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The Future of Investment Treaty Protection in Eastern Europe

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In recent years, the countries of Eastern Europe have emerged as highly attractive destinations for foreign direct investment (FDI). Having shed their legacy of state-controlled economic policies and embraced market reforms, these states have managed to attract investors from around the globe seeking to capitalise on opportunities arising from this historic and ongoing transformation. In furtherance of this trend, Eastern European states have entered into a variety of international treaties designed to protect foreign investment and thus to induce the further inflow of needed capital. Investors, for their part, have frequently taken advantage of such treaties to protect their rights, in some cases pursuing international arbitration claims worth hundreds of millions of dollars.¹

The accession of many Eastern European countries to the European Union in recent years, however, has raised a number of questions regarding the interaction of EU law and the obligations that those countries have undertaken under their investment treaties. Investors participating in the Eastern European market – and those who seek to do so – must be aware of these developments as they consider their investment strategies for the region.

Eastern Europe as a destination for FDI

The increase in FDI in Eastern Europe in recent years has been nothing short of dramatic. With GDP figures more than tripling over the past decade in many such countries, FDI has consistently poured into their economies, contributing to these states' rapid development while providing substantial returns to investors. For example, according to statistics from the United Nations Committee on Trade and Development (UNCTAD), Poland's total FDI increased from US\$11.463 billion in 1996 to US\$103.616 billion in 2006.² The trend over the decade was similar in neighbouring states: in Hungary, the figure increased from US\$13.282 billion to US\$81.76 billion; in the Czech Republic, from US\$8.572 billion to US\$77.46 billion; and in Slovakia, from US\$2.046 billion to US\$30.327 billion.³ UNCTAD's 2008 World Investment Prospects Survey ranks four Eastern European countries – Poland, the Czech Republic, Bulgaria and Romania – among the top 30 preferred locations for FDI.⁴

Protection of FDI in Eastern European countries

Among the features that make Eastern European countries such attractive destinations for investment are those states' numerous bilateral investment treaties (BITs) with other states, including many EU member states. BITs provide a number of substantive protections to foreign investors by requiring the host state to provide certain standards of treatment to foreign investments. For example, most BITs prohibit the host state from discriminating against foreign investors and in favour of domestic competitors, or competitors from a third state. In addition, BITs often require that if a host state expropriates an investment, it must also provide full compensation to the affected investor. BITs also typically obligate the host state to treat foreign investors in accordance with certain

internationally recognised principles, such as 'fair and equitable treatment' and 'full protection and security', and may contain provisions limiting the host state's freedom to restrict financial transfers or impose 'performance requirements' on foreign investment.

Just as importantly, most of the Eastern European states' BITs contain provisions allowing investors to submit claims for host state violations of the BIT to international arbitration. Awards rendered in such arbitrations are binding and may require the host state to pay substantial monetary damages to the injured investor. The possibility of such damages awards can be useful not only in obtaining relief for harm caused by adverse government actions, but also in discouraging such actions at the outset, or in negotiating mutually acceptable resolutions to disputes with the host state.

Many Eastern European states have entered into a large number of such BITs. For example, the Czech Republic has entered into well over 70 BITs, with states as diverse as the Netherlands, Pakistan and Venezuela. Similarly, Hungary has entered into more than 50 BITs; Romania, Slovakia, Latvia, and Lithuania, more than 40; Bulgaria, Poland, and Slovenia, more than 30; and Estonia, nearly 20. Investors from both EU member states and non-EU states may thus be able to benefit from BIT protections when investing in Eastern Europe.

EU accession and its implications

In May 2004, 10 countries – including the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia – acceded to the EU. They were followed in January 2007 by Bulgaria and Romania. In joining the EU, these states gained access to the world's largest free trade zone (by market size), significantly expanding their market reach and growth potential, and solidifying their integration into the Western political and economic community. These developments have made Eastern Europe a still more attractive investment destination.

EU accession, however, has also given rise to complications. As a condition of joining the EU, each of these states had to ensure that its domestic laws and regulatory systems conform to EU legal requirements. Accordingly, each state had to undertake a lengthy process of reform and adjustment, removing certain regulatory restrictions, implementing others, and developing new institutions.

Further, these states' EU accession has raised questions regarding the status of their various treaty commitments, including their commitments under BITs entered into before and after EU accession. To the extent that certain BIT obligations might potentially conflict with EU legal requirements, there is a question whether investors from other states can continue to rely on the BITs' protections when making investment decisions. This has given rise to conflicting views among commentators, litigation in the European Court of Justice, and discussion in several recent arbitral awards.

Conflicts between EU law and BITs with non-EU states

The perceived tensions between EU law and new EU members' BIT obligations arise in two primary contexts: BITs with non-EU states, and BITs with other EU member states. In the first context, there exists the potential for direct conflict between EU law on the one hand, and a BIT between an Eastern European state (eg, Poland) and a non-EU country (eg, the United States) on the other hand. Under article 307 of the EC Treaty – a provision to which all EU members are required to adhere – EU member states must take all appropriate steps to eliminate any incompatibility between the EC Treaty and any other agreements which they may have entered into, such as BITs with other states.⁵

This tension can lead to very real conflicts within the EU system itself. For example, the European Commission has filed cases against Austria, Sweden and Finland in the European Court of Justice (ECJ), alleging that all three countries (who joined the EU in 1995) failed to comply with their obligations under EU law to take 'all appropriate steps to eliminate the incompatibility between their pre-accession bilateral investment agreements' and EC law.⁶ According to the Commission, because these BITs do not include exceptions allowing for the possibility of EU-wide controls on capital flows in exceptional circumstances, Austria, Sweden and Finland's failure to amend the BITs has left them in breach of the EC Treaty.⁷ An advocate general of the European Court of Justice has issued opinions in support of the Commission's position.⁸ 'Free transfer' provisions are common in modern BITs, suggesting that the same issue could well arise with respect to those Eastern European member states who acceded in 2004 and 2007.

At the same time, the new EU member states also face pressure from another direction: from investors objecting under BITs to actions that EU law requires of the states. Indeed, various attempts by these new member states to comply with EU law have given rise to BIT arbitration claims by frustrated investors. For example, in response to a Commission determination that certain long-term power purchasing agreements (PPAs) between a Hungarian state-owned utility and foreign-owned investors (including a US company) violated EU rules on 'state aid', Hungary terminated the PPAs. In response, the foreign firms initiated arbitration proceedings against Hungary at the International Centre for Settlement of Investment Disputes (ICSID).⁹

These arbitrations are likely to raise important questions regarding the relationship between EU law and BITs. On the one hand, there is an argument that Hungary's obligations under its BITs stand unaffected. Under article 30(4)(b) of the Vienna Convention on the Law of Treaties, a treaty between two parties will not be superseded by a subsequent treaty that one of the parties enters into with a third party.¹⁰ Thus, to the extent that investors hail from countries that are not parties to the EC Treaty, they may argue that article 30(4)(b) of the Vienna Convention mandates application of the relevant BITs. Further, another provision of article 307 of the EC Treaty states that as a general rule the EC Treaty itself is not intended to affect 'rights and obligations' from treaties that EU member states entered into with non-EU states prior to accession,¹¹ and article 30(2) of the Vienna Convention provides that when a given treaty specifically states that it is 'not to be considered as incompatible with, an earlier or later treaty', then the earlier or later treaty (here, a BIT) is to prevail. On the other hand, there is an argument that Hungary's EU law obligations have affected its obligations under its BITs in a way that investors should have known and expected. Interestingly, the Commission has sought to intervene in the dispute as an inter-

ested non-party, or *amicus curiae*, on the side of Hungary.¹²

Some non-EU states have taken deliberate steps to try to eliminate or reduce any tension between their BITs with the new EU member states and EU law. For example, prior to the 2004 accessions, the United States engaged in extensive negotiations with the Commission, with the aim of amending its BITs with the acceding states and thereby harmonising those treaties with EU requirements. As a result of those negotiations, the United States, the Commission and the acceding states entered into an 'Understanding' regarding revision of the BITs to increase conformity with EU law.¹³ Subsequently, the United States entered into protocols with certain of the acceding states, revising the respective BITs. Among the specific BIT provisions adjusted through the protocols were those concerning performance requirements, which the new EU member states were permitted to adopt in certain market sectors (such as agriculture).¹⁴ In addition, the protocols limited the requirements of national treatment and most-favoured-nation treatment as applied to future investments in certain sectors.¹⁵ Shortly after the 2004 accessions, Canada similarly reached an agreement with the Commission to develop amendments to its investment treaties with new EU member states.¹⁶

Conflicts between EU law and BITs with EU member states

The second context in which tension between Eastern European BITs and EU law has arisen is in BITs between Eastern European states and other EU member states. In this context, both the Commission and some of the new EU member states have taken an assertive stance regarding the primacy of EU law.

In 2006, European Commission officials issued an informal note on this issue to the Economic and Financial Committee (EFC), an entity that reviews the EU's internal market policies. In the note, the Commission referred to the existence of BITs between EU member states and commented that '[t]here appears to be no need for agreements of this kind in the single market and their legal character after accession is not entirely clear. It would appear that most of their content is superseded by Community law upon accession of the respective Member State.'¹⁷ Thus, the Commission took the position that EU law should in effect supersede the provisions of any BITs that the newly acceded Eastern European states had previously entered into with existing EU member states. In response, the EFC stated in its 2006 annual report that 'in order to avoid legal uncertainties and unnecessary risks for member states in the unclear situation, member states are invited to review the need for such agreements; and inform the Commission about the actions taken in this context so that progress can be reviewed by the EFC by the end of 2007.'¹⁸

Recently-acceded EU member states that find themselves facing BIT claims from investors in other EU member states may be tempted to invoke this notion that their intra-EU BITs have been implicitly terminated, in order to defend against the BIT claims. Article 59 of the Vienna Convention provides that a treaty between two states may be terminated if the same two states enter into a subsequent treaty covering the 'same subject matter' as the first treaty, and if either the states indicate their intent that the later treaty shall govern the matter, or the provisions of the two treaties are so incompatible that they cannot both be applied at the same time. A state facing an investor's BIT claim may characterise the BIT or particular BIT provisions as encompassing the 'same subject matter' and, therefore, as superseded by the relevant provisions of EU law. On the other side, investors can be expected to argue that the BIT parties have not formally terminated the relevant BITs, and that the allegedly competing obliga-

tions of the BITs and EU law are capable of being reconciled.

At least one Eastern European state has already attempted – without success – to invoke an inconsistency between EU law and a BIT with another EU member state as a defence to arbitration claims brought by investors from the other EU member state. In *Eastern Sugar v Czech Republic*, a Dutch company brought claims against the Czech Republic based on allegedly discriminatory application of agricultural quota rules, which it claimed violated the Netherlands–Czech BIT. The Czech Republic argued that all of its BITs with other EU member states had been implicitly terminated when it acceded to the EU. The tribunal in that case rejected the argument and then proceeded to find in favour of the Dutch investor on certain of its claims.¹⁹ A tribunal in a separate case brought against the Czech Republic by a German investor, addressing a similar Czech Republic argument, has reportedly reached a similar conclusion.²⁰

Expansion of EU competence to investment issues

Another potential development on the horizon could have far-reaching implications for the future of all EU member states' BITs. For a number of years, the Commission has sought to increase the scope of its authority over issues concerning FDI. The proposed EU Constitution, and subsequently the Lisbon Treaty (or Reform Treaty) – particularly article 207(1) thereof – explicitly grant the EU 'competence' in that field. What is not yet clear is whether such competence would extend merely to investment 'liberalisation' – that is, admission of new investment – or whether it would additionally cover the protection and treatment of existing investment.²¹ If the Lisbon Treaty is ultimately adopted, and if a broad interpretation of article 207(1) is accepted, the Commission may move to take over the role of the various member states in negotiating and concluding new investment treaties, overhauling existing investment treaties, and perhaps even defending BIT claims brought against EU member states (as the Commission does at the WTO). The Lisbon Treaty and its interpretation bear close watching, as they may have important effects on the status of the various EU member states' BITs with one another and with non-EU states, as well as the rights of concerned investors.

The accession of various Eastern European states to the EU both presents new opportunities and raises complex questions for investors in that region. The potential for conflict between investment treaties and EU law creates some uncertainty regarding the strength of the protections such treaties will provide to investors. However, given the enormous stakes involved for investors, until the legal situation becomes much clearer, one should not expect an imminent decline either in investment into Eastern Europe, or in investors' invocation of treaty rights when facing adverse government actions.

Notes

- 1 Examples include *Eureko BV v Poland* (UNCITRAL) (claim by Dutch entity against Poland for over US\$1 billion in damages); *Saluka Investments BV v Czech Republic* (UNCITRAL) (claim by Japanese-owned Dutch entity against the Czech Republic for over US\$1 billion in damages); *Noble Ventures, Inc v Romania*, ICSID case no. ARB/01/11 (claim by US company against Romania); *Telenor Mobile Communications AS v Republic of Hungary*, ICSID case no. ARB/04/15 (claim by Norwegian company against Hungary). There have been a number of other claims against Eastern European states.
- 2 See UNCTAD, *World Investment Report 2007: Transnational Corporations, Extractive Industries and Development – 'Major FDI Indicators' FDI Inward Flow and Stock*.
- 3 *Ibid.*
- 4 UNCTAD, *World Investment Prospects Survey 2008-2010*, p32.
- 5 See EC Treaty, article 307 ('To the extent that such [prior] agreements are not compatible with this Treaty, the Member State or States concerned shall take all appropriate steps to eliminate the incompatibilities established.').
- 6 See *European Commission v Republic of Austria*, case C-205/06 and *European Commission v Republic of Sweden*, case C-249/06, Opinion of Advocate General, 10 July 2008 (Advocate General's Opinion); Internal Market: Infringement Proceedings against Austria, Finland, France, Italy, Greece, Portugal and Sweden, Press Release, Europa.eu (official website of the EU), 17 October 2005 (EU Press Release).



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Sidley Austin LLP's international arbitration practice is comprehensive and truly global in reach, with experience in arbitral fora ranging from London to Washington, DC to Hong Kong. In addition to a full international commercial arbitration practice, Sidley is particularly known for its substantial practice in the high-profile field of investor-state (investment treaty) arbitration.

Sidley represents multinational companies as claimants, and sovereign governments as respondents, in disputes over government actions that allegedly injure foreign investments. Sidley lawyers also serve as arbitrators in investor-state cases, and Sidley has one of the largest dockets of any firm of ICSID and UNCITRAL cases.

In tandem with its investor-state arbitration practice, the international arbitration team advises Sidley's corporate clients on structuring multinational transactions to take advantage of the protections and arbitration options that investment treaties have to offer.

Sidley's investment treaty team includes lawyers who have served in government negotiating, and overseeing negotiations of and disputes under, bilateral and multilateral investment treaties. Sidley lawyers have served as arbitrators in investor-state disputes, have been appointed by governments to serve on standing rosters of arbitrators, and have taught courses and seminars in investment treaty arbitration.

- 7 See Advocate General's Opinion; EU Press Release.
- 8 See Advocate General's Opinion.
- 9 See 'European Commission Seeks to Intervene as Amicus Curiae in ICSID Arbitrations to Argue that Long-Term Power Purchase Agreements between Hungary and Foreign Investors are Contrary to European Community Law', *Investment Arbitration Reporter*, 17 September 2008.
- 10 See Vienna Convention on the Law of Treaties, article 30(4)(b) ('When the parties to a later treaty do not include all the parties to the earlier one... as between a State party to both treaties and a State party to only one of the treaties, the treaty to which both States are parties governs their mutual rights and obligations.').
- 11 See EC Treaty, article 307 ('The rights and obligations arising from agreements [pre-dating] accession, between one or more Member States on the one hand, and one or more third countries on the other hand, shall not be affected by the provisions of this treaty.').
- 12 See above, note 9.
- 13 Understanding Concerning Certain US Bilateral Investment Treaties, signed by the United States, the European Commission, and acceding and candidate countries for accession to the European Union, 22 September 2003.
- 14 Ibid.
- 15 Ibid.
- 16 See 'Canada-European Union Reach Deal to Amend Six Investment Treaties', *INVEST-SD: Investment Law and Policy Weekly News Bulletin*, 13 October 2004.
- 17 'EU Members Review Intra-European BITs in Light of Potential Overlap with EU Law', *Investment Treaty News*, 30 June 2007.
- 18 Ibid.
- 19 See *Eastern Sugar BV v Czech Republic*, SCC Case No. 088/2004, Partial Award, 27 March 2007, at paragraphs 142-81.
- 20 See 'Czech Republic Quietly Pursues Challenge to Jurisdictional Ruling in Prague Court', *Investment Treaty News*, 17 January 2008.
- 21 See Stephen Woolcock, *The Potential Impact of the Lisbon Treaty on European Union External Trade Policy*, Swedish Institute for European Policy Studies, June 2008.

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