservation or proper operation of the property and the purposes of the Association as set forth in its governing instruments and (2) whether the power was exercised in a fair and nondiscriminatory manner. (Cf. *Pinsker v. Pacific Coast Society of Orthodontists* (1974) 12 Cal.3d 541, 550 [116 Cal.Rptr. 245, 526 P.2d 253]; *Lewin v. St. Joseph Hospital of Orange* (1978) 82 Cal.App.3d 368, 388 [146 Cal.Rptr. 892]; *Ascherman v. Saint Francis Memorial Hosp.* (1975) 45 Cal.App.3d 507, 511-512 [119 Cal.Rptr.507].) Another consideration might be the nature and severity of the consequences of application of the restriction (e.g., transfer declared void, estate forfeited, action for damages). (See 3 Witkin, *Summary of Cal. Law* (8th ed. 1974) *Real Property*, § 315, p. 2025; *Rest. Property*, §§ 404-406.)

As to the last observation, a potential problem in the case at bench was avoided by the nature of the relief granted in the court below. Although in its complaint Association asserted a right to terminate the Dargers' ownership interest because of their assignments without board approval and although there is some reference in the briefs to a "forfeiture," the judgment of the trial court simply invalidated the transfers to the other defendants, leaving the Dargers as the owners of the unit as they were at the outset. If Association's disapproval of the transfers were otherwise reasonable, we would find nothing unreasonable in the invalidation of the transfers.

To determine whether or not Association's disapproval of the transfers to the other defendants was reasonable it is necessary to isolate the reason or reasons approval was withheld. Aside from the assertion that it had the power to withhold approval arbitrarily, essentially three reasons were given by the Association for its refusal to approve the transfers: (1) the multiple ownership of undivided interests; (2) the use the defendants proposed to make of the unit would violate a bylaw restricting use of all apartments to "single family residential use"; and (3) the use proposed would be inconsistent with "the private single family residential character of Laguna Royale, together with the use and quiet enjoyment of all apartment owners of their respective apartments and the common facilities, taking into consideration the close community living circumstances of Laguna Royale." As to (3) Association asserted: "A four family ownership of a single apartment, with the guests of each owner potentially involved, would compound the use of the apartment and common facilities well beyond the normal and usual private single \*685 family residential character to the detriment of other owners and would frustrate effective controls over general security, guest occupants and rule compliance, ..." We examine each of these

reasons in light of the indicia of reasonableness referred to above.

Insofar as approval was withheld based on multiple ownership alone, Association's action was clearly unreasonable. In the first place, multiple ownership has no necessary connection to intensive use. Twenty, yea a hundred, persons could own undivided interests in a condominium for investment purposes and lease the condominium on a long-term basis to a single occupant whose use of the premises would probably be less intense in every respect than that considered "normal and usual." Secondly, the Association bylaws specifically contemplate multiple ownership; in *section 7 of article III*, dealing with voting at meetings, it is stated: "Where there is more than one record owner of a unit, any or all of the record owners may attend [the meeting] but only one vote will be permitted for said unit. In the event of disagreement among the record owners of a unit, the vote for that unit shall be cast by a majority of the record owners." Finally, the evidence is uncontroverted that a number of units are owned by several unrelated persons. Although those owners at the time of trial used their units "as a family," there is nothing in the governing instruments as they presently exist that would prevent them from changing the character of their use.

We turn to the assertion that the use of the premises proposed by defendants would be in violation of *section 1 of article VIII* of the bylaws which provides: "All apartment unit uses are restricted and limited to single family residential use and shall not be used or occupied for any other purpose" and paragraph 4 of the subassignment and occupation agreement which provides: "The premises covered hereby shall be used solely for residential purposes, ... " <sup>(15)</sup>The term "single family residential use" is not otherwise defined, and if there is any ambiguity or uncertainty in the meaning of the term it must be resolved most favorably to free alienation. (*Randol v. Scott* (1895) 110 Cal. 590, 595-596 [42 P. 976]; *Burns v. McGraw* (1946) 75 Cal.App.2d 481, 485-486 [171 P.2d 148]; *Riley v. Stoves* (1974) 22 *Ariz.App.* 223 [526 P.2d 747, 749].) Actually, there is no evidence that defendants proposed to use the property other than for single family residential purposes. It is uncontroverted that they planned to and did use the property one family at a time for residential purposes. Thus, the proposed use was not in \*686 violation of the restriction to single family residential use.<sup>9</sup> (*White Egret Condominium v. Franklin, supra.*, 379 So.2d at p. 352.)

9 In the trial court counsel for Association argued that "single family residential use" meant the same thing as "single family residential" customarily found in zoning

ordinances, typically in connection with the zoning designation R-1. We cannot conceive a decision that the ownership of a private dwelling in an R-1 zone by four families to be used by each family 13 weeks each with no use being made by more than 1 family at any time would be a use in violation of the R-1 zoning. We note also that our conclusion is in accord with the opinion originally expressed by the attorney for the Association that under the existing governing instruments there was nothing the board could do legally to prevent multiple ownership if the interests were no smaller than quarter interests.

(<sup>12b</sup>)The reasonableness of Association's disapproval of the transfers from the Dargers to the other defendants must stand or fall in the final analysis on the third reason offered by the Association for its action: the prospect that defendants' proposed use of the apartment and common facilities would be so greatly in excess of that considered "usual and normal" as to be inconsistent with the quiet enjoyment of the premises by the other occupants and the maintenance of security.<sup>10</sup>

10 It is probable that this was the principal reason Association refused to approve the transfers. Defendants' proposed use of the unit has been characterized from time to time during these proceedings as "time sharing."

There can be no doubt that the reason given is rationally related to the proper operation of the property and the purposes of the Association as set forth in its governing instruments. The bylaws provide that "[t]he purpose of the Association is to manage and maintain the community apartment project ... on a non-profit basis for the benefit of all owners of Laguna Royale." By subdivision (M)(6) of section 2 of article V of the bylaws the board is empowered to "prescribe reasonable regulations pertaining to ... [r]egulating the purchase and/or lease of an apartment to a buyer or sublessee who has no children under 16 years of age that will occupy the apartment temporarily or full time as a resident." This power is said by the bylaws to be given the board in recognition of "the prime importance of both security and quiet enjoyment of the Apartments owned by each member, and of the common recreational areas ...."

We reject defendants' contention that the Association had established a practice of approving or disapproving transfers solely on the basis of factors relating to the character, reputation and financial responsibility of the proposed transferee. There was testimony that during personal \*687 interviews with proposed transferees, the

board always inquired into the use proposed to be made of the premises.

The difficulty with upholding the Association's disapproval of the transfers by the Dargers to the other defendants is twofold. First, no evidence was introduced to establish that the intensity or nature of the use proposed by defendants would in fact be inconsistent with the peaceful enjoyment of the premises by the other occupants or impair security. We may take judicial notice as a matter of common knowledge that the use of a single apartment by four families for thirteen weeks each during the year would create some problems not presented by the use of a single, permanent resident family. The moving in and out would, of course, be more frequent, and it might be that some temporary residents would not be as considerate of their fellow occupants as more permanent residents. However, we are not prepared to take judicial notice that the consecutive use of unit 41 by these four families, one at a time, would be so intense or disruptive as to interfere substantially with the peaceful enjoyment of the premises by the other occupants or the maintenance of building security.

Secondly, and most persuasive, a provision of the bylaws, subdivision (A) of section 1 of article VIII, provides: "Residential use and purpose, as used herein and as referred to in the lease, sub-assignment and occupancy agreement pertaining to and affecting each apartment unit in Laguna Royale shall be and is hereby deemed to exclude and prohibit the rental of any apartment unit for a period of time of less than ninety (90) days, as it is deemed and agreed that rentals of apartment units for less than ninety (90) day periods of time are contrary to the close community apartment character of Laguna Royale; interfere with and complicate the orderly administration and process of the security system and program and maintenance program of Laguna Royale, and interfere with the orderly management and administration of the common areas and facilities of Laguna Royale. Accordingly, no owner shall rent an apartment unit for a period of time of less than ninety (90) days."

The point is self-evident: under the present bylaws the Dargers could effect the same *use* of the property as is proposed by defendants by simply leasing to each couple for a period of 90 days each year.<sup>11</sup> \*688

11 We note that on the form supplied by the board to be filled in and executed by proposed purchasers or lessees, it is indicated that no lease less than six months in duration will be approved. While the board is authorized by the bylaws to promulgate regulations concerning sales and leases of the units, its regulations



must be consistent with the bylaws and cannot supersede or, in effect, amend a provision of the bylaws. The bylaws provide that they may be amended only by majority vote of the owners.

Under these circumstances we are constrained to hold that board's refusal to approve the transfers to the other defendants on the basis of the prospect of intensified use was unreasonable as a matter of law.

Our conclusion that Association's disapproval of the transfers by the Dargers to the other defendants must be characterized as unreasonable as a matter of law disposes of the appeal, and it is unnecessary for us to deal with the applicability of the regulation of the Real Estate Commissioner which provides that bylaw restrictions on sale or lease of a condominium must include uniform, objective standards not based upon "the race, color, religion, sex, marital status, national origin or ancestry of the vendee or lessee," and which, in effect, requires an owners' association to buy out the owner's interest on the terms of the proposed sale if the Association disapproves "a bona fide offer by a person who does not meet the prescribed standards." (Cal. Admin. Code, tit. 10, § 2792.25, subds. (a), (b); see *Richey v. Villa Nueva Condominium Assn.*, *supra.*, 81 Cal.App.3d at pp. 694-695.) We do observe that the transfers from the Dargers were not disapproved on the basis that the other defendants are not "person[s] who [do] not meet the prescribed standards." We further observe that the regulation in question was apparently first filed in January 1976 whereas the subassignment and occupancy agreement involved in the case at bench was executed by the defendants' predecessor in interest in 1965 and assigned to the Dargers in 1973. Finally, we observe that insofar as the necessity of exercising the right to approve or disapprove sales or leases on the basis of uniform, objective standards is concerned, our decision is substantially in accord with the commissioner's regulation.

### *Disposition*

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The judgment is reversed with directions to the trial court to enter judgment for the defendants.

McDaniel, J., concurred.

GARDNER, P. J.

I dissent.

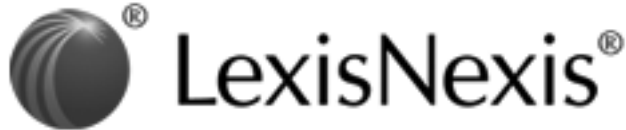
Stripped to its essentials, this is a case in which the other owners of a condominium are attempting to stop the owner of one unit from embarking \*689 on a time sharing enterprise. The majority properly conclude that the owners as a group have the authority to regulate reasonably the use and alienation of the units. The majority then conclude that the board's refusal to approve this transfer was unreasonable as a matter of law. To the contrary, I would find it to be entirely reasonable and would affirm the judgment of the trial court.

The use of a unit on a time sharing basis is inconsistent with the quiet enjoyment of the premises by the other occupants. Time sharing is a remarkable gimmick. P. T. Barnum would have loved it. It ordinarily brings enormous profits to the seller and in this case would bring chaos to the other residents. Here we have only 4 occupants but if this transfer is permitted there is nothing to stop a more greedy occupant of a unit from conveying to 52 or 365 other occupants.

If as an occupant of a condominium I must anticipate that my neighbors are going to change with clocklike regularity I might just as well move into a hotel-and get room service.

Respondent's petition for a hearing by the Supreme Court was denied August 26, 1981.

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**ETHEL MAJOR, an Incompetent Person, etc., et al., Plaintiffs and Appellants, v.  
MIRAVARDE HOMEOWNERS ASSOCIATION, INC., et al., Defendants and  
Respondents.**

**No. B048423**

**COURT OF APPEAL OF CALIFORNIA, SECOND APPELLATE DISTRICT,  
DIVISION SEVEN**

*7 Cal. App. 4th 618; 9 Cal. Rptr. 2d 237; 1992 Cal. App. LEXIS 790; 92 Cal. Daily Op.  
Service 5491; 92 Daily Journal DAR 8452*

**June 19, 1992, Decided**

**SUBSEQUENT HISTORY:** [\*\*\*1] Review Denied September 2, 1992, Reported at *1992 Cal. LEXIS 4433*.

Panelli, J., is of the opinion the petition should be granted.

**PRIOR HISTORY:** Superior Court of Los Angeles County, No. LASC SWC 110873, J. Gary Hastings, Judge.

**DISPOSITION:** The order denying the preliminary injunction is reversed as to the Rasmussens, and the matter is remanded to the trial court for further proceedings not inconsistent with the views expressed herein. The appeal of Ethel Major is dismissed as moot. Each party is to bear its own costs on appeal.

**SUMMARY:**

**CALIFORNIA OFFICIAL REPORTS SUMMARY**

The owners of a condominium brought an action against the condominium owners association, alleging that the association unreasonably interfered with their right to use the recreational facilities of the condominium project by classifying them as nonresidents once they moved out, leaving the mother of one of the plaintiffs in residence. The mother joined in the suit, alleging

violation of her rights under the Unruh Civil Rights Act (*Civ. Code, § 51 et seq.*). Plaintiffs moved for a preliminary injunction. The trial court, finding that the owners were nonresidents under a condominium rule, and that the condominium rules relating to the use of recreational facilities by nonresidents were reasonable, denied the motion. (Superior Court of Los Angeles County, No. LASC SWC 110873, J. Gary Hastings, Judge.)

The Court of Appeal reversed the order denying the preliminary injunction, remanded the matter, and dismissed the mother's appeal as moot. The court held that the mother's appeal was moot for two reasons: she had suffered a stroke and moved out of the condominium project, and, while the appeal was pending, the trial court sustained a demurrer to her cause of action under the Unruh Civil Rights Act without leave to amend. The court further held that the trial court erred in denying plaintiffs a preliminary injunction. The association acted without authority in restricting the use of common areas by members who were not residents; the effect of this rule was to terminate a right originally granted by the covenants, conditions, and restrictions to all members whether resident or not. The court held that where an association exceeds the scope of its authority, any rule or decision resulting from such an ultra vires act is invalid whether or not it is a "reasonable" response to a particular

circumstance. The court further held that it was reasonably probable that plaintiffs would prevail on the merits, and that they would suffer a greater harm from denial of the injunction than would the association from its grant. (Opinion by Johnson, J., with Lillie, P. J., concurring. Separate opinion by Woods (Fred), J., concurring in the judgment.)

## HEADNOTES

### CALIFORNIA OFFICIAL REPORTS HEADNOTES

Classified to California Digest of Official Reports

**(1a) (1b) Appellate Review § 120--Dismissal--Grounds--Mootness--What Constitutes--Appeal of Denial of Preliminary Injunction--Sustaining of Demurrer in Underlying Action.** -- --An appeal from the denial of a preliminary injunction restraining a condominium home-owners association from enforcing certain rules was moot as to one plaintiff, where that plaintiff had suffered a stroke and moved out of the condominium project, and where, while the appeal was pending, the trial court sustained a demurrer to that plaintiff's cause of action under the Unruh Civil Rights Act (*Civ. Code, § 51 et seq.*) without leave to amend. Since that plaintiff was no longer a resident, there was no longer any discriminatory action on the part of defendants to be enjoined. Further, her Unruh Civil Rights Act claim was her only basis for a preliminary injunction, and she had already requested a stay of proceedings and writ review of the order sustaining the demurrer to that cause of action, both of which requests were denied.

**(2) Injunctions § 21--Temporary Restraining Orders and Preliminary Injunctions--Appeal--Effect of Failure to State Cause of Action.** -- --A preliminary injunction is an interim remedy designed to maintain the status quo pending a decision on the merits. It is not, in itself, a cause of action. Thus, a cause of action must exist before injunctive relief may be granted. Accordingly, where the complaint fails to state a cause of action, an order granting a preliminary injunction must be reversed.

**(3) Injunctions § 21--Temporary Restraining Orders and Preliminary Injunctions--Appeal--Effect on Trial Court's Jurisdiction.** -- --An appeal from an order denying a preliminary injunction does not deprive the trial court of jurisdiction to proceed to try the case on the merits. If the court can try the case on the merits, then a fortiori it can determine the case has no merit by

sustaining a demurrer without leave to amend.

**(4) Mandamus and Prohibition § 35--Mandamus--To Courts and Court Officers--Pleading.** -- --Although an order sustaining a demurrer is not appealable, it is reviewable by petition for a writ of mandate.

**(5) Injunctions § 15--Temporary Restraining Orders and Preliminary Injunctions--Preliminary Injunctions--Discretion of Trial Court.** -- --It is within the trial court's sound discretion to grant or deny a preliminary injunction. However, a trial court abuses that discretion by denying a preliminary injunction where the plaintiffs establish a "reasonable probability" of success on the merits and that they will suffer more harm from its denial than the defendant will from its grant.

**(6a) (6b) Condominiums and Cooperative Apartments § 2--Condominiums--Restriction of Right to Use Common Areas to Residents--Preliminary Injunction.** -- --In an action by owners of a condominium against the condominium owners association, alleging that the association unreasonably interfered with their right to use the recreational facilities of the condominium project by classifying them as nonresidents once they moved out, leaving the mother of one of the plaintiffs in residence, the trial court erred in denying plaintiffs a preliminary injunction. The association acted without authority in restricting the use of common areas by members who were not residents; the effect of this rule was to terminate a right originally granted by the covenants, conditions, and restrictions to all members whether resident or not. Where an association exceeds the scope of its authority, any rule or decision resulting from such an ultra vires act is invalid whether or not it is a "reasonable" response to a particular circumstance. It was reasonably probable that plaintiffs would prevail on the merits, and that they would suffer a greater harm from denial of the injunction than would the association from its grant.

[See 4 **Witkin**, Summary of Cal. Law (9th ed. 1987) Real Property, § 320 et seq.]

**(7) Condominiums and Cooperative Apartments § 2--Condominiums--Disputes Between Homeowners and Association--Resolution.** -- --When disputes arise between condominium owners and the condominium homeowners association, the courts will look to the governing instruments for guidance in determining whether the association has acted within its authority. Actions taken in excess of the association's power are

unenforceable, and courts have granted injunctive relief against associations which have exceeded the scope of their authority.

**COUNSEL:** Ayscough & Marar and Sidney Lanier for Plaintiffs and Appellants.

Kaiser, DeBiaso, Palmer & Lopez and Eric C. Demler for Defendants and Respondents.

**JUDGES:** Opinion by Johnson, J., with Lillie, P. J., concurring. Separate opinion by Woods Fred, J., concurring in the judgment.

**OPINION BY: JOHNSON, J.**

## OPINION

[\*621] [\*238] Plaintiffs sought a preliminary injunction restraining a condominium homeowners association from enforcing certain rules plaintiffs contended unreasonably interfered with their right to use the recreational facilities of the condominium project. The trial court denied an injunction. We reverse the denial of injunctive relief as to the Rasmussens. The appeal of [\*2] Ms. MaJor is dismissed as moot.

### STATEMENT OF FACTS AND PROCEEDINGS BELOW

John and Donna Rasmussen, husband and wife, own a condominium unit in the [\*239] Miraverde condominium project. The project is managed by the Miraverde Homeowners Association, Inc. (Association).

The Rasmussens purchased the condominium pursuant to a "Declaration of Covenants, Conditions and Restrictions" (CC&R's) whose provisions are discussed below. The unit was originally occupied by the Rasmussens and their sons, Keith and Kyle. Ms. Rasmussen's mother, Ethel MaJor, subsequently moved into the unit. A few years later, the Rasmussens moved into a new residence and Ms. MaJor remained in the Miraverde condominium.

The dispute in this case centers on the right of the Rasmussens to continue using the recreational facilities of Miraverde, principally the tennis court, even though they are no longer residents of the condominium. Miraverde has only one tennis court. After moving from Miraverde, Ms. Rasmussen and Keith continued to use

the court occasionally, while Kyle played regularly. Ms. MaJor is 82 years old and senile. She does not play tennis.

In July 1989, the Association made new rules regarding the use [\*3] of the tennis court and other common facilities by the Miraverde residents and others. Rule 1.7 states "non-resident" homeowners are not entitled to use any Miraverde facilities except as guests of an authorized resident. Rule 6.4.2 provides only "registered residents" over 18 years of age may reserve the tennis court and rule 6.4.5 requires a "registered resident" to be present whenever a guest plays tennis.

The day after it adopted these rules, the Association informed the Rasmussens they were nonresident homeowners and only entitled to use the tennis court as guests of an authorized resident. As a result, Ethel MaJor, whom the Association considered the authorized resident, would have to personally sign up the Rasmussens and be present during their use of the tennis court. There was evidence Ms. MaJor, because of her physical disabilities, could [\*622] not go to the guard building to sign up the Rasmussens to play tennis or be present while they played. The Rasmussens failed to follow the new rules and were denied use of the tennis court. The Association also imposed fines on the Rasmussens for using the tennis court in violation of the new rules.

The Rasmussens and [\*4] Ms. MaJor filed a complaint against the Association and its directors alleging, inter alia, violation of the Unruh Civil Rights Act, slander of title, and breach of fiduciary duty and seeking injunctive and declaratory relief. The Rasmussens and Ms. MaJor requested a temporary restraining order and preliminary injunction against enforcement of the rules restricting use of the recreational facilities by nonresident homeowners. The trial court issued a temporary restraining order against the assessment of fines against the Rasmussens and set a hearing on the motion for a preliminary injunction.

At the hearing on the preliminary injunction, the parties introduced the following evidence. The Rasmussens purchased their condominium in 1975. The Miraverde condominium project contains one tennis court, two swimming pools, one basketball court, one paddle tennis court, barbecue facilities, recreation room, and some green belt parking all of which the CC&R's refer to as common areas. The board of directors approved the disputed rules effective July 1989. The

Association fined the Rasmussens for using the tennis court in violation of the disputed rules. The CC&R's, articles of incorporation, [\*\*\*5] and bylaws were also admitted into evidence.

At the conclusion of the hearing, the trial court made the following findings: that the term "resident" means someone who primarily resides at Miraverde whether they are an owner or a nonowner or a lessee; the Rasmussens are nonresidents; the rules relating to the use of the tennis court and other facilities by "nonresidents" are reasonable. The trial court denied the motion for preliminary injunction and vacated the temporary restraining order.

The Rasmussens and Ms. MaJor appealed the denial of the preliminary injunction.

## DISCUSSION

### I. *The Appeal of Ethel MaJor Is Moot.*

The complaint of Ethel MaJor alleges, in relevant part, the rules adopted by [\*\*240] the Association with respect to guests' use of the tennis facilities discriminate against her in the use and enjoyment of her property on the basis of her [\*623] age and physical disabilities in violation of the Unruh Civil Rights Act. (*Civ. Code*, § 51 *et seq.*) The complaint seeks a preliminary and permanent injunction against further enforcement of those rules. (*Civ. Code*, § 52 *subd. (c)(3)*, 52.1, *subd. (b)*.) As noted, the trial court denied a preliminary injunction and Ms. MaJor [\*\*\*6] appealed.

(1a) While this appeal was pending, two events rendered the appeal moot: Ms. MaJor suffered a stroke and moved out of Miraverde and the trial court sustained a demurrer to her Unruh Civil Rights Act cause of action without leave to amend.

Because Ms. MaJor is no longer a resident of Miraverde there is no longer any discriminatory action on the part of defendants to be enjoined. (*Cf. Old National Financial Services, Inc. v. Seibert* (1987) 194 Cal.App.3d 460, 467 [239 Cal.Rptr. 728].) We recognize Ms. MaJor might recover from her stroke and might move back into Miraverde thus raising the possibility the alleged discrimination might be repeated. However, we need not consider these possibilities because the appeal is moot for a second reason.

As previously noted, while this appeal was pending the trial court sustained a demurrer to Ms. MaJor's Unruh Civil Rights Act cause of action. Because the Unruh Civil Rights Act claim was her only basis for a preliminary injunction, Ms. MaJor's appeal from denial of an injunction is now moot.

(2) A preliminary injunction is an interim remedy designed to maintain the status quo pending a decision [\*\*\*7] on the merits. (*Gray v. Bybee* (1943) 60 Cal.App.2d 564, 571 [141 P.2d 32].) It is not, in itself, a cause of action. Thus, a cause of action must exist before injunctive relief may be granted. (*Shell Oil Co. v. Richter* (1942) 52 Cal.App.2d 164, 168 [125 P.2d 930].) Accordingly, where the complaint fails to state a cause of action an order granting a preliminary injunction must be reversed. (*Watson v. Santa Carmenita etc. Co.* (1943) 58 Cal.App.2d 709, 719 [137 P.2d 757].)

(3) An appeal from an order denying a preliminary injunction does not deprive the trial court of jurisdiction to proceed to try the case on the merits. (*Gray v. Bybee, supra*, 60 Cal.App.2d at p. 571.) If the court can try the case on the merits then a fortiori it can determine the case has no merit by sustaining a demurrer without leave to amend. In the present case, the trial court having sustained a demurrer without leave to amend to the only cause of action which might have supported a preliminary injunction in favor of Ms. MaJor, [\*\*\*8] her appeal from the denial of a preliminary injunction is moot.

In order to avoid this result the plaintiff may request a stay of trial court proceedings while the appeal from denial of the preliminary injunction is [\*624] pending. (4) Furthermore, although an order sustaining a demurrer is not appealable (*Cohen v. Equitable Life Assurance Society* (1987) 196 Cal.App.3d 669, 671 [242 Cal.Rptr. 84]), it is reviewable by petition for writ of mandate (*Coulter v. Superior Court* (1978) 21 Cal.3d 144, 148 [145 Cal.Rptr. 534, 577 P.2d 669]). We see no reason why such review could not also encompass the denial of preliminary relief. (1b) In the present case, plaintiffs, including Ms. MaJor, requested a stay of proceedings and writ review of the order sustaining the demurrer to the Unruh Civil Rights Act cause of action. Both requests were denied.

II. *The Trial Court Erred in Denying the Plaintiffs a Preliminary Injunction Against an Ultra Vires Rule Which Prevented the Homeowners' Use and Enjoyment of the Common Areas of Their Condominium.*

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(5) It is within the trial court's sound discretion [\*\*\*9] to grant or deny a preliminary injunction (*IT Corp. v. County of Imperial* (1983) 35 Cal.3d 63, 69 [196 Cal.Rptr. 715, 672 P.2d 121].) However, a trial court abuses that discretion by denying a preliminary injunction where the plaintiffs establish a [\*\*241] "reasonable probability" of success on the merits and that they will suffer more harm from its denial than the defendant will from its grant. (*Friends of Westwood, Inc. v. City of Los Angeles* (1987) 191 Cal.App.3d 259, 264 [235 Cal.Rptr. 788].)

*Civil Code section 1353* requires the owner of a project, prior to the conveyance of any condominium, to record a declaration of restrictions relating to such project. Under *Civil Code section 1354*, those restrictions, where reasonable, are enforceable equitable servitudes and inure to and bind all condominium owners in the project. (See *Ritchey v. Villa Nueva Condominium Assn.* (1978) 81 Cal.App.3d 688, 693-694 [146 Cal.Rptr. 695, 100 A.L.R.3d 231].) The Association and the Rasmussens do not dispute the validity of the Miraverde [\*\*\*10] condominium's CC&R's. The CC&R's provide in relevant part:

"Article IV, Section 1.

"Every person or entity who is a record owner of a condominium in the project... shall be a member of the Association. ... Ownership of such condominium shall be the sole qualification for membership.

"Article IV, Section 2.

"The membership held by any owner of any Condominium shall not be transferred, pledged or alienated in any way, except upon the sale or [\*625] encumbrance of such Condominium, and then only to the purchaser or mortgagee of such Condominium. Any attempt to make a prohibited transfer is void.

"Article VI, Section 2.

"Every member shall have a right and easement of enjoyment in and to the common area within the properties, and such easement shall be appurtenant to and shall pass with the title to every assessed Condominium, subject to the following provisions: ... (b) The right of the Association to establish uniform rules and regulations pertaining to the use of the common area and recreational facilities.

"Article VI, Section 3.

"Any member may delegate, ..., his right of enjoyment to the common area and facilities to the members of his family, his tenants, or contract [\*\*\*11] purchasers who reside on the property."

As record owners of a Miraverde condominium, the Rasmussens are members of the Association. This membership is not transferable unless the Rasmussens were to sell the condominium. There is no evidence in the record the Rasmussens ever delegated their right to use the common areas to Ms. MaJor or anyone else.

(6a) The principal issue in this case is whether the Association is authorized to discriminate between members who reside at Miraverde and nonresident members, such as the Rasmussens, in the use and enjoyment of common areas including recreational facilities. The CC&R's grant every *member* of the Association a right and easement of enjoyment in and to the common areas within the property. (Art. VI, § 2.) These rights are subject only to the right of the Association to establish uniform rules and regulations pertaining to a *member's* use of the common areas and recreational facilities (*Ibid.*) The Rasmussens assert the Association acted without authority in restricting the use of common areas, including recreational facilities, by members who are not residents of Miraverde. We agree.

The Association's bylaws, article IV, section 1, grant [\*\*\*12] the Association's board of directors the power to manage and maintain the common areas and to make such rules and regulations therefore not inconsistent with law, the Association's articles of incorporation and its bylaws. The Association's articles of incorporation, article IV, section 2(a), require the Association to perform the duties and obligations as set forth in the CC&R's. The CC&R's [\*626] state that "every member shall have a right and easement of enjoyment in and to the common area." The legal effect of the CC&R's is to grant "every member" the right to use the common areas subject to uniform rules and regulations.<sup>1</sup> By classifying [\*\*242] members into two categories, residents and nonresidents, the Association created rules that are not uniform as to all members. Under the Association's rules, a resident member of the Association is entitled to use the common areas subject only to reasonable restrictions on time and manner. A nonresident member is not entitled to use the common areas unless he or she is an authorized guest of a registered resident. Hence, the Rasmussens are

not entitled to use the common areas, including recreational facilities, unless Ethel Major, the [\*\*\*13] authorized registered resident, reserves the recreational facility and is personally present during its use. The evidence was undisputed Ethel Major's physical handicap prevented her from reasonably complying with this rule. Thus, the Rasmussens were denied the use and enjoyment of the recreational facilities on an equal footing with resident members of Miraverde, and the trial court so found. The Association's rule became a de facto termination of the Rasmussens' use of the common areas. The effect of the Association's rule was to terminate a right originally granted by the CC&R's to all members whether resident or not.

1 The CC&R's grant any member the right to delegate his right of enjoyment to the common areas to the members of his family, tenants, or contract purchasers who reside on the property (art. of incorp., art. VI, § 3.) Here we do not address the issue whether the member's right and easement to the common areas is extinguished upon delegation to a third party.

Furthermore, the Association's rules [\*\*\*14] exclude the Rasmussens from the common areas while simultaneously charging them a fee for the common areas' use and improvements. (Art. VII, § 1.) If the Rasmussens were to fail to pay their annual or special assessments, the Association would have the right to charge interest, bring an action at law, or foreclose the lien upon the condominium. (Art. VIII, § 1.) In return for the annual or special assessment fees, the Rasmussens, as nonresident members, would receive nothing. To de facto terminate the Rasmussens' right would impose a substantial obligation upon the Rasmussens while imposing no obligation at all on the Association. Such an illusory agreement would be not enforceable. (See Farnsworth, Contracts (2d. ed. 1990) § 2.13, p. 106 et seq.)

The Association relies on *Sunrise Country Club Assn. v. Proud* (1987) 190 Cal.App.3d 377, 381-382 [235 Cal.Rptr. 404] for the proposition ownership of a condominium has no necessary relationship to its use. We do not find this case persuasive in the matter at hand. In *Sunrise Country Club Assn.*, the court refused to uphold the prohibition on sale of a condominium designated for "adults [\*\*\*15] only" to persons having children. The court recognized an owner [\*627] with

children could comply with the "adults only" restriction because the owner may own the condominium for investment purposes or for use by less than all family members (190 Cal.App.3d at p. 383.) It was in that context the court remarked ownership of a condominium has no necessary relationship to its use. (*Ibid.*) This case is distinguishable from the Rasmussens' case. Whether, in general, there is no necessary connection between ownership and use, there is a specific connection between ownership and use in our case. The terms of the CC&R's link ownership with the use of the common areas. The Rasmussens' right to use the common areas comes from being owners of a Miraverde condominium.

(7) When disputes arise between the homeowners and the homeowners association, the courts will look to the governing instruments for guidance in determining whether the association has acted within its authority. (Thomas & Grogan, Cal. Condominium and Planned Development Practice (Cont.Ed.Bar 1984) State Regulation of Common Interest Subdivision Sales, p. 236.) Actions taken in excess of [\*\*\*16] the association's power are unenforceable and courts have granted injunctive relief against associations which have exceeded the scope of their authority.

For example, in *Spitser v. Kentwood Home Guardians* (1972) 24 Cal.App.3d 215, 218 [100 Cal.Rptr. 798], the association assessed the homeowners' fees to correct a nuisance emanating from the local airport. The CC&R's expressly prohibited the use of homeowners' lots in a manner which [\*\*243] constituted a nuisance to the neighborhood and allowed the use of assessment funds to enforce this restriction. In upholding the lower court's injunctive relief against the association's assessment of the homeowners, the court held the association was not authorized or required to protect Kentwood from nuisances emanating from *outside* the area. In *Ticor Title Ins. Co. v. Rancho Santa Fe Assn.* (1986) 177 Cal.App.3d 726 [223 Cal.Rptr. 175], the appellant challenged the association's action changing setback restrictions set forth in the CC&R's. The association was authorized to adopt rules and regulations for the general welfare of the community. However, [\*\*\*17] the CC&R's specifically set forth setback restrictions for the community and provided any change required approval by two-thirds of the owners. The association proceeded to change the setback requirements on its own. The court held the association's actions were invalid because it was not authorized to enact setback regulations different from

those contained in the CC&R's.

Florida courts have adopted a similar approach to challenges directed at rules adopted by the homeowners association:

"When a court is called upon to assess the validity of a rule enacted by a board of directors, it first determines whether the board acted within its [\*628] scope of authority and, second, whether the rule reflects reasoned or arbitrary and capricious decision making." (*Beachwood Villas Condominium v. Poor* (Fla. Dist. Ct. App. 1984) 448 So.2d 1143, 1144; see also Note, *Judicial Review of Condominium Rulemaking* (1981) 94 Harv. L. Rev. 647, 652-653.)

(6b) In view of the foregoing authorities, we conclude an association may not exceed the authority granted to it by the CC&R's. Where the association exceeds its scope of authority, any rule [\*\*\*18] or decision resulting from such an ultra vires act is invalid whether or not it is a "reasonable" response to a particular circumstance. Where a circumstance arises which is not adequately covered by the CC&R's, the remedy is to amend the CC&R's. The courts have held homeowners are subject to any reasonable amendment of the CC&R's properly adopted (See, e.g., *Ritchey v. Villa Nueva Condominium Assn.*, *supra*, 81 Cal.App.3d at p. 697.)

For the reasons set forth above, we conclude it is reasonably probable the Rasmussens will prevail on the merits in establishing the Association exceeded its authority by excluding nonresident members from the common areas.

We further find the Rasmussens would suffer a greater harm from denial of the injunction than the Association would from its grant. *Civil Code section 783* recognizes that ownership of a condominium constitutes a statutory estate in real property. (See *Laguna Royale Owners Assn. v. Darger* (1981) 119 Cal.App.3d 670, 673, fn. 1 [174 Cal.Rptr. 136].) The Rasmussens' purchase of the condominium vested in them the right to the physical [\*\*\*19] unit as well as a right to use the common area. To exclude the Rasmussens from the common area would prevent them from enjoying a significant part of their estate.

The Association asserts the restrictions regarding the use of the common areas are necessary in order to prevent overcrowding. In view of the condominium's CC&R's,

the owners of the condominiums were well aware of the limited facilities available at the Miraverde condominium project. The owners of the condominiums should not expect anything more than they bargained for. Furthermore, the Association should be able to cure any inconvenience or overcrowding with proper rules and regulations, consistent with the CC&R's, governing the reasonable time and manner of use of the recreational facilities.<sup>2</sup>

2 Our decision, of course, is based on the record before us. We note, for example, the Rasmussens were not seeking to both use the tennis court themselves and have a tenant or other delegatee use the court. Consequently the Rasmussens' unit was placing no greater burden on the Association's facilities than it did when the Rasmussens occupied that unit and no greater burden than if they still did. As mentioned earlier (see fn. 1, *ante*), we need not reach the question whether, under the CC&R's, a delegation to a tenant or contract owner of the owner's right to enjoy common facilities would have the effect of terminating (or suspending) the owner's personal rights to use those facilities. We leave this question to the trial court for resolution in the first instance should new facts be developed on remand.

[\*\*\*20] [\*629] [\*\*244] DISPOSITION

The order denying the preliminary injunction is reversed as to the Rasmussens, and the matter is remanded to the trial court for further proceedings not inconsistent with the views expressed herein. The appeal of Ethel Major is dismissed as moot. Each party is to bear its own costs on appeal.

Lillie, P. J., concurred.

**CONCUR BY: WOODS (Fred), J.**

**CONCUR**

I concur in the judgment only since the majority opinion, in my view, reaches the correct result but unnecessarily adverts to and inadequately treats the issue of delegation. By its brevity the approach of the majority may create confusion for trial courts and litigants in future cases involving related issues.



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1992 Cal. App. LEXIS 790, \*\*\*20; 92 Cal. Daily Op. Service 5491

Respondents' petition for review by the Supreme Court  
was denied September 2, 1992.

Panelli, J., was of the opinion that the petition should  
be granted.

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Send To: Sancheti, Harshavardhan  
DECHERT LLP  
1775 I ST NW  
WASHINGTON, DC 20006-2402