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# Investment Treaty Protection for International Principals and Contractors

## *'Friend or Foe'*

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# INVESTMENT TREATY PROTECTION

# FOR INTERNATIONAL PRINCIPALS AND CONTRACTORS

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## I INTRODUCTION

Over the last 20 years there has been substantial growth in cross-border work for international principals and contractors, particularly in the planning, financing, construction, and operation of complex infrastructure projects in developing countries. The duration of such projects, and their significance to host economies can give rise to unpredictable changes in government policy or administrative interference. International principals and contractors, in addition to negotiating suitable international arbitration dispute provisions in underlying agreements, are also increasingly relying on investment treaties to provide a level of protection for political sovereign risk. This trend is reflected in the significant growth in recent years of construction related investor-state disputes, with the United Nations Conference on Trade and Development reporting a total of 96 investor-state disputes in the construction sector, 37 of which are pending, and 59 resolved.[1] Of those resolved, 14 were decided in favour of the investor, 26 in favour of the State, 14 settled, and 5 discontinued.

The author examines in this paper; (a) the ability of international principals and contractors to gain protection for political sovereign risk under investment treaties; and (b) recent international investment treaty jurisprudence relevant to construction contracts and infrastructure.

## II INVESTMENT TREATIES – WHY ARE THEY IMPORTANT?

Investment treaties are agreements between two or more States by which each contracting State agrees to promote and protect investments made in its territory by investors of the other contracting State or States. Although the treaties are inter-state in nature, they are designed to protect investors in the host State, and they are the direct beneficiaries of the treaties.

The majority of treaties are bilateral investment treaties (‘BITs’). The first BIT was signed in 1959 by Germany and Pakistan. However, it was not until the 1980s that countries started increasingly to negotiate and enter into BITs, in parallel with the substantial growth of international investment, which has required a more flexible and precise scope than under customary international law. There are now approximately 2900 BITs globally, with approximately 2350 in force.[2]

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[1] https://investmentpolicyhub.unctad.org/ISDS/FilterByEconomicSector. The construction sector comprises of three sub-sectors, construction of buildings, civil engineering, and specialized construction activities.

[2] https://investmentpolicy.unctad.org/international-investment-agreements.

The underlying rationale for BITs on the part of the capital exporting country is that they provide foreign investors with a degree of protection for capital invested. From the developing country's perspective, BITs are intended to increase the inflow of foreign investment, and thereby contribute to the country's economic development.

BITs generally provide for disputes arising under the treaty to be resolved through investor-state arbitration by *ad hoc* arbitration under the United Nations Commission on International Trade Law Arbitration rules, institutional arbitration under the International Chamber of Commerce rules, or under the Convention on Settlement of Investment Disputes between States and Nationals of Other States 1965 (the 'ICSID Convention').

In cases where principals and contractors have entered into agreements with host States or their State entities, interference by the State in the performance of the contract may give a right to investor-state arbitration proceedings against the State, in addition to principals' and contractors' right to dispute resolution under the contract. In other cases, where the State is not the contracting entity, a BIT claim may be an investor's only remedy.

Whether a principal or contractor can bring arbitration proceedings against a host State under an investment treaty involves questions of jurisdiction under the treaty, the scope of substantive protection under the treaty, and whether breaches of any agreement or other measures causing damage or loss can be attributed to the host State or one of its entities.

## III WHAT JURISDICTIONAL REQUIREMENTS MUST PRINCIPALS AND CONTRACTORS ESTABLISH?

### A *Definition of a 'National' or 'Investor'*

All BITs contain a definition of the term *'national'* or *'investor'* for the purpose of making it clear which entities are covered by the protection afforded by a BIT, and is the fundamental criterion for determining the scope of the protection. Such provisions broadly fall into two categories:

(1) incorporation in the host State, without other restrictions; or

(2) less commonly, incorporation in the host State, together with other restrictions, usually relating to control or management of the entity (sometimes referred to as a *'denial of benefits'* clause), such as a requirement that a company's place of *'effective management'* be situated in the country of incorporation, or that a company is *'actually doing business'* in the country of incorporation.

Shell companies controlled by their overseas owners have generally been entitled to claim for breaches of a host State's BIT obligations. For example, in a construction context, in *Garanti Koza v Turkmenistan*[3], Garanti Koza was a limited liability partnership incorporated in the United Kingdom and partially owned by a Turkish company, Garanti Koza Insaat. Garanti Koza LLP acknowledged that it was established in the United Kingdom in April 2007 solely for the purpose of entering into the construction contract the subject of the proceedings. The tribunal found that Garanti Koza LLP fell within the scope of *'nationals or companies of the other Contracting Party'* in the relevant BIT, commenting as follows:

> …the BIT requires only that Garanti Koza be incorporated somewhere in the United Kingdom in order to bring its investments within the protection of the treaty. The BIT contains no denial-of-benefits clause that would require that a U.K. investor have actual operations in the U.K. And the weight of the evidence shows that Turkmenistan knew and accepted that it was dealing with an English company.[4]

Joint venture structures are often used by international contractors, and although an unincorporated joint venture is unlikely to qualify as an investor, the individual joint venture companies may qualify.

### B *Nationality Planning*

It is now settled law that a prudent investor, at the time of making its investment, may design its corporate structure to take advantage of the protection afforded under an investment treaty entered into by a host country,[5] a practice referred to as *'nationality planning'*.

Australia has entered into 19 BITs,[6] including with countries where Australia's international principals and contractors may wish to develop or construct projects, such as China, India, Indonesia, Lao, Pakistan, and the Philippines. Australian principals or contractors can seek protection under these treaties, or, alternatively, establish its corporate structure in a third country to take advantage of a favourable investment treaty between the third country and the host country. Whilst an investor's selection of place of incorporation of an investing entity is often governed principally by commercial reasons, such as taxation, treaty protection is often a factor in such decisions.

As noted above, some investment treaties include a *'denial of benefits'* clause, and these are designed to limit the scope of nationality planning.

Whilst nationality planning is permissible, tribunals will decline jurisdiction on abuse of process grounds where an investor establishes or changes its corporate structure in circumstances where the

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[3] *Garanti Koza v Turkmenistan* (ICSID Case No ARB/11/20).
[4] Ibid, (ICSID Case No ARB/11/20), [222].
[5] See,eg, *ADC v Hungary* (ICSID Case No ARB/ 03/16); *Pac Rim v El Salvador* (ICSID Case No ARB/09/12); *Bureau Veritas v Paraguay* (ICSID Case No ARB/07/9).
[6] 18 of these are in force.

dispute has already arisen or is foreseeable.[7] This was the arbitral tribunal's finding in *Philip Morris v Australia*,[8] which involved Australia's introduction of plain-packaging legislation for cigarettes. The Australian government announced in April 2010 its intention to implement the legislation, and Phillip Morris restructured its corporate group 10 months later, in February 2011, with the principal aim of bringing an investment claim under the Hong Kong-Australia BIT. The arbitral found that the dispute was foreseeable *'well before the Claimant's decision to restructure was taken (let alone implemented)'*,[9] and declined jurisdiction.

C *Definition of an 'Investment'*

The definition of *'investment'* is typically widely drafted in BITs, using phrases such as *'means every kind of asset owned or controlled and invested by investors of one Party'*. Most treaties then set out a non-exclusive list to illustrate assets included, such as *'[C]laims to money or to any performance under contract having a financial value'*. The wide scope of the expression *'investment'* reflects the commercial reality that international investments and investment structures take many forms and have varying degrees of complexity.

In addition to falling with the scope of the definition of *'investment'* in the relevant treaty, in the context of ICSID arbitrations, there may also be a question of whether the investment falls within the scope of Article 25 of the ICSID Convention. Some tribunals have taken the position that if the investment falls within the scope of the investment treaty itself, it also qualifies under Article 25.[10] Other tribunals, following the lead in the decision in *Salini v. Morocco*,[11] have treated a list of features as a test that an asset must pass to be recognized as an investment under the ICSID Convention, commonly referred to as the *Salini* test.[12] These features are that the investment; (a) should have a certain duration; (b) regularity of profit and return; (c) an element of risk for both sides; (d) the commitment should be substantial; and (e) should be significant for the host State's economic development.

In a project development context, where principals and contractors are involved in the financing, construction, owning and/or operating of infrastructure projects under build operate own or build operate transfer structures, arbitral tribunals have had no difficulty in finding that such projects fall within the scope of an *'investment'* under both the investment treaty and Article 25 of the ICSID Convention.

[7] Emmanuel Gaillard, 'Abuse of Process in International Arbitration', ICSID Review, (2017), 1-21.
[8] *Philip Morris v Australia* (PCA Case No 2012-12).
[9] Ibid, [586].
[10] See, eg, *Gruslin v Malaysia* (ICSID Case No ARB/05/10); SGS *v Pakistan* (ICSID Case No ARB/01/13); *MSH v Malaysia* (ICSID Case No ARB/05/10); *Garanti Koza v Turkmenistan* (ICSID Case No ARB/11/20).
[11] *Salini v. Morocco* (ICSID Case No ARB/00/4).
[12] First identified in *Fedax v. Venezuela* (ICSID Case No ARB/96/3).

There was previously some doubt as to whether traditional stand-alone construction contracts fall within the scope of an *'investment'*, on the basis that these are simple commercial agreements, unaffected by risk, which should be analysed as contracts of sale, rather than investments.[13] However, arbitral tribunals have found traditional construction contracts for a range of projects fall within the scope of an investment under the relevant BIT, for example, contracts for construction of roads and highways,[14] bridges,[15] dams,[16] dredging of a canal,[17] a housing and sports facility,[18] residential units,[19] a highway tunnel,[20] and buildings.[21] Of the 96 investment treaty arbitrations involving the construction sector, at least 20 have involved traditional construction contracts.

For example, in *Pantechniki v Albania*,[22] which involved a contract for road construction, the tribunal held that the contract was an *'investment'* under both the definition in Article 1(1) of the Greece-Albania BIT, and Article 25 of the ICSID Convention, as follows:

> Albania does not come close to being able to deny the presence of an investment. Albania cannot and does not dispute that the Claimant committed resources and equipment to carry out the works under the Contracts. Its own officials have accepted that materiel committed to infrastructural development was brought by the Claimant to Albania and lost there.
>
> …
>
> There is no need to use one's imagination to list the possible risks associated with the Contracts; one need only consider what actually happened. The Contracts envisaged aggregate remuneration to the Claimant of some US$7 million. The expectation of commercial return is self-evident. The objection is unsustainable.[23]

Similarly, the tribunal in *Bayindir v. Pakistan*[24] observed *that '[The] construction of a highway is more than construction in the traditional sense'* and *'implies substantial resources during significant periods of time'* and *'clearly qualifies as an investment'*.[25]

[13] Nathan, KVSK, 'Submission to ICSID in Breach of the Convention: Disputes in International Civil Engineering Contracts', 1994, Thesis, University of London.
[14] *Bayindir v Pakistan* (ICSID Case No ARB/03/29); *Pantechniki v Albania* (ICSID Case No ARB/07/21); *Karmer Marble v Georgia* (ICSID Case No ARB/08/19).
[15] *Garanti Koza v Turkmenistan* (ICSID Case No ARB/11/20); *Lesi v Algeria* (ICSID Case No ARB/05/3).
[16] *Salini v Jordan* (ICSID Case No ARB/02/13).
[17] *Jan de Nul and Dredging International v Egypt* (ICSID Case No ARB/04/13).
[18] *Muhammet Capi v Turkmenistan* (ICSID Case No ARB/12/6).
[19] *KCI v Gabon* (not public).
[20] *Grassetto v Slovenia* (ICSID Case No ARB/13/10).
[21] *Bershader v Russia* (SCC Case No 080/2004); *Ickale v Turkmenistan* (ICSID Case No ARB/10/24).
[22] *Pantechniki v Albania* (ICSID Case No ARB/07/21).
[23] Ibid, [48]-[49].
[24] *Bayindir v. Pakistan* (ICSID Case No ARB/03/29).
[25] Ibid, [128], and referring with approval to the decision in *Autopista Concesionada de Venezuela, C.A. v. Bolivarian Republic of Venezuela* (ICSID Case No. ARB/00/5).

## IV WHAT SUBSTANTIVE PROTECTION DO INVESTMENT TREATIES PROVIDE?

### A *Introduction*

BITs typically provide five heads of substantive protection relevant to construction projects:

(1) freedom from expropriation without compensation;

(2) fair and equitable treatment;

(3) full protection and security;

(4) non-discrimination; and

(5) observance of obligations.

### B *Freedom from Expropriation*

All BITs provide the investor with protection from a State's expropriation or nationalisation of its investments without adequate compensation, in wider terms than protection under customary international law. Typically, such provisions are worded as an obligation not to *'nationalise, expropriate or subject to measures having effect equivalent to nationalisation or expropriation'* without adequate compensation.

The phrase *'equivalent to nationalisation or expropriation'* has been interpreted by tribunals as being a reference to conduct which is substantially wider than simply direct acquisition of property by a State party, and is said to be a reference to *'creeping expropriation'* or *'de facto expropriation'* of the investment. The host State's actions may not involve overtly acquiring the investment, but the acquiring occurs when governmental measures or conduct have *'effectively neutralised the benefit of property of the foreign owner'*.[26] Ownership or enjoyment can be said to be *'neutralised'* where a party is no longer in control of the investment, or where it cannot direct the day-to-day operations of the investment.[27]

Successful claims of expropriation in a construction or infrastructure context have almost exclusively involved concessions for the on-going operation of infrastructure projects, rather than arising from traditional construction contracts. Examples include a water and sewage system,[28] a hazardous waste

[26] *CME v Czech Republic*, ad hoc, UNCITRAL Arbitration, Partial Award, 604, 13 September 2001.
[27] *Pope & Talbot v Canada*, ad hoc, UNCITRAL Arbitration, Interim Award, 100, 26 June 2000.
[28] *Videndi v Argentina* (ICSID Case No ARB/97/3).

disposal facility,[29] hotels,[30] residential housing,[31] airports,[32] a water and sewerage company,[33] tourist complexes,[34] an arbitral award arising out of a gas pipeline project,[35] a water and sewerage infrastructure project,[36] an oil and gas pipeline,[37] an ecotourism project,[38] a hazardous waste landfill and treatment plant,[39] and electricity generation.[40]

For example, in *Abengoa v Mexico*,[41] the claimants constructed a hazardous waste landfill and treatment plant, which was opened in April 2009, but was the subject of ongoing protests by local citizens. Shortly after opening, and as a result of the protests, the local municipal council withdrew the project's license to deposit toxic waste at the site. The claimants commenced ICSID arbitral proceedings in December 2009, and were awarded US$40m, including for indirect expropriation as a consequence of the actions of local and federal authorities.

### C *Fair and Equitable Treatment*

A State's obligation to accord investments fair and equitable treatment remains the most relied upon and successful basis for a treaty claim. The standard is an objective one. Conventionally, a claim for breach of fair and equitable treatment usually requires some regulatory, legislative, or administrative action by a government authority which is viewed as breaching the fair and equitable treatment standard, incorporating both substantive and procedural rights, and requiring treatment which is reasonable, consistent, non-discriminatory, transparent, and in accordance with due process.[42]

Tribunals have also emphasised States' conduct which frustrates an investor's legitimate expectations, and which, as a consequence, breaches the fair and equitable treatment standard. The tribunal's decision in *Tecmed v Mexico*[43] has been consistently referred to by subsequent tribunals addressing investors' legitimate expectations. The tribunal in that case developed the concept of legitimate expectations from the principle of good faith in international law obliging a State to provide treatment that does not affect the basic expectations taken into account by the investor in making the investment.

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[29] *Metalclad v Mexico* (ICSID Case No ARB(AF)/97/1).
[30] *Wena Hotels v Egypt* (ICSID Case No ARB/98/4); *Sistem v Kyrgyzc* (ICSID Case No ARB(AF)/06/1); *Alpha Projektholding v Ukraine* (ICSID Case No ARB/07/16).
[31] *AIG v Kazakhstan* (ICSID Case No ARB/01/6).
[32] *ADC v Hungary* (ICSID Case No ARB/03/16); *Flughafen Zurich v Venezuela* (ICSID Case No ARB/10/19).
[33] *SAUR v Argentina* (ICSID Case No ARB/04/4).
[34] *Siag v Egypt* (ICSID Case No ARB/05/25); *OKKV v Krygyz*.
[35] *Saipem v Bangladesh* (ICSID Case No ARB/05/7).
[36] *Biwater v Tanzania* (ICSID Case No ARB/05/22).
[37] *Fuchs v Georgia* (ICSID Case No ARB/07/15).
[38] *Marion Unglaube v Costa Rica* (ICSID Case No ARB/08/1).
[39] *Abengoa v Mexico* (ICSID Case No ARB(AF)/09/2).
[40] *Guaracachi v Bolivia* (PCA Case No 2011-17).
[41] (ICSID Case No ARB(AF)/09/2).
[42] Vandeveld, Kenneth, 'A Unified Theory of Fair and Equitable Treatment', International Law and Politics (20102) Vo. 43.43.
[43]*Tecmed v Mexico* (ICSID Case No ARB/05/17).

Tribunals have also held a breach of the fair and equitable treatment standard as a consequence of breaches by the State of the underlying contract, thereby frustrating investors' legitimate expectations at the time of entering into the contract. For example, in a construction context, in *Alpha Projektholding v Ukraine*,[44] the claimant had modernised a hotel complex in Kiev, following which the government turned the hotel in a public corporation. The tribunal found that the claimant had a legitimate expectation that the government would not interfere with the contractual relationship, and that the agreements would be honoured.

### D *Full Protection and Security*

Investment treaties also specify the requirement that investments of nationals of either contracting party shall enjoy *'full protection and security'* in the territory of the other contracting party. This standard is typically concerned with failures by the State to protect the investor's property from actual damage by State officials or the actions of third parties where the State has failed to exercise due diligence. The scope of the standard extends beyond physical protection, and includes legal protection.[45]

Tribunals have generally found that the obligation involves exercising due diligence and taking reasonable measures for protection of the investment,[46] rather than a guarantee of constant and complete security.[47]

An example in a construction context is the decision in *Cengiz v Libya*, where the claimant had entered into several contracts with a State-owned entity for the construction of infrastructure projects, and the construction sites were subsequently destroyed during the civil war in Libya. The tribunal found that the destruction arose from the government's acts and omissions.[48]

### E *Non-Discrimination*

Investment treaties also provide protection against interference by the host State with performance of a contract by unfair or discriminatory action. This is to ensure that foreign investors are subject to the same conditions in the host State as both domestic entities and other foreign investors. With respect to the former, the investor has a right to receive the same treatment as domestic investors (*'national'* treatment), and with respect to the latter, the investor has a right to receive the same treatment as foreign investors from other states, even where the host state has agreed more favourable treatment under different treaties (*'Most favoured nations'* treatment).

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[44] *Alpha Projektholding v Ukraine* (ICSID Case No ARB/07/16).
[45] *Azurix v Argentina* (ICSID Case No ARB/01/12), *Siemens v Argentina* (ICSID Case No ARB/02/8); *AES v Hungary* (ICSID Case No ARB/07/22).
[46] *Wena Hotels v Egypt* (ICSID Case No ARB/98/4).
[47] *Lesi v Algeria* (ICSID Case No ARB/05/3).
[48] https://investmentpolicy.unctad.org/investment-dispute-settlement/cases/776/cengiz-v-libya

F *Observance of Obligations*

An investor's claims against a State for breaches of contract are not subject to the jurisdiction of tribunals under investment treaties, or under the ICSID Convention, and are subject to the forum selection in the contract. However, tribunals have jurisdiction over an investor's claims for breaches of a treaty which arise from the investment. As the tribunal observed in *Bayindir v. Pakistan*,[49] the fact that a State may exercise a contractual right or remedy does not of itself exclude the possibility of a treaty breach, because treaty claims are juridically distinct from claims for breach of contract, even where they arise out of the same facts. Therefore, where an investor has a right under both the underlying contract and a treaty, the investor has a self-standing right to pursue the remedy accorded by the treaty.[50]

The issue of an investor's parallel contractual and treaty claims has given rise to controversy on interpretation of provisions in BITs commonly referred to as *'umbrella clauses'* or *'elevator clauses'*. Such provisions create a reciprocal international obligation owed by the contracting States to each other that require them, as host States, to observe obligations they have entered into with regard to investments of investors of nationals of the other contracting party.

The general principle under international law is that a breach of contract *per se* by the State does not give rise to direct international responsibility, and tribunals have been sharply divided on whether an umbrella clause has the effect of elevating a contractual breach to a breach of the treaty. The two ICSID cases which first considered this issue both involved the same claimant, SGS Societe Generale de Surveillance SA, involving its contracts with States for the provision of import supervision services.

The tribunal in the landmark case of *SGS v Philippines*[51] held that it had jurisdiction over SGS' breach of contract claims *per se* under the umbrella clause, relying on the clear wording of the relevant provision, as follows:

> …if commitments made by the State towards specific investments do involve binding obligations or commitments under the applicable law, it seems entirely consistent with the object and purpose of the BIT [bilateral investment treaty] to hold that they are incorporated and brought within the framework of the BIT by Article X(2).[52]

In a similar case decided five months earlier, *SGS v Pakistan*,[53] concerning SGS' equivalent contract with Pakistan for the provision of import supervision services, the tribunal came to the opposite

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[49] *Bayindir v Pakistan* (ICSID Case No ARB/03/29).
[50] Ibid, [148], [157], and [167].
[51] *SGS v Philippines* (ICSID Case No ARB/02/6)
[52] Ibid, [117]
[53] *SGS v Pakistan* (ICSID Case No ARB/01/13).

conclusion on the issue of elevating claims for breach of contract to treaty claims under the relevant umbrella clause.

In a construction context, two international contractors have been successful in establishing breaches of an umbrella clause arising from a breach of the underlying construction contract. In *Garanti Koza v Turkmenistan,*[54] the claimant entered into a lump construction contract with *Turkmenistan* for the design and construction of 28 highway bridges. In breach of the contract, Turkmenistan imposed on the claimant a progress payment regime involving substantiation of prices on a unit cost basis, and which limited profit and overhead. The tribunal applied the ordinary and natural meaning of the umbrella clause to find that an act of an organ of a State that results in the breach of a contractual obligation *'relating to an investment'* of a national or company of the other State party falls within the scope of the provision.[55]

In *Intersema Bau AG v. Libya*,[56] the tribunal found Libya liable for breach of the umbrella clause in the Libya-Switzerland BIT due to the government's failure to comply with a settlement agreement related to construction contracts for road, water, sewerage and lighting infrastructure.

## V STATE ATTRIBUTION

In order to bring a claim under a BIT, the wrongful conduct giving rise to the loss or damage must be by the host State or attributable to the host State under international law. The laws of State responsibility are the principles governing when and how a State is held responsible for international wrongs. The general principle under international law is that a State is a single persona, and is responsible for all of its organs.

In a construction context, in cases where the State itself is the contracting party, as noted in Section IV(F) above, breaches of the contract may also give rise to breaches of the umbrella clause, if the treaty contains such a provision. In addition, the State's conduct in administering the contract may give rise to other breaches of the treaty, such as the fair and equitable treatment standard, and therefore, State attribution may be established. Similarly, where the State has interfered with an investment by legislative or other measures, State attribution may be established.

However, more complex questions arise when the State acts through a State-owned entity or State-controlled private entity.

[54] *Garanti Koza v Turkmenistan*, (ICSID Case No ARB/11/20).
[55] Ibid, [228]-[330], following the approach in *Eureko v. Poland*.
[56] UNCITRAL Rules, 2010, non-public award, https://investmentpolicy.unctad.org/investment-dispute-settlement/cases/787/intersema-bau-v-libya.

The International Law Commission published in 2001 the *'Articles on Responsibility of States for Internationally Wrongful Acts 2001'* ('AOSR'), which is frequently referred to by tribunals as guidance on the question of State attribution. Articles 4 and 5 of the AOSR set out a structural test and functional test respectively for State attribution. In the former, the question is whether the entity is an organ of the State, as a matter of structure, in the sense of exercising legislative, judicial or executive authority. In the latter, the question is whether the entity, although not an organ of the State, exercises elements of governmental authority. Article 8 is also relevant, which refers to conduct attributable to the State where an entity acts on the instructions of, or under the direction or control, of the State.

For example, in a construction context, in *Salini v Morocco*,[57] the claimant entered into a contract with ADM, a Moroccan private limited company with its own legal personality, for construction of a highway in Morocco. The tribunal, in finding that ADM's conduct was attributable to the government, applied both the structural and functional tests, and concluded that ADM was distinguishable from the State only on account of its legal personality.[58]

## VI CASE STUDY

### A *Introduction*

The author sets out below, as a case study, the relevant facts and findings in the ICSID arbitral tribunal's decision in *Garanti Koza v Turkmenistan*,[59] in which the contractor claimant was partially successful. The decision is illustrative of the problems that can arise for contractors in an unfamiliar host country, construction related claims under a number of provisions of a BIT, including under an umbrella clause, and challenges to jurisdiction, including relying on an MFN clause for consent to ICSID arbitration. The case also demonstrates the significance of particular wording of key provisions of a treaty.

### B *Garanti Koza v Turkmenistan*

#### 1. *Facts*

On 18 March 2008, Garanti Koza LLP ('GK'), a United Kingdom entity, entered into a contract with a Turkmenistan State Concern, Turkmenautoyollari ('Tay'), for the design and construction of 28 highway bridges for the lump sum price of US$100m. The contract provided for GK to complete the works by October 2008, a period of some seven and a half months.

The contract price was US$86,956,521.74, and Value Added Tax of US$13,043,478.26, and provided for monthly progress payments, and an advance payment of 20%, paid against an advance payment guarantee. The 80% balance of the contract price, minus a 5% retention, was then to be paid in

[57] *Salini v Jordan* (ICSID Case No ARB/02/13).
[58] Ibid, [35].
[59] *Garanti Koza v Turkmenistan* (ICSID Case No ARB/11/20).

instalments corresponding to the percentage of the work completed on each bridge, and the bank guarantee reduced in proportion to each payment.

GK commenced work immediately after signing the contract on 18 March 2008 by constructing a precast concrete factory, installation of a concrete plant, importation of construction equipment, and construction of an office and a dormitory for its workers.

GK claimed that there was delay in commencing construction on the bridges due to Tay's delay in handing over the sites, and demolition of the existing bridges. There was also delay in GK furnishing the advance payment guarantee, and GK was paid the advance payment of US$17,391,304, which represented approximately 21% of the bridges by length, on 7 July 2008.

On 30 April 2008, GK claimed its first progress payment for 7.61% of the contract price for a total amount of US$6,615,304,33. TAY rejected the claim, not because GK had not completed the work, or that the claim was not submitted in accordance with the contract, but because the claim was not prepared in accordance with a procedure called *'Smeta'*. Smeta is a method for valuing construction work developed in the Soviet Union, and still in use in some former Soviet republics. The Smeta system requires contractors to certify a detailed forecast of the work to be performed and expenses incurred, being essentially unit-cost or cost-plus pricing. The Smeta system also limits profit margin to 6% plus an additional 8% for administrative expenses. TAY asserted that the Smeta system was standard practice, including for lump sum prices. The effect of the Smeta system was that if there was an amount of work listed to be paid $10, but it could be done for $2, the claim will not be paid.

GK objected to the change in pricing, but revised its first invoice to comply with Smeta, which took some time, the result of which was that GK was required to reduce its first invoice by about 30%, which TAY paid on 17 December 2008.

As at October 2008, a significant portion of the works were incomplete, which GK attributed to late payment of the advance, payment delays caused by the Smeta system, and delays in TAY handing over the sites. By November 2008, 15 bridges in one direction were complete. The parties agreed to extend the date for completion to November 2009.

By December 2008, GK had been paid three invoices for a total of US$8.8m, and between January and April 2009, it submitted five further invoices for a total of US$3.9m, which were unpaid. TAY rejected the invoices because the advance payment guarantee expired in February 2009, and GK asserted that it had no obligation to renew it.

By March 2009, GK had completed 21 bridges in one direction, after which progress slowed, and work was stopped by May 2009. In August 2009, GK submitted a further 5 invoices for a total of US$10.2m,

which remained unpaid. In February 2010, TAY conducted an inventory of GK's pre-cast factory, and GK asserted that TAY had taken over the factory. GK's employees returned to Turkey.

On 22 February 2010, TAY terminated the contract, and on the same day commenced proceedings in the Turkmenistan courts against GK. The court, on 12 March 2010, awarded TAY a US$3m delay penalty, judgment of about US$11.0m, and allowed TAY to enforce the judgment against GK's assets.

2. *Claims and Decision*

In May 2011, GK filed a request for arbitration at ICSID under the United Kingdom and Turkmenistan bilateral investment treaty ('UK-Turkmenistan BIT'), claiming an amount of US$46.1m on the basis that Turkmenistan had breached the treaty in five respects; (a) unlawful expropriation of the investment; (b) failed to treat the investment fairly and equitably; (c) breach of the umbrella clause; (d) unreasonable, unjustified, and arbitrary measures; and (e) breach of its obligation to provide full protection and security of the investment.

The tribunal awarded GK the sum of US$2,529,900 for breaches of the fair and equitable treatment standard, and the umbrella clause.

3. *The Tribunal's Reasoning*

*(a) Jurisdiction*

Turkmenistan challenged both the jurisdiction and merits of GK's claims. Turkmenistan disputed that it had consented to ICSID arbitration under the dispute provisions in Article 8 of the UK-Turkmenistan BIT. The majority of the tribunal interpreted Article 8(1) as the parties agreeing to international arbitration, with Article 8(2) setting out a menu of three options, including ICSID arbitration which the parties *'may agree'* to, with the default option being international arbitration under the UNCITRAL Rules. The tribunal found that Turkmenistan had not agreed to ICSID arbitration. The tribunal then turned to GK's reliance on the most favoured nations ('MFN') clause in Article 3 to import the terms of Turkmenistan's consent to ICSID arbitration with Swiss, French, Turkish, and Indian investors. The tribunal noted that there was an even split between the number of tribunals that have applied the MFN clause of a BIT to vary its dispute resolution provisions, and the number that have declined to do so.[60] However, the tribunal relied on the express reference in Article 3(3) to the MFN applying to *'the provisions of Articles 1 to 11 of this Agreement'*, therefore including the dispute provisions in Article 8, and concluded that Turkmenistan had consented to ICSID arbitration.

Turkmenistan also argued that GK was a façade for its Turkish parent. However, the tribunal found that the definition of *'companies'* in Article 1(d) of the treaty included a limited liability partnership,

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[60] Ibid, [41].

and contains no *'denial-of-benefits'* clause that would require a UK investor to have actual operations in the UK. The tribunal also found that the weight of evidence shows that Turkmenistan knew and accepted that it was dealing with an UK company.[61]

Turkmenistan also disputed that GK had made an *'investment'* in Turkmenistan, both under the UK Turkmenistan BIT, and under Article 25 of the ICSID Convention, arguing that the contract was a simple commercial transaction lacking in risk, duration, or contribution to the host State's development. In concluding that GK had made an investment, the tribunal noted that construction of a highway is more than construction in the traditional sense, relying on the wide definition of *'investment'* in Article 1(a) to mean *'every kind of asset'*, and noted that GK had invested equipment and material resources, and left behind a number of bridges.[62]

With respect to Article 25 of the ICSID Convention, the tribunal declined to apply the *Salini* test, noting that the tribunal had found that GK's investment falls within the scope of the UK-Turkmenistan BIT, and that GK's investment does not exceed what is permissible under the ICSID Convention.[63]

Turkmenistan's final objection to jurisdiction was that GK's claims arise under the contract, rather than the BIT, and should be referred to the Turkmenistan courts. GK relied on the umbrella clause in Article 2(2) of the UK-Turkmenistan BIT. The tribunal found that GK's claim under Article 2(2), pleaded as a breach of an obligation imposed on Turkmenistan to *'observe any obligation it may have entered into with regard to investments of nationals or companies of the other Contracting Party'*, is sufficient to invoke the jurisdiction of the tribunal.[64]

*(b) Merits*

The tribunal commenced its assessment of the merits by assessing GK's claim under the umbrella clause in Article 2(2). The tribunal noted the debate among tribunals about the meaning of umbrella clauses and the extent to which they may elevate breaches of a contract to breaches of a treaty. The tribunal applied the ordinary and natural meaning of the umbrella clause to find that an act of an organ of a State that results in the breach of a contractual obligation *'relating to an investment'* of a national or company of the other State party falls within the scope of the provision.[65]

The tribunal considered Turkmenistan's obligations under the contract, which it noted included payment of the advance payment and progress payments.[66] The tribunal found that Turkmenistan had breached the second of these obligations, which deprived GK of the benefit of the bargain, and

[61] Ibid, [222].
[62] Ibid, [234].
[63] Ibid, [241].
[64] Ibid, [247].
[65] Ibid, [228]-[330], following the approach in *Eureko v. Poland*.
[66] Ibid, [336].

contributed significantly to the delay of the project.[67] The tribunal found that it was not possible for GK to comply with the Smeta system and submit invoices for the agreed lump sum price, and that the only way to do so was to manipulate the figures.[68]

The tribunal then turned to the consequences of TAY failing to comply with the progress payments. The tribunal found that this caused some delay, but that a significant proportion of delay to the project was caused by GK, including its slow start, delayed arrival of the pile driving machine, and delay in procuring steel beams required for two bridges.[69]

With respect to GK's claim for expropriation, this was based on various factors, including the actions of the Turkmen courts, seizure of GK's factory resulting from termination of the contract, and failure to pay invoices. The tribunal found that the evidence did not support a claim for direct expropriation, but rather, showed that the loss of GK's factory etc followed as a matter of normal legal process under Turkmen law from GK's default under the contract.[70] The tribunal noted that seizure of property by a court as a result of normal domestic legal process does not amount to an expropriation under international law unless there is an element of serious and fundamental impropriety about the legal process,[71] and referred to the test in *Impregilo v Argentina*[72]that when a state entity terminates a contract, the decisive factor is whether the reasons given for the termination constituted a legally valid ground for termination according to the provisions of the contract.

The tribunal found that the termination of the contract and the subsequent actions by the Turkmen courts were largely either the result of choices made by GK, including its decision not to seek an extension or renewal of the bank guarantee, or were caused by circumstances within its control.

The tribunal also found that Turkmenistan's insistence on the use of Smeta was too remote to amount to direct expropriation. For the same reasons, the tribunal found that the evidence did not support indirect expropriation.

With respect to GK's claim for breach of the fair and equitable treatment standard, the tribunal noted that tribunals have focused on questions such as *'whether the shock or surprise occasioned to an impartial tribunal leads, on reflection, to justified concerns as to the judicial propriety of the outcome'*,[73] whether there has been *'a willful disregard of due process of law, an act which shocks, or*

[67] Ibid, [346].
[68] Ibid, [349].
[69] Ibid, [357]-[359].
[70] Ibid, [364].
[71] Ibid, [365].
[72] *Impregilo. v. Argentina* (ICSID Case No. ARB/07/17), [278].
[73] Referring to *Mondev v USA*, [127].

*at least surprises, a sense of judicial propriety'*,[74] and whether there has been *'inconsistency of action between two arms of the same government vis-à vis the same investor'*.[75]

The tribunal concluded that Turkmenistan's insistence on applying the Smeta system breached the fair and equitable standard, noting the inconsistency of behaviour between TAY's agreement to the terms of the contract for a lump sum price, and other arms of the government insisting on application of the Smeta system. The tribunal also emphasised that insisting on the Smeta system put GK in the position of either accepting less compensation it bargained for, or manipulating the invoices, and that *'using governmental power to put an investor in such a situation is so fundamentally unfair as to amount by itself to a denial of fair and equitable treatment'*.[76]

The tribunal also noted that it was troubled by the Trukmen court's imposition of a US$3m delay penalty by; (a) the calculation from October 2008 rather than November 2009; (b) the absence of GK from the court proceedings; and (c) the speed with which the proceedings were conducted.[77] However, the tribunal noted that GK had not paid the penalty, and declined to give Turkmenistan a credit for this amount in its calculation of damages.[78]

With respect to GK's claims for denial of full protection and security and discriminatory measures, the tribunal found that these claims added nothing to the claims already considered, and therefore, rejected them.[79]

With respect to the quantum of damages, the tribunal rejected GK's claim for loss of know-how of US$12m, finding that there was no credible basis to assign any value to it.

The tribunal also rejected GK's claim for loss of equipment of amount US$10.3 and loss of the factory of amount US$9.3, finding that GK had not established that these losses resulted from any breach of the treaty, including breaches of the umbrella clause and fair and equitable treatment standard.[80]

With respect to payment for work completed, the tribunal noted that it would have difficulty in resolving the difference between the parties' respective cost experts, and instead, relied on the value of work claimed by GK during progress of the works, of amount US$29,838, 591. The tribunal, taking account

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[74] Referring to *Pope & Talbot. v Canada*, ad hoc, UNCITRAL Arbitration, Interim Award, 100, 26 June 2000, [105]-[118].
[75] Referring to *MTD Equity v Chile* (ICSID Case No. ARB/01/7), [163].
[76] *Garanti Koza v Turkmenistan* (ICSID Case No ARB/11/20), [383].
[77] Ibid, [389].
[78] Ibid. [390].
[79] Ibid, [394].
[80] Ibid, [423]-[424].

of the amount already paid of US$27,308,691, and the amount of the unallocated advance payment, awarded GK the amount US$2,529,900,[81] and interest of 2% from 13 August 2009.

With respect to the parties' claims for costs, the tribunal, taking into account that GK was not successful on all its claims, and the amount of compensation awarded, directed Turkmenistan to pay GK the amount of US$362,500, being reimbursement of one-half of the payments to ICSID on account of registration fees, administration, and the fees and expenses of the arbitrators. However, the tribunal denied GK's application for reimbursement of its legal fees and expenses, and ordered each party to bear its own costs.[82]

## VII CONCLUSION

Of the total of ICSID cases filed to date, 8% of these are in the construction sector.[83] The ability of international principals and contractors to structure their involvement in construction contracts and infrastructure projects in host countries provide them with a degree of protection for political sovereign risk, and also provides a strategic option for negotiating disputes which may arise.

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[81] Ibid, [428]-[431].
[82] Ibid, [452].
[83] ICSID, 'The ICSID Caseload Statistics (Issue 2019-1)', up to 31 December 2018.