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New ICSID Annulment Decision Exposes Possible Gap in United States Investment Treaty Protection

A recent arbitral decision by an annulment panel of the Washington, D.C.-based International Centre for Settlement of Investment Disputes (ICSID) exposes possible shortcomings in the protection afforded to investors under numerous bilateral investment treaties (BITs) and Free Trade Agreements (FTAs) to which the U.S. is party. The decision concerned claims by U.S. investor Sempra Energy International against the Republic of Argentina under the U.S.-Argentine BIT¹ — an investment treaty that since its entry into force in 1994 has been the subject of numerous claims against Argentina. This decision may have broader implications for U.S. investors under other BITs/FTAs.

Background: The “Pesification” Measures of 2000-02

In 1996, Sempra acquired an indirect equity interest in Sodigas Sur and Sodigas Pampera, two Argentine companies that owned a majority stake in two 35-year Argentine gas distribution licenses. Those licenses, granted in 1992 as part of a wide-scale privatization program, provided for calculation of tariffs in U.S. dollars, with periodic inflation adjustments based on the U.S. Producer Price Index (PPI).²

Between 2000 and 2002, in the context of what was then regarded by the Argentine government as a major economic and currency crisis, the Argentine government enacted measures that profoundly affected the value of contracts, licenses and concessions that had dollar adjustment features, such as the Sempra licenses. In particular, the government (1) issued an administrative order in 2000 suspending the right of licensees to adjust their tariffs according to the United States PPI; and (2) enacted a 2002 “Emergency Law” eliminating the right of utilities licensees to calculate tariffs in U.S. dollars, and converting all tariffs to a fixed peso rate — a process known as “pesification.”³ In the face of a sharply devalued Argentine currency, Sempra claimed that these measures violated various provisions of the U.S.-Argentine BIT, including the BIT’s safeguards against “expropriation” and the BIT’s guarantee that investors are entitled to “fair and equitable treatment” by the host state.

The Initial Award

In 2007, an ICSID arbitral tribunal⁴ upheld Sempra’s claims. In their 139-page award, the arbitrators found that Argentina’s measures, while not constituting expropriation, nevertheless violated Article II(2)(a) of the BIT (guaranteeing against unfair or

1 Treaty between the United States of America and the Argentine Republic Concerning the Reciprocal Encouragement and Protection of Investment, Nov. 14, 1991.

2 *Sempra Energy Int’l v. Argentina*, No. ARB/02/016, Award ¶ 185 (ICSID Sept. 28, 2007) (*Sempra I*).

3 *Id.* ¶¶ 93, 100-03, 116.

4 The *Sempra I* tribunal comprised: Professor Francisco Orrego Vicuna (Chile), Marc Lalonde, Q.C. (Canada) and Dr. Sandro Morelli Rico (Colombia).

inequitable treatment) and Article II(2)(c) of the BIT (an “umbrella” clause providing that states shall not violate “obligations” previously assumed by them with respect to investments).⁵

In reaching these conclusions, the arbitrators considered, but expressly rejected, Argentina’s plea that the “pesification” measures were necessary in light of the crisis arising from the economic pressures facing Argentina in 2000-02. Based on this plea of “necessity,” Argentina asserted that Sempra’s treaty claims were precluded by Article XI of the BIT, which provides:

This Treaty shall not preclude the application by either Party of measures necessary for the maintenance of public order, the fulfillment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests.

However, the arbitral tribunal held that Article XI should be interpreted in a manner consistent with general international law, which narrowly defined the grounds upon which a state could plead “necessity” as a basis for excusing performance with its legal obligations.⁶ Applying those grounds, which it developed from established sources of international law, it rejected the notion that a state of “necessity” under Article XI of the BIT existed in Argentina sufficient to excuse the violations of investor rights caused by the pesification measures. Specifically, the tribunal held that (1) the economic “crisis” of 2000-02, while “severe,” was not one that “compromised the very existence of the state and its independence”; (2) the “pesification” measures were not “the only [option] available” to Argentina; (3) the measures “seriously impaired” the interests of investors whose rights were protected by the BIT; and (4) Argentina had, by its own actions, “substantially contributed” to the situation of alleged “necessity.”⁷ Thus Argentina could not rely on Article XI of the BIT to escape liability because it had failed to satisfy recognized international law criteria for establishing that a state of “necessity” excused its conduct.

The arbitrators also rejected Argentina’s argument that Article XI was satisfied as long as Argentina itself considered the relevant measures to be “necessary.” To construe Article XI as “self-judging,” they held, would “definitely be inconsistent with the object and purpose of the BIT” and would “deprive[]” the BIT “of any substantive meaning.”⁸

Having rejected Argentina’s arguments under Article XI of the BIT, the arbitrators awarded Sempra the sum of \$128,250,462 as compensation for Argentina’s BIT violations.⁹ Argentina then exercised its right under Article 52 of the ICSID Convention to seek “annulment” of the tribunal’s award.¹⁰

5 *Sempra I* ¶¶ 286, 304, 314. This holding is similar to the rulings in numerous other ICSID arbitrations brought against Argentina under the U.S.-Argentina BIT and other BITs.

6 *Id.* ¶ 375 (citing Article 25 of the International Law Commission Articles on State Responsibility on the basis that they were declarative of general international law).

7 *Id.* ¶¶ 348-53, 388.

8 *Id.* ¶ 374.

9 *Id.* at 139.

10 “Annulment” is a form of limited review by which an “ad hoc committee” of arbitrators chosen by ICSID determines whether the arbitral tribunal’s award contains certain fundamental legal defects, e.g., “manifest excess of powers” or “failure to give reasons.”

The Annulment Decision

In a decision issued on June 29, 2010, an *ad hoc* ICSID annulment committee¹¹ annulled the arbitrators' award in its entirety at Argentina's request. The annulment committee held that the arbitrators' analysis of the "necessity" defense had led to annulable error. Specifically, the annulment committee held that the arbitrators had erred in interpreting Article XI's "necessity" provision as being subject to the same stringent criteria prescribed by general international law for determining whether a state measure was justified by "necessity."¹² Rather, the committee held, Article XI created treaty-based, stand-alone criteria different from — and potentially broader than — the general international law criteria of "necessity." Thus, because the arbitrators had treated Article XI as being informed or defined by general international law on the meaning of "necessity," they had failed to apply the required treaty standard and thereby "manifest[ly] exce[ded]" their powers. Their award, therefore, was annulled.¹³

As may be of interest to U.S. investors generally, the annulment committee's decision highlights two fundamental issues:

1. The risk that U.S. BITs and FTAs from the 1980s and 1990s, such as the U.S.-Argentina BIT, give host states some leeway to abridge investors' rights by claiming "necessity" or "economic crisis," even where the crisis is one that the local government played a role in creating. The *Sempra* annulment committee's decision, while not definitively ruling on the issue, may leave open the possibility that the U.S. BIT's "necessity" exclusion is broader than ordinarily permitted by recognized principles of international law on the issue of "necessity."
2. The risk that the "necessity" defense in U.S. BITs or FTAs is "self-judging," thus permitting host states to evade liability for expropriation or unfair measures merely by declaring that the measures were "necessitated" by national security or "economic crisis" conditions. Under the most "pro-state" view of a "self-judging" clause, a government may be able to evade liability for a BIT violation simply by declaring that its measures were the product of "necessity," without any third party or arbitral tribunal being able to review that claim.

These issues are particularly acute in light of the most recent U.S. BIT and FTA texts that increasingly show a tendency to expand the "necessity" defense and to accommodate the interests of host states. For example, Article 22.2 of the 2006 U.S.-Peru Free Trade Agreement provides that "nothing" in the FTA (including its investment protections) shall be "construed":

to preclude a Party from applying measures that it considers necessary for the fulfillment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests.

¹¹ *Sempra Energy Int'l v. Argentina*, No. ARB/02/16 (ICSID *ad hoc* annulment committee June 29, 2010) (*Sempra II*). The annulment committee comprised Christer Söderland (Sweden), David Edward (U.K.) and Ambassador Andreas Jacovides (Cyprus).

¹² *Id.* ¶¶ 196-203.

¹³ *Id.* ¶¶ 206-10; see also *id.* ¶¶ 211-19.

Article 22.2 is accompanied by a special note stating that:

For greater certainty, if a Party invokes Article 22.2 [the “essential security” defense] in an arbitral proceeding initiated under Chapter Ten (Investment) or Chapter Twenty-One (Dispute Settlement), the tribunal or panel hearing the matter shall find that the exception applies.

If this clarifying “note” results in the U.S.-Peru FTA’s “essential security” provisions being “self-judging,” it may potentially undermine the treaty’s investment protections.¹⁴

Given this trend in the drafting of U.S. BITs and FTAs, investors who have historically relied on U.S. investment treaties for robust protection of their foreign investments may wish to consider whether that expected level of treaty protection still holds. It may be necessary, after such a review, to repatriate or re-channel investments to bring them within the coverage of other countries’ BITs that do not contain the same potentially broad or self-judging “necessity” or “essential security” exclusion. Any such restructuring would have to take into account a range of tax and other regulatory considerations. However, the practice of corporate restructuring to maximize BIT protection, when done prior to any investment dispute, was recently characterized by an ICSID tribunal as “perfectly legitimate.”¹⁵

14 Thus far, according to one commentator, self-judging language appears “in only a small number” of U.S. BITs and FTAs. Kenneth Vandervelde, *Bilateral Investment Treaties: Practice, Policy & Interpretation* at 180 (2010). Even in those cases, it has been argued that “the invocation of the self-judging exception should be subject to an obligation of good faith.” *Id.*

15 *Mobil Corp. v. Venezuela*, Decision on Jurisdiction ¶ 190 (ICSID June 10, 2010) (observing that “the main, if not the sole purpose of [a corporate] restructuring was to protect Mobil investments from adverse Venezuelan measures in getting access to ICSID arbitration through the Dutch-Venezuela BIT” and adding that “that this was a perfectly legitimate goal as far as it concerned future disputes”).