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**THE “UMBRELLA CLAUSE” IN BILATERAL  
INVESTMENT TREATIES – NO END TO THE RAIN?**

LLM RESEARCH PAPER  
INTERNATIONAL ARBITRATION (LAWS 521)

LAW FACULTY  
VICTORIA UNIVERSITY OF WELLINGTON

2008



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The so-called umbrella clause in bilateral investment agreements between states is one of the most controversial standards of protection in international investment arbitration. This paper will discuss three issues arising with regards to the interpretation and the scope of the clause. The most relevant case law on the topic will be presented and analysed, as well as early developments of the clause.

One issue debated intensely is whether the umbrella clause allows foreign investor to bring purely contractual claims before an arbitral tribunal established under ICSID. It is argued in the paper that this is only possible if the alleged state act violating the contractual agreement involves sovereign state behaviour.

Furthermore, the problem of competing jurisdiction that arises when a contractual dispute mechanism provides for the jurisdiction of domestic courts or domestic arbitration, but at the same time an ICSID tribunal is conferred jurisdiction by virtue of an umbrella clause is discussed. It is argued in the paper that the contractual jurisdiction clause should be given priority unless there is a case of denial of enforcement of the domestic award or a change in legislation that targets the foreign investment.

Finally, the effect of the umbrella clause on locally incorporated subsidiaries of a foreign investor is analysed. The umbrella clause can only apply if Article 25(2)(b) of the ICSID convention is not deprived of any meaning or if the locally incorporated subsidiary may be considered as an "investment" of the foreign investor.

**The text of this paper (excluding abstract, contents, footnotes and bibliography) comprises approximately 15 008 words.**



## *I INTRODUCTION*

One of the most controversial standards of investment protection in bilateral investment treaties are the so-called “umbrella clauses”, which are to be found in nearly every investment treaty and appear in many variations. The clause appeared first in the 1959 Germany-Pakistan BIT<sup>1</sup> and has become a regular feature in bilateral investment treaties. Umbrella clauses create the obligation for host states to observe their contractual obligations with the foreign investor at all times, and in case of a breach of obligation they provide the medium through which investors may invoke proceedings by an arbitral tribunal established under the ICSID convention. Thus they represent a very important tool for the protection of foreign investments. Yet with respect to their usually very general wording, they open up the possibility of a very broad interpretative spectrum, which in turn entails a range of issues and questions that have sparked heated debates amongst scholars and arbitrators alike. Their significance, their scope of application and their effect on disputes arising out of investor-state contracts are in the obscure.

Until recently, umbrella clauses did not receive a lot of attention in the field of investor-state arbitration, but in the past few years the number of cases concerned with the issues surrounding the interpretation and the application of the clause has grown considerably. A number of open questions have been identified, and efforts to find an answer have been made. Yet the disputes are characterized by a high level of inconsistency regarding the outcome of the decisions and awards, the results of interpretation and the level of argumentation by the respective tribunals differs significantly. The outcome of the respective interpretations affects primarily the law applicable to a contractual dispute (national or international) and the question of jurisdiction of either an ICSID tribunal or a domestic court or arbitral tribunal.

This paper will deal with the question of the effect of such clauses on the jurisdiction of tribunals established under the ICSID-convention regarding claims arising

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<sup>1</sup> Katia Yannaca-Small “Interpretation of the Umbrella Clause in Investment Agreements” (2006) Organisation for Economic Co-Operation and Development Working Papers on International Investment, [www.oecd.org](http://www.oecd.org) (last accessed 14.09.2008).



out of investment contracts. Furthermore, the problem of whether umbrella clauses in consequence invalidate forum selection clauses in investment contracts will be subject of discussion. Finally, it will be discussed if a foreign investor's locally incorporated subsidiary is included by the protective umbrella as a third party.

## II THE EFFECT OF "UMBRELLA CLAUSES": A SOURCE OF DISPUTES

### A The Function and Purpose of Umbrella Clauses in BITs

#### 1 The many-named monster

In principle, umbrella clauses define the scope of disputes that fall under the protection, the "umbrella", of a bilateral investment treaty. The umbrella clause in the Germany-China BIT for example encompasses disputes regarding "investments in [the other Contracting Party's] territory by investors of the other Contracting Party."<sup>2</sup> BIT practice regarding the design of such clauses is not consistent and thus the scope of protection varies. The Belgium-China BIT, for example, does not include a reference to "investments" of the other party but merely refers to "any obligations".<sup>3</sup> Such clauses are often included in treaties in order to protect foreign investments and contractual rights by making the state internationally responsible for either a breach of contract or any unilateral act that might deprive the investor of his or her rights.<sup>4</sup> For this reason, the umbrella clause is also known as "observance obligation clause", "*pacta sunt servanda* clause" or "sanctity of contract clause".

#### 2 Outlining the problem

It was not until two tribunals in 2004 had to deal with the same clause and rendered completely opposed awards within half a year that the umbrella clause received any significant attention in the field of investor-state arbitration.<sup>5</sup> Both tribunals were

<sup>2</sup> [www.unctadxi.org](http://www.unctadxi.org) (last accessed 15 July 2008).

<sup>3</sup> Ibid.

<sup>4</sup> Christoph Schreuer "Travelling the BIT Route – Of Waiting Periods, Umbrella Clauses and Forks in the Road" (2004) 5 J.W.I.T. 231, 250; Bjorn Kunoy "Singing in the Rain – Developments in the Interpretation of Umbrella Clauses" (2006) 7 J.W.I.T. 275, 276.

<sup>5</sup> *SGS v Pakistan* (SGS Société Générale de Surveillance v. Islamic Republic of Pakistan (Decision on



faced with the question of whether a breach of the investment contract, governed by the host State's law, would, by virtue of the umbrella clause, be transformed into a breach of the investment treaty and thus of international law.<sup>6</sup> This is the problem at the core of all questions relating to umbrella clauses, and due to the many variations of the clause in existing BITs it seems near impossible to find a standardized solution. It is not to be confused with the principle that an ICSID tribunal has jurisdiction over treaty claims, even if they arise out of an underlying investment contract.<sup>7</sup> The consequences of answering this question in the affirmative is that an ICSID tribunal established under the respective BIT not only has jurisdiction over the dispute, but would also be able to apply international law to the formerly purely contractual dispute.<sup>8</sup> But does that also mean that the very nature of the claim is changed by virtue of an umbrella clause from contractual to international? This has been contended by Tribunals and scholars alike,<sup>9</sup> and this is where the interests of foreign investors and States clash, as investors usually prefer ICSID arbitration over the host State's domestic courts as the more (politically) neutral and efficient dispute resolution forum. Furthermore, in most cases it would be easier for the foreign investor to prove the violation of a contractual obligation than the violation of a substantive treaty standard,<sup>10</sup> which is why a broad interpretation of the respective umbrella clause would bring arbitration under ICSID within reach more easily. Does the inclusion of an umbrella clause in a BIT thus have the effect of altering the choice of law made by the parties in favour of the application of international law? Attached to the question of whether umbrella clauses transform contractual obligations governed by

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*Objections to Jurisdiction*)) (2004) 8 ICSID Reports 352; *SGS v Philippines* (*SGS Société Générale de Surveillance v. Republic of the Philippines - on Objections to Jurisdiction*) (2004) 8 ICSID Reports 515.

<sup>6</sup> McLachlan/Shore/Weiniger *International Investment Arbitration: substantive principles* (Oxford University Press, Oxford, 2007), 4.97.

<sup>7</sup> Stanimir A. Alexandrov "Breaches of Contract and Breaches of Treaty – *The Jurisdiction of Treaty-based Arbitration Tribunals to Decide Breach of Contract Claims in SGS v. Pakistan and SGS v. Philippines*" (2004) 4 W.I.T. 555, 559.

<sup>8</sup> Unless the parties had explicitly agreed on the application of the host State's law to the dispute, which would not allow a tribunal to apply international law.

<sup>9</sup> *CMS (CMS Gas Transmission Company v the Argentine Republic (Decision on Annulment))* (2007) 19 World Trade and Arbitration Materials 227, 95(c); August Reinisch "Umbrella Clauses" (2006 Seminar on Investment Protection, Vienna, 12 September 2006), 14.

<sup>10</sup> Ethan G. Shenkman/Jason File *Recent Developments in Investment Treaty Jurisprudence: Arbitrating Contract Claims Under Umbrella Clauses* The International Comparative Legal Guide to: International Arbitration (Global Legal Group Ltd., London, 2007), 7.



domestic law into treaty-based claims is the issue of whether choice of forum clauses in favour of domestic courts, expressly agreed to by the parties, can be disregarded in view of the existence of an umbrella clause, activating the treaty remedies. In the event of the clash of jurisdiction of a treaty-based tribunal and domestic remedies, does the existence of an umbrella clause cause the domestic jurisdiction to be overridden by the jurisdiction of the treaty-based tribunal? Another field of scholarly dispute is the question of whether investment contracts with third parties, such as locally incorporated subsidiaries or state-owned entities, are covered by the protection of umbrella clauses. The uncertainties surrounding umbrella clauses in BITs are thus numerous on all levels. It is not clear what sort of protection these clauses contain specifically in the case of acts that simultaneously violate the investment contract as well as the treaty. Do they provide an additional protection for the investor with regard to ICSID access or merely a restatement of the state's obligation to comply with the BIT? Their effect on investment contracts with regard to claims, contractual jurisdiction clauses and parties to the contract is entirely uncertain. If one argues that they only confer jurisdiction on ICSID tribunals if treaty standards are violated, it becomes quite difficult to see how any freestanding effect may be attributed to such clauses at all, as the violation of a treaty standard is sufficient to invoke the jurisdiction of a treaty-based tribunal. The task that tribunals are faced with when it comes to the application of an umbrella clause is therefore to interpret it in a way that does not deprive contractual choices of law and contractual remedies of any meaning while applying it as an independent treaty standard.

## **B Contractual Claims "elevated" to an International Level?**

### *1 The SGS-decisions*

The decisions in *SGS v Pakistan* and *SGS v Philippines* have sparked a heated academic debate, as these tribunals were the first to discuss the interpretation of umbrella clauses and their effect on contractual obligations in some depth. In addition, the two tribunals dealt with a very similar clause and set of facts but reached totally opposed conclusions.



(a) *SGS v Pakistan*

In this case SGS, the dispute concerned a concession contract between the Swiss company SGS and Pakistan. SGS first sued in Swiss courts. As the contract provided local arbitration Pakistan subsequently initiated commercial arbitration before a Pakistani tribunal. While these proceedings were still pending, SGS brought the claim before an ICSID tribunal under the Swiss-Pakistani BIT. SGS alleged both a breach of the concession contract and a breach of the investment treaty, grounding the jurisdiction over the contract claims on Article 11 of the BIT which stated "Either contracting Party shall constantly guarantee the observance of commitments it has entered into with respect of the other Contracting Party". The Tribunal examined the clause in the light of the ordinary meaning and the object and purpose of the treaty, concluding that it didn't have the effect of transforming contract violations into treaty breaches.<sup>11</sup> The Tribunal argued that the contracting parties could not have intended to give the clause the expansive scope attributed to it by SGS, and that the wording of the clause must be more explicit in order to allow such an assumption.<sup>12</sup> Furthermore, the Tribunal thought that a broad interpretation would invalidate all other substantive provisions in the BIT if simple contract breaches sufficed to bring a claim before ICSID.<sup>13</sup>

(b) *SGS v Philippines*

In principle, the facts of this case are similar to *SGS v Pakistan*. SGS tried to invoke breach of contract, as well as breach of treaty claims, referring to Article X (2), the umbrella clause, in the Swiss-Philippines BIT. Here too the concession contract between SGS and the Philippines contained a forum selection clause providing jurisdiction for Philippine courts. The tribunal found that the object and purpose of the BIT required an interpretation which gave it the most effect, and with this approach interpreted the umbrella clause in a way favourable to foreign investments and investors.<sup>14</sup> Thus it concluded that the umbrella clause turned a breach of a contractual obligation on part of the State into a breach of the investment treaty, but it took care to

<sup>11</sup> *SGS v Pakistan* (*SGS Société Générale de Surveillance v. Islamic Republic of Pakistan*), above n 5, 165.

<sup>12</sup> *Ibid*, para 170.

<sup>13</sup> *Ibid*, para 168.

<sup>14</sup> *SGS v Philippines* (*SGS Société Générale de Surveillance v. Republic of the Philippines - on Objections to Jurisdiction*), above n 4, 116, 117.



stress that the contractual obligation in itself was still governed by domestic law.<sup>15</sup> Regarding the exclusive jurisdiction clause, the Tribunal concluded that it was not overridden by the BIT,<sup>16</sup> and this could not be the case in general.<sup>17</sup> The Tribunal made an exception to this rule in the case of extreme contractual breaches.<sup>18</sup>

## 2 *The aftermath of the SGS-decisions*

The diametrically opposed approaches of the two tribunals mirror the divide amongst awards of ICSID tribunals and experts in the field of investment treaty arbitration faced with these issues. In the wake of the *SGS*-decisions ICSID tribunals tend to concur with either of the two awards. There is a strong tendency in favour of the interpretation of the umbrella clause expressed in *SGS v Philippines*. With regard to the overall purpose of providing a certain standard of protection to foreign investors providing them to reach a neutral forum to settle investment disputes it would be a step backwards to restrict the accessibility of ICSID tribunals in a way *SGS v Pakistan* does.<sup>19</sup> However, where investment contracts contain an explicit forum selection clause and the breach of contract does not violate substantive standards of the BIT, it seems justified to hold the investor to the terms of the contract in order to comply with his part of the agreement, and in this case the protection of the host state's court or arbitration system should be sufficient.<sup>20</sup> In order to solve this dilemma, first and foremost the respective clause in the treaty and the parties' intentions need to be examined carefully since maybe the parties have explicitly agreed on the effect of an umbrella clause. Unfortunately, such crystal clarity is a rare phenomenon in the field of investment arbitration, so tribunals will have to recur upon the means of treaty interpretation provided by international law, that is the textual interpretation of treaty provisions, taking into account object and purpose of a

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<sup>15</sup> Ibid, para 128.

<sup>16</sup> Ibid, para 143.

<sup>17</sup> Ibid, para 153.

<sup>18</sup> Ibid, para 154.

<sup>19</sup> See also Thomas Waelde "The 'Umbrella' Clause in Investment Arbitration – A Comment on Original Intentions and Recent Cases" (2005) 6 J.W.I.T. 183, 190.

<sup>20</sup> McLachlan/Shore/Weiniger *International Investment Arbitration: substantive principles*, above n 6, 4.112.



treaty.<sup>21</sup> In recent case law there have been attempts to approach umbrella clauses from a different angle. These shall be discussed in the following.

### 3 Only certain contracts covered?

One approach to the question of whether contract claims fall within the protective umbrella is to ask whether the State is involved either in the contract itself or the breach of contract as a sovereign.<sup>22</sup> If a state acts as a sovereign, making use of its administrative and executive power, this may trigger responsibilities on an international level. The idea to limit the application of the clause to cases where there is an "interference" of the state as a sovereign is a result of the need for an investor's protection against such state behaviour, as opposed to acts of the state as "*fisc*" where domestic law systems and remedies provide sufficient protection.<sup>23</sup> A similar mechanism is already in practice in the field of EU jurisdiction, where protective provisions of the EC Treaty are not applied if a member state's conduct equals that of an investor on the common market, so-called "market investor test".<sup>24</sup> The idea of the clause targeting sovereign state conduct runs like a red thread through the history of the emergence of umbrella clauses and shall briefly be described. For this reason, the original purpose of the clause needs to be distilled and adapted to the circumstances prevailing in investment treaty arbitration.

#### (a) Historical background to the emergence of early observance of obligation clauses

##### (i) The *Lena Goldfields* arbitration<sup>25</sup>

The *Lena Goldfields* arbitration proceedings were conducted in 1930 and the case deserves to be mentioned in connection with the question of to what matters of a contractual relationship between a state and a foreign investor principles of international

<sup>21</sup> See also Christoph Schreuer "Travelling the BIT Route – Of Waiting Periods, Umbrella Clauses and Forks in the Road," above n 4, 256.

<sup>22</sup> Thomas Waelde "The 'Umbrella' Clause in Investment Arbitration – A Comment on Original Intentions and Recent Cases" above n 19, 196.

<sup>23</sup> Ibid, 197.

<sup>24</sup> Gabriela v. Wallenberg in Eberhard Grabitz/ Meinhard Hilf (eds) "Das Recht der Europäischen Union" (loose leaf, C.H.Beck, Muenchen) Article 87 ECT, para 32 (last updated September 2004).

<sup>25</sup> For the full text of the award see Arthur Nussbaum "The Arbitration between the Lena Goldfields, LTD. and the Soviet Government" 36 Cornell LQ 31, 42.



law may be applied. The case is as remarkable not only as it is the only arbitration in which the Soviet Union appeared as a party,<sup>26</sup> but also as general principles of law were applied to a private claim, while domestic law was applied to other aspects of the agreement in question.<sup>27</sup>

*Lena Goldfields, Ltd.* received an exploring, mining and transportation concession by the Soviet Government in 1925, while the Soviet Republic was living through the new economic policy-period (NEP), where small private businesses were allowed to operate within the Soviet Union in order to restore the weak Soviet economy. This policy was replaced by the so-called Five Year Plan in 1929, in the course of which the Soviet Government's attitude towards privately owned enterprises changed. Performances were withheld from *Lena* which prevented the company from complying with its obligations under the concession contract. In addition to that, a class war was waged against *Lenas'* employees who eventually resigned completely, and raids were conducted during which important documents on technical details were confiscated. As a result, *Lena* was forced to discontinue its activities in the Soviet Union and withdrew, after having invested a sum of £ 3,500,000 in the concessions. After an arbitration tribunal was established under the provisions of a separate arbitration agreement, the Soviet Union suddenly declared said arbitration agreement as "dissolved" and refused to be represented in the first session of the Tribunal. Nevertheless the proceedings could still be continued as the arbitration clause in the agreement provided for the arbitration to continue in such a situation.<sup>28</sup>

With regards to the claims brought forth by *Lena Goldfield* for unjust enrichment, Dr V.R. Idelson, legal counsel for *Lena* argued that the Tribunal should apply general principles of law such as those recognized by Article 38 of the Statute of the Permanent Court of International justice at The Hague to the claim as "proper law" of the concession agreement.<sup>29</sup> On all the domestic matters and with regard to the performance of the

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<sup>26</sup> Ibid, 31.

<sup>27</sup> V.V. Veeder "The *Lena Goldfields* Arbitration: The Historical Roots of Three Ideas" 47 ICLQ 747, 772.

<sup>28</sup> Arthur Nussbaum "The Arbitration between the *Lena Goldfields, LTD.* and the Soviet Government", above n 66, 33.

<sup>29</sup> Ibid, 50.



contract, the law of the USSR should apply as the proper law of the contract.<sup>30</sup> To support this, it was argued that the 1925 concession agreement was signed amongst other members of the Russian Executive by the Commissary of Foreign affairs, and the fact that the Soviet Union had agreed to foreign private arbitration implied the application of international law.<sup>31</sup> This argumentation was eventually accepted by the Tribunal who thus applied general principles of law to the claim of unjust enrichment. As apparently the Soviet Civil Code did contain appropriate remedies for claims of unjust enrichment, the "splitting" of laws especially along this line has been contended and criticised.<sup>32</sup> In principle, the Tribunal had to deal with the question of what law is applicable to a contract partially removed from domestic law and which law is applicable to determine whether such a contract has been violated by the state as a sovereign. An explanation can be found by taking a closer look at the legal nature of concession agreements under Soviet law, under which a concession agreement is removed to a certain extent from Soviet domestic law by virtue of approval of the Council of People's Commissioners,<sup>33</sup> while at the same time constituting a bilateral agreement between the Soviet Union and the private investor.<sup>34</sup> Because of this mixture of public and private law elements, the concession agreement could not be made to fit either under public or private law, hence the necessity to apply two "proper laws" and the necessity to recur upon general principles of law for want of applicability of the Soviet civil law code.<sup>35</sup> In effect, the Lena Tribunal internationalized part of a transnational contract, thus removing the part containing provisions for the protection of private investors from the grasp of Soviet domestic law, especially as Soviet municipal law in the given circumstances was prone to be altered to the disadvantage of *Lena Goldfield*.

The approach of the *Lena* Tribunal may have paved the way for future Tribunals to remove certain agreements from the domestic law sphere into the international law sphere and thus creating not only state liability under international law but also

<sup>30</sup> Ibid.

<sup>31</sup> V.V. Veeder "The Lena Goldfields Arbitration: The Historical Roots of Three Ideas", above n 28, 766.

<sup>32</sup> Arthur Nussbaum "The Arbitration between the Lena Goldfields, LTD. and the Soviet Government", above n 66, 36.

<sup>33</sup> V.V. Veeder "The Lena Goldfields Arbitration: The Historical Roots of Three Ideas", above n 28, 760.

<sup>34</sup> Ibid, 771.

<sup>35</sup> Ibid.



jurisdiction for Tribunals established outside the scope of national legal systems. Yet it seems that this approach could only be derived and justified from the peculiarities of the Soviet legal system, which allowed for such reasoning, a result which was not contended by the Soviet Government.<sup>36</sup> Although other legal systems did not feature such a distinction, the award was vitally important for the development of international commercial arbitration not only as a freestanding module of dispute settlement,<sup>37</sup> but also for the application of international law to violations of contracts governed by domestic law.

(ii) The nationalization of the Iranian oil industry

The concept of internationalising contract claims arose in the early 1950s when concession contracts between the Anglo-Iranian Oil Company (AIOC) and Iran were threatened by a policy advocating the nationalisation of the Iranian oil sector after a change of government.<sup>38</sup> Since settlement of conflicts arising out of this process under municipal law would not prove to be successful, Sir Elihu Lauterpacht advised AIOC to include a clause in investment agreements that provided for the incorporation of the agreement into a treaty governed by international law,<sup>39</sup> creating the idea of a system of parallel protection. The objective behind this was to protect the agreement from unilateral changes in Iranian domestic law by withdrawing it from the latter, thus “stabilizing” the applicable law,<sup>40</sup> supported by an inter-state remedy in case of a breach of the agreement.

(iii) The Abs-Shawcross draft

A further initiative to provide a greater protection for foreign investment was made by Dr Hermann Abs,<sup>41</sup> who participated in the drafting of the 1959 International Convention for the Mutual Protection of Private Property Rights in Foreign Countries (so-called “Abs-Draft”), later changed in cooperation with Sir Hartley Shawcross into the

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<sup>36</sup> Ibid, 772.

<sup>37</sup> Ibid.

<sup>38</sup> Anthony C. Sinclair “The Origins of the Umbrella Clause in the International Law of Investment Protection” (2004) 20 Arb Int’l 411, 414.

<sup>39</sup> Ibid, 415.

<sup>40</sup> Ibid.

<sup>41</sup> Chairman of the Deutsche Bank and Director of the German Society to Advance the Protection of Foreign Investments.



combined Abs-Shawcross Draft Convention on Investments Abroad. This draft contained the following clause, Article II:

*"Each Party shall at all times ensure the observance of undertakings which it may have given in relation to investments made by nationals of any other Party."*

This may be considered as the earliest version of the clause as no similar attempts had been made in other multinational drafts for the protection of foreign investors.<sup>42</sup> The authors' intention was to protect contractual undertakings between states and foreign investors, which was also the interpretation of commentators at the time.<sup>43</sup> The purpose of Article II was to extend the rule of *pacta sunt servanda* to state contracts, thus bringing concession contracts under the protective umbrella.<sup>44</sup> The Abs-Shawcross draft was never actually implemented, but did have a significant impact as a template for the next attempt to establish a multilateral framework for the protection of investments.

(iv) The OECD Draft Convention<sup>45</sup>

The 1962 OECD Draft Convention on the Protection of Foreign Property included an observance of undertakings provision in Article 2,

*"Each Party shall at all times ensure the observance of undertakings given by it in relation to property of nationals of any other party."*

This provision was meant to have the effect of extending *pacta sunt servanda* to the property of nationals of another party<sup>46</sup>, and the term "undertaking" in relation to

<sup>42</sup> Anthony C. Sinclair "The Origins of the Umbrella Clause in the International Law of Investment Protection" above n 38, 422.

<sup>43</sup> Comment on the Draft Convention by its Authors (1960) 9 J. Pub. L. 119, 120; Georg Schwarzenberger "The Abs-Shawcross Draft Convention on Investments Abroad: A Critical Commentary" (1960) 9 J. Pub. L. 147, 155.

<sup>44</sup> Ignaz Seidl-Hohenveldern "The Abs-Shawcross Convention to Protect Private Foreign Investment: Comments on the Round Table" (1961) 10 J. Pub. L. 100, 104.

<sup>45</sup> Organisation for Economic Co-Operation and Development: Draft Convention on the Protection of Foreign Property, Notes and Comments (1968) 1 Int'l Legal Materials 117, 123.



property referring to a contract or in a concession".<sup>47</sup> A limitation of this protection was envisaged by the drafters of the Convention insofar as there needs to be a certain link between the undertaking and the property concerned, meaning that it is not sufficient that said undertakings incidentally affect the protected property.<sup>48</sup> Intended to serve as a model for member states for the drafting of their own investment treaties, the draft did not gain much support and was never implemented.

(b) Analysis

The historical background of the umbrella clause demonstrates that such clauses were drafted with regard to the protection of investors in an effort to avoid subjecting claims arising out of long-term investment agreements to the jurisdiction of domestic powers and instead to refer them to a system of protection under international law. The protection envisaged a protection of especially contractual claims arising out of concession contracts. Against the backdrop of the nationalization process of the Iranian oil industry, a period of time marked by instable governments and governmental conduct, a means to implement a certain amount of stability and predictability was needed. The type of state behaviour feared most in such long-term agreements were changes in domestic law unilaterally affecting such contracts and, ultimately, resulting in direct or indirect expropriation.<sup>49</sup> The OECD Draft Convention pursues similar intentions, interestingly, the commentary connects a failure to observe undertakings with a failure to observe a party's constitutional law.<sup>50</sup> Although there is no explicit distinction between purely commercial contract disputes as opposed to dispute involving sovereign state behaviour, the draft focuses, as noted, sovereign state behaviour, considering the "giving of an undertaking" as a sovereign act and the breach of a right arising out of such an undertaking as a breach of international law.<sup>51</sup> In conclusion, the drafters of early

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<sup>47</sup> Ibid.

<sup>48</sup> Ibid, 124.

<sup>49</sup> Anthony C. Sinclair "The Origins of the Umbrella Clause in the International Law of Investment Protection" above n 38, 416; Thomas Waelde "The "Umbrella" Clause in Investment Arbitration – A Comment on Original Intentions and Recent Cases" above n 19, 201.

<sup>50</sup> Organisation for Economic Co-Operation and Development: Draft Convention on the Protection of Foreign Property, Notes and Comments, above n 45, 123.

<sup>51</sup> Ibid, 123.



umbrella clauses envisaged a system to stabilize long-term contracts and to provide investors with an international dispute remedy in order to establish effective justice.

In the face of a significant change in the context of investment treaty arbitration since 1960, it is questionable if such an interpretation of the clause is still tenable. With the dramatic rise of BITs during the 1990's,<sup>52</sup> investor-state arbitration directly initiated by the foreign investor as opposed to state-initiated arbitration became frequent practice, giving investors an effective procedural tool for claiming the violation of their rights.<sup>53</sup> This explains states' interest to interpret the provisions of such treaties as narrowly as possible. Another aspect is that the wording of the clause has not changed significantly over the course of time, and an instrument that was formerly thought to protect long-term concession contracts now is included in the protection of treaties which operate with a notion of "investment" that is much wider in scope.<sup>54</sup> The early drafters of the clause possibly did not foresee the rapid development in BIT practice and the consequences for the applicability of the umbrella clause. In this regard, it is to be doubted that the early drafters of the clause intended it to have an extensive effect of covering all breaches of contract, regardless of whether the acts of the state are purely fiscal or involve a sovereign element.

(c) Parallel structures in stabilization clauses?

Stabilization or "freezing" clauses are included in investment agreements in order to prevent the host state from making subsequent changes in municipal law that negatively affect such agreements.<sup>55</sup> Stabilization clauses are used primarily in contracts of long duration, typically concession agreements between states and foreign investors.<sup>56</sup> Such provisions are often included in contracts in order to protect them from unilateral acts of the state, such as changes in policy or law by which a state justifies non-

<sup>52</sup> UNCTAD Analysis of BITs, [www.unctadxi.org](http://www.unctadxi.org) (last accessed 19.08.2008).

<sup>53</sup> Thomas Waelde "The 'Umbrella' Clause in Investment Arbitration – A Comment on Original Intentions and Recent Cases" above n 19, 195.

<sup>54</sup> Ibid, 205.

<sup>55</sup> Thomas Waelde/George Ndi "Stabilizing International Investment Commitments: International Law versus Contract Interpretation" (1996) 31 Tex. Int'l. L. J. 215, 216.

<sup>56</sup> Georges R. Delaume *Transnational Contracts – applicable law and settlement of disputes: a study in conflict avoidance* (Oceana Publications, New York, 1975) 44.



compliance with contractual obligations. In principle, such clauses represent the assurance of the state to the investor not to change domestic law affecting the contract. Stabilization clauses may appear in two slightly different forms. In the first alternative, the clause is designed to incorporate the law as it stands at the time of the constitution of the agreement as the proper law applicable to the contract.<sup>57</sup> The second alternative contains a guarantee to the investor that legislation drafted subsequently to the contract will not be applied to the agreement.<sup>58</sup> As it is simply not sustainable to create a *status quo* which prevents the state from making reasonable adjustments to an agreement with a foreign investor, especially in a long term relationship which needs to weather the rapid, significant changes of (world) economy, the scope of the stabilising effect may be limited to certain areas only.<sup>59</sup> For example, only the regulation of tariffs or exchange rates may be subjected to stabilisation,<sup>60</sup> while other matters, such as politically charged or sensitive issues of law, may be excluded. Thus, certain areas of special relevance to the investment may be secured, but other areas of law remain subject to changes in the host states law, and, consequently, so does the investment contract. Umbrella clauses have often been likened to stabilization clauses as being their equivalent on an international level, only without the “freezing” function.<sup>61</sup> This is convincing as both types of provisions seek to ensure that a state complies with its contractual commitments and does not alter its laws so as to impede the investor’s contractual performance. In their basic intention to create a stable legal framework for the investor to operate in and to prevent states from “legally” ignoring their obligations under an investment agreement, stabilization clauses are very similar to observance of obligations clauses in investment treaties. Yet stabilization clauses are fraught with two basic problems, which tend to make them appear somewhat clumsy in their attempt to shield investments from changes in domestic law affecting them. Their intended function to “freeze” the law at the time of the investment seems rather artificial, and furthermore is quite a strong intrusion into the host state’s

<sup>57</sup> Ibid, 45.

<sup>58</sup> Ibid.

<sup>59</sup> Ibid, 47.

<sup>60</sup> Compare *CMS (CMS Gas Transmission Company v the Argentine Republic(Award))*, above n 9, para 61 for an example of such a specific “freezing” effect.

<sup>61</sup> Thomas Waelde/George Ndi “Stabilizing International Investment Commitments: International Law versus Contract Interpretation” (1996), above n 55, 216; McLachlan/Shore/Weiniger *International Investment Arbitration: substantive principles*, above n 6, 4.114.



sovereignty, which is why the clause in this form is no longer very popular in investment agreements.<sup>62</sup> Furthermore, even if stabilization clauses prohibit the host state to change the law regarding the contract, domestic law is applicable and the State is not restrained from altering the clause itself, which basically neutralizes the effect of the clause.<sup>63</sup> And, as mentioned, it is simply unrealistic and unprofitable for both the state and the investor to create such an inflexible system of proper law that is not compatible with current economic developments. Umbrella clauses don't freeze the law so as to create "rigid" proper law. They do have the same intention though to create a certain stability and predictability regarding the legal framework under which an investment contract must operate, which is expressed in the requirement of states to observe their obligations, and in effect not to behave in a way that negatively affects the contractual agreement. As part of a treaty subject to international law, the clause is withdrawn from the grasp of the host state, so one could say that they fulfill the function of stabilization clauses on an international level. The idea that only sovereign acts of the host state are covered by umbrella clauses stems from the notion of the parallelism of umbrella clauses and stabilization clauses, the latter only intending to operate in case of sovereign, not commercial acts. Furthermore, only sovereign states can give the guarantee not to alter their laws and thus not to exercise their most primordial function.

An interesting approach towards the relation of stabilization clauses in contracts and umbrella clauses in treaties was developed by the Tribunal in the case of *El Paso*,<sup>64</sup> which will be discussed below in more detail. The Tribunal rejected the applicability of an umbrella clause to contract claims unless the investment contract included additional protection that can only be granted by the state as a sovereign.<sup>65</sup> Such additional protection is granted through a stabilization clause included in the contract. The effect of a stabilization clause in combination with an umbrella clause is described by the Tribunal in the *CMS* award, where the investment contract contained two stabilization clauses.

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<sup>62</sup> Thomas Waelde/George Ndi "Stabilizing International Investment Commitments: International Law versus Contract Interpretation" (1996), above n 55, 217.

<sup>63</sup> Ibid, 239.

<sup>64</sup> *El Paso (El Paso Energy International Company v. The Argentine Republic - Decision on Jurisdiction (2006))*, [www.iisd.org](http://www.iisd.org) (last accessed 17 July 2008).

<sup>65</sup> Ibid, 81.



Both contained the obligation not to alter components of the basic legal framework directly affecting the contract, and certain measures adopted by Argentina did alter the said framework to the disadvantage of the foreign investor.<sup>66</sup> With regards to Argentina's "interferences", the Tribunal emphasized the link between the stabilization and the umbrella clause.

To ground the applicability of an umbrella clause to a contract on the existence of a provision in the contract that is granted through sovereign power seems to overstretch the idea that only sovereign acts of the state trigger its protective function. It is a difficult and delicate task for the investor to persuade the respective host State into agreeing to specially designed protective provisions in investment contract such as stabilization clauses.<sup>67</sup> Host states might prove rather reluctant to consent, and especially since the Argentine financial crisis the appearance of stabilization clauses in contracts has declined.<sup>68</sup>

Furthermore, it seems a little odd that an umbrella clause should have the sole function to protect yet another protective provision designed to immunize contracts from subsequent changes in law. It is apparent that clauses falling under domestic law may be preserved through international law in order not to fall victim to changes in the host state's domestic law themselves.<sup>69</sup> But a violation of such a clause will in most cases be a breach of a substantive treaty standard like "fair and equitable treatment" by disregarding the investor's legitimate expectations, so that it is not necessary to recur upon umbrella clauses. For this reason, the requirement of the existence of a contractual protection granted by the state as a sovereign seems to be a bit off the mark in trying to solve the conflicts occurring in connection with umbrella clauses. What needs to be taken into account as well is that stabilization clauses tend to have much lower requirements regarding their violation to the point that less intrusive government behaviour may

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<sup>66</sup> *CMS (CMS Gas Transmission Company v the Argentine Republic (Award))*, above n 66, para 302.

<sup>67</sup> *McLachlan/Shore/Weiniger International Investment Arbitration: substantive principles*, above n 6, 4.115.

<sup>68</sup> Lorenzo Cotula "Regulatory Takings, Stabilization Clauses and Sustainable Development" (2008) OECD Global Forum on International Investment, 7.

<sup>69</sup> *McLachlan/Shore/Weiniger International Investment Arbitration: substantive principles*, above n 6, 4.1142.



already constitute a breach.<sup>70</sup> This would in consequence lower the threshold for the initiation of treaty protection and might thus seriously affect the willingness of states to make further commitments regarding the protection of foreign investors.

What remains to be noted at this point is that the concept of stabilization clauses as well as their function is helpful in understanding the type of protection that umbrella clauses add to the system of investment protection.

(d) ICSID case law

The distinction between commercial and sovereign acts of the state can be found in numerous cases decided by Tribunals established under ICSID.

(i) *Joy Mining v Egypt*<sup>71</sup>

The dispute in Joy Mining concerned an investment contract between Joy Mining Machinery Limited and the General Organization for Industrial and Mining Projects of the Arab Republic of Egypt ("IMC") over a phosphate mining project in Egypt. IMC withheld bank guarantees given by Joy Mining. The Tribunal drew a basic distinction between commercial aspects of a dispute and disputes involving some sort of "state interference".<sup>72</sup> The Tribunal doubted that purely contractual claims would get past the jurisdictional test of treaty-based tribunals, and it rejected its own jurisdiction on the basis that the bank guarantees in dispute were purely commercial aspects of the dispute.<sup>73</sup> Since disputes about the releases of bank guarantees were of a common nature in such contracts, the fact that a state agency was involved did not change the nature of such disputes as purely commercial.<sup>74</sup>

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<sup>70</sup> Lorenzo Cotula "Regulatory Takings, Stabilization Clauses and Sustainable Development", above n 68, 9.

<sup>71</sup> *Joy Mining (Joy Mining Machinery Limited v The Arab Republic of Egypt (Decision on Jurisdiction))* (2004), available at [www.ita.law.uvic.ca](http://www.ita.law.uvic.ca) (last accessed 15.09.2008).

<sup>72</sup> Ibid, para 72.

<sup>73</sup> Ibid, para 78.

<sup>74</sup> Ibid, para 79.



(ii) *Impregilo v Pakistan*<sup>75</sup>

Impregilo was the leader of a joint venture operating in Pakistan. In 1995, an investment contract was concluded between Impregilo on behalf of the joint venture, and the Pakistan Water and Power Development Authority ("WAPDA"), concerning the construction of a dam. Disputes arose when Impregilo alleged that the performance of the contract was impeded amongst other reasons through acts of the representative of WAPDA and WAPDA itself. Even though the Tribunal concluded that the contracts concluded between Impregilo and WAPDA as sub-state entity were not covered by the relevant investment treaty because Pakistan could not be considered party to the contracts, further reasons were given for why the jurisdiction of the Tribunal did not exist in the first place. In order for a breach of contract to amount to a breach of the BIT, a state's behaviour must go "beyond that which an ordinary contracting party could adopt".<sup>76</sup> This statement given more contour further on in the decision, where the Tribunal states that a "bad" performance of the contract does not automatically amount to a breach of treaty provision unless the state has gone "beyond its role as a mere party to the contract", exercising sovereign power.<sup>77</sup> According to the Tribunal, this means for contractual claims that the investment treaty only applies where the host state has actually violated the investment treaty itself through his acts.<sup>78</sup>

(iii) *CMS v Argentina*<sup>79</sup>

In the course of the economic and financial crisis 1999-2000 in Argentina, the government passed emergency regulations that seriously affected foreign investments and investors in Argentina. One of the affected investors was CMS, a United States company operating in the gas sector through TNG, which CMS partly owned. CMS alleged that, through the alteration of contractual provisions based on the emergency regulations, Argentina failed to fulfill its contractual obligations. CMS based its claim on the

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<sup>75</sup> *Impregilo (Impregilo SpA v. Republic of Pakistan (Decision on Jurisdiction))* (2005) 12 ICSID Reports 242.

<sup>76</sup> *Ibid.*, para 260.

<sup>77</sup> *Ibid.*, para 278.

<sup>78</sup> *Ibid.*, para 260.

<sup>79</sup> *CMS (CMS Gas Transmission Company v the Argentine Republic (Award))*, above n 66.



operation of an umbrella clause in the Germany-Argentina BIT. Article II(2)(c) of the BIT provided that each party

*"shall observe any obligation it may have entered into with regard to investments."*

In principle, the Tribunal did not object to the idea that contractual rights could be protected under the treaty, yet in the next sentence the Tribunal stressed that purely commercial claims may not be protected unless there was some significant government interference with the rights of the investor.<sup>80</sup>

(iv) *Noble Ventures v Romania*<sup>81</sup>

In *Noble Ventures*, the Claimant argued that an investment contract between the Claimant and the Romanian State Ownership Fund had been breached by the latter. The US-Romania BIT included in Article II(2)(c) a clause which required that "Each party shall observe any obligation it may have entered into with regard to investments", which the Claimant tried to invoke as an umbrella clause and alleged a violation of the Treaty.<sup>82</sup> The Tribunal first stated that Article II(2)(c) of the Treaty had to be interpreted according to its ordinary meaning and in the light of the object and purpose of the treaty, taking into consideration the *effet utile* of the clause. After applying these principles of interpretation to the clause in question, it found that without doubt the parties intended it to include obligations going beyond those of the other BIT provisions, thus also including obligations arising out of investment contracts. Otherwise, so the Tribunal, Article II(2)(c) would be deprived of any function.<sup>83</sup> In this context it is interesting to note that the Tribunal derived from the wording "any obligation *entered into*..." that specific commitments were addressed, not only general commitments, for example in the form of legislative acts.<sup>84</sup> Turning to a more general evaluation of the clause, the Tribunal held

<sup>80</sup> Ibid, para 299.

<sup>81</sup> *Noble Ventures (Noble Ventures Inc v Romania (Award))*(2005) Case No. ARB/01/11, available at [www.ita.law.uvic.ca](http://www.ita.law.uvic.ca) (last accessed 15.09.2008).

<sup>82</sup> Treaty between the Government of the United States of America and the Government of Romania concerning the reciprocal Encouragement and Protection of Investment, available at [www.unctadxi.org](http://www.unctadxi.org) (last accessed 15.09.2008).

<sup>83</sup> *Noble Ventures (Noble Ventures Inc v Romania (Award))*, above n 81, para 51.

<sup>84</sup> Ibid.



that umbrella clauses in BITs dissolve the general distinction between obligations of states under domestic and international law, and that thus a restrictive interpretation is appropriate. Regarding the concept of state responsibility and the Respondent's argument that only governmental conduct was attributable, the Tribunal stated that it did not give this distinction much weight, since it considered it difficult to distinguish governmental from non-governmental conduct. It supported this conclusion with the inclusion of such a distinction in the ILC draft work on international responsibility, which should demonstrate that the distinction needed codification in order to be recognized.<sup>85</sup> The Tribunal concluded, that, although in international law a breach of contract is not automatically a breach of international law, by virtue of an umbrella clause, breaches of contract may constitute breaches of treaty where a certain act is attributable to the state in any way.<sup>86</sup>

(v) *El Paso v Argentina*<sup>87</sup>

El Paso, a US company, claimed that the emergency measures adopted by Argentina in view of the economic crisis negatively affected their undertakings in Argentina. The Tribunal had to decide whether these measures amounted to a failure to perform the concession contracts with El Paso and if so, if a breach of these contracts in turn violated the investment treaty.<sup>88</sup> In order to do this, the Tribunal thought it necessary to adopt a "balanced" interpretation, weighing state sovereignty and state responsibility to create and maintain an environment favourable for foreign investment.<sup>89</sup> Following the line of interpretation set out in *SGS v Pakistan*, the Tribunal came to the conclusion that umbrella clauses do not have the effect of transforming contract into treaty claims, unless this intention was expressed "clearly and unambiguously"<sup>90</sup> by the parties to the treaty. Only if an act violated both the investment contract and the standards of protection of the investment treaty could contract claims amount to treaty claims. In order to determine when this was the case, the Tribunal considered the distinction between the state as a

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<sup>85</sup> Ibid, para 82.

<sup>86</sup> Ibid, para 85.

<sup>87</sup> *El Paso (El Paso Energy International Company v. The Argentine Republic - Decision on Jurisdiction (2006))*, [www.iisd.org](http://www.iisd.org) (last accessed 17 July 2008).

<sup>88</sup> Ibid, para 67.

<sup>89</sup> Ibid, para 70.

<sup>90</sup> Ibid, para 74.



sovereign and the State as a merchant as highly relevant.<sup>91</sup> Referring to the decision in *Joy Mining v Egypt*,<sup>92</sup> which distinguished between purely commercial aspects and State interference with the contract in dispute, the tribunal further relied on Article VII (1) of the Argentine-US BIT. According to the tribunal, this provision defined an “investment dispute” under the BIT as a dispute that arises between the investor and the State as a sovereign.<sup>93</sup> From this the tribunal concluded that the umbrella clause in the Argentine-US BIT did not cover purely commercial contracts, yet such provisions in investment contracts were covered that give special protection to foreign investments and that were granted by the state as a sovereign.<sup>94</sup> As an example the tribunal referred to a stabilization clause in the contract, which is usually intended to “freeze” the law at the time of the investment, making the investment immune to subsequent changes in domestic law.<sup>95</sup>

(e) Analysis

A significant body of ICSID Tribunals developed and emphasized an interpretation of the umbrella clause that is very much in line with its origins in the brief history of investment arbitration. The origins of the clause as a measure to protect foreign investors from sovereign acts amounting to expropriation in turn supports these Tribunals’ application of the clause only where there is a sovereign element in the behaviour of the state. On the other hand, the arguments brought forth by the Tribunal in *Noble Ventures* stating that the distinction between purely commercial and sovereign act in order to attribute a certain behaviour to the state is not very meaningful, is somewhat compelling. Is the distinction between commercial and sovereign acts of the state a distinction that helps to attribute state responsibility to either the national or the international level? Usually, these criteria are implemented within the concept of restrictive immunity to determine whether a state is granted immunity for its or its

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<sup>91</sup> Ibid, para 81.

<sup>92</sup> *Joy Mining v Egypt (Joy Mining Machinery Limited and the Arab Republic of Egypt – Award on Jurisdiction* (2004)), [www.asil.org](http://www.asil.org) (last accessed 17 July 2008), para 72.

<sup>93</sup> *El Paso (El Paso Energy International Company v. The Argentine Republic-Decision on Jurisdiction* (2006)), above n 23, para 81.

<sup>94</sup> Ibid.

<sup>95</sup> Thomas Waelde “The “Umbrella” Clause in Investment Arbitration – A Comment on Original Intentions and Recent Cases” above n 19, 200.



entities' actions.<sup>96</sup> In principle, these two directions of interpretation stem from the debate regarding the meaning of the term "state" in national and international law and the intercommunication between the international and the domestic legal order.<sup>97</sup> Which "state" is party to a contract with a private investor and how is this "state" liable? According to the dualist theory, the state acting under international law different to the state acting under national law, in other words, the legal personality of the state differs with the law applied to its acts.<sup>98</sup> As, traditionally, international law is purely interstate law,<sup>99</sup> then how can a state with acting as a subject of private law be responsible under international law?

The approach followed by most Tribunals when faced with the interpretation of the observance of obligation clause has been favouring the dualist approach. According to this approach the term "state" has different meanings in international and domestic law. In domestic law, the state can both act as a sovereign as well as a private party whereas in international law a state is only able to act as a sovereign contracting party. Thus a state acting as a private party can not be liable for breaches of international law.<sup>100</sup> In order for the state to be held liable under a treaty for acts violating a domestic law contract, there needs to be some sort of link between the two legal orders. This implies that the state behaviour does not only violate the contract but also treaty obligations. The function of an umbrella clause under this interpretation would only be relevant for the "domestic law state", equating its liability with that of the "international law state". This is correct insofar as international law may be allocated to the field of public law, where forms of private or purely commercial law do not appear. On the other hand, with the growing power and influence of transnational corporations on a global level, private entities may be subjects to international law to a certain extent. Under contemporary international law,

<sup>96</sup> Dhisadee Chamlongrasdr "Defining a State for the Purposes of Immunity and Liability of a State and its Entities" 16 *European Business Law Review* 1287, 1291.

<sup>97</sup> Bjorn Kunoy "Singing in the Rain – *Developments in the Interpretation of Umbrella Clauses*", above n 4, 291.

<sup>98</sup> Charles Leben *Contrat d'Etat et droit international des investissements*, (2003) *Recueil des Cours de l'Académie de Droit International de la Haye*, 202, 322.

<sup>99</sup> *Ibid.*, 320.

<sup>100</sup> Bjorn Kunoy "Singing in the Rain – *Developments in the Interpretation of Umbrella Clauses*", above n 4, 291.



individuals may be subjects of international law to a certain extent. With the emergence of investor-state arbitration under ICSID, diplomatic protection of foreign individual through states has lost significance in the field of investment. These are developments which the dualist theory fails to explain,<sup>101</sup> as here only states as the creators of international law are also its subjects.

The dualist approach is contested by the so-called "monist approach"<sup>102</sup>, which knows only a unilateral "state" and therefore, under this approach it is doubted that a distinction between sovereign and commercial acts with respect to the attribution of responsibility is of any significance.<sup>103</sup> By stating that the umbrella clause constitutes an exception to the concept of separation between municipal and international law, the *Noble Ventures* Tribunal supported this line of argumentation. Although the monist approach opposes the idea of a state with a "split personality", it does embody the notion of a two-dimensional personality of the state: municipal and international,<sup>104</sup> and the distinction between sovereign and commercial acts only serves to differ between these spheres regarding the legal nature of the act.<sup>105</sup> According to this approach, if a state is generally liable for its acts, no matter whether sovereign or commercial, then an umbrella clause would have the effect of invoking the jurisdiction of an ICSID tribunal in every case of a breach of contract, regardless of whether a sovereign act is involved, thus having a very broad scope. It seems that the Tribunal in *Noble Ventures* still shied away from explicitly voicing this conclusion by requiring a restrictive interpretation of the clause.

The meaning given to the umbrella clause under the monist approach is considerably wider than the one under the dualist approach, since the latter excludes certain areas of state operations from its scope. Yet it seems strange that under the monist approach, the nature of the state as a contracting partner under domestic law is turned into

<sup>101</sup> Charles Leben *Contrat d'Etat et droit international des investissements*, above n 99, 302, 323.

<sup>102</sup> Ibid, 294; see Hans Kelsen *General Theory of Law and State* (Harvard University Press, Cambridge, 1946) 377.

<sup>103</sup> Charles Leben *Contrat d'Etat et droit international des investissements*, above n 99, 330.

<sup>104</sup> Hans Kelsen *General Theory of Law and State*, above n 102, 377.

<sup>105</sup> Charles Leben *Contrat d'Etat et droit international des investissements*, above n 99, 330.



a contracting partner under international law. As the Committee in the *CMS* Decision on Annulment pointed out, if the content and the proper law of an obligation are not transformed into something else by virtue of the umbrella clause, neither are the parties to the obligation.<sup>106</sup> It may be true that the dualist approach has difficulties with the inclusion of private persons as subjects of international law, but the question at the root of the discussion that needs to be solved is what effect the umbrella clause has on claims arising under domestic law, not if foreign investors can be treated as a subject of international law. This implies that any form of international responsibility can only be conferred on a state that is acting as a sovereign contracting party. For this reason, the distinction between acts of the state as sovereign or as a merchant remains significant for the question of whether an umbrella clause has the effect of conferring jurisdiction upon an ICSID tribunal in a specific case. Furthermore, such an interpretation is in line with the ideas of the first drafters, who envisaged the clause as a safeguard against inconsistent state behaviour. The protection of foreign investors is much more advanced now than at the time of the emergence of the clause, and investors may directly initiate arbitral proceedings with states, so there is no reason to give the clause an even wider scope and to include purely commercial claims.

In principle, to attribute to umbrella clauses a function similar to stabilization clauses in order to prevent states to legalize their contractual breaches would complete the protective framework set up under investment treaties, and would support the requirement of having a sovereign state act in order to invoke BIT protection under an umbrella clause.<sup>107</sup> In other words, an umbrella clause will only convert breaches of contract into breaches of treaty if there is a sovereign element in an otherwise purely commercial contract, either through the existence of a protective provision granted by the state as a sovereign or through a breach of contract induced by the state as a sovereign. What remains to be discussed is whether thus umbrella clauses, by targeting sovereign acts of a state in violation of a contract, restrain the host state from making any changes in domestic investment law that negatively affect the contractual framework. This must

<sup>106</sup> *CMS (CMS Gas Transmission Company v the Argentine Republic (Decision on Annulment))* above n 9, para 95(c).

<sup>107</sup> *Ibid.*



be answered in the negative as this would place the effect of umbrella clauses on host state law too close to the undesirable "freezing" effect of stabilization clauses. It cannot be reasonably suggested that through a provision in an investment treaty a state waives the right to adapt its investment laws to the rapidly fluctuating (world) economy. What is certain is that the state behaviour must display the "colour of government".<sup>108</sup> If that is the case, it must be determined whether said behaviour is legitimate, whether it is a general and non-discriminatory measure that does not specifically aim at the investor with the intention of escaping contractual obligations.<sup>109</sup> If a state abuses its governmental powers by inflicting arbitrary and discriminatory measures upon the foreign investor or the investment, thus preventing the investor from the performance of obligations under the contract or creating a legal framework that renders the contractual agreement completely useless, then the umbrella clause has the effect of "internationalizing" State responsibility and invoking the protection of the investment treaty.

This interpretation of the clause comes to terms with the dilemma described above. The foreign investment is protected from violation through sovereign acts against which there rarely is an effective domestic remedy. At the same time, if the states acts merely as any merchant would, then the remedies negotiated in the investment contract must suffice. What does remain a concern in this respect is the question of how to exactly determine when a state has used or abused sovereign power. This might prove a difficult task for the investor, especially with a view to the burden of proof, since it might be a daunting task for the investor to provide proof of an abusive use of a state's sovereign power. In order to determine this, Tribunals could refer to the criteria developed in *Joy Mining* and *Impreglio*, according to which there needs to be a state "interference" in such a way that the state behaves beyond that of what a normal, private investor would be capable of.

A distinction between breaches of contract and breaches of treaty needs to be maintained when considering the effects of umbrella clauses. Purely contractual claims,

<sup>108</sup> Thomas Waelde "The 'Umbrella' Clause in Investment Arbitration – A Comment on Original Intentions and Recent Cases" above n 19, 197.

<sup>109</sup> Ibid, 198.



or purely commercial contracts remain subject to domestic law, as here the parties' intention must prevail. Only when the parties' contractual agreement is overridden by sovereign acts of the state, or when the contract in itself is concluded between an investor and a state as a sovereign, the protective purpose and function of BITs under international law may be activated by recurring upon an umbrella clause.

### *C Exclusive Contractual Jurisdiction Clauses v Treaty Remedies*

Conflicts may also arise related to the simultaneous existence of an umbrella clause in an investment treaty and an exclusive jurisdiction clause in the investment contract, referring contractual disputes to domestic courts or commercial arbitration. Once the question is decided on whether an ICSID tribunal has jurisdiction over the claim brought to ICSID by virtue of an umbrella clause in the affirmative, there are two competing jurisdictions. Which one should be given priority?

#### *1 Treaty claims*

It is commonly recognized that contractual forum selection clauses do not deprive a treaty-based tribunal of its jurisdiction over treaty-based claims, as these are governed by international law and therefore fall within the jurisdiction of the international forum.<sup>110</sup>

#### *2 Contract claims*

In this context, problematic are the so-called "overlapping" claims that constitute both a breach of the investment treaty by virtue of the umbrella clause as well as a breach of the investment contract.

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<sup>110</sup> John P. Gaffney/James L. Loftis "The 'Effective Ordinary Meaning' of BITs and the Jurisdiction of Treaty-Based Tribunals to hear Contract Claims" (2007) 8 J.W.I.T. 5, 28.



(a) ICSID case Law

(i) *Vivendi*<sup>111</sup>

In the *Vivendi* case, the Claimant, a foreign investor operating in Argentina, alleged the termination of a long-term concession contract concluded with the province of Tucuman through various acts of Argentina. The concession contract in question contained a forum selection clause in favour of local proceedings. The Tribunal held that such a forum selection clause in the contract could not exclude the jurisdiction of ICSID tribunals over treaty claims.<sup>112</sup> The Tribunal then went on to distinguish alleged violations of the BIT from claims arising out the concession contract with the province. It held that claims essentially based on a breach of contract, and thus do not giving rise to treaty violations, needed to be referred to the respective forum in the contractual forum selection clause.<sup>113</sup> The Tribunal concluded that, by virtue of the contractual forum selection clause, it did not have jurisdiction over such claims and thus its' otherwise given jurisdiction under the BIT did not preclude the jurisdiction of local courts.<sup>114</sup> Only in the case of the denial of substantive juridical rights could the jurisdiction of the Tribunal be asserted in connection with contractual claims.<sup>115</sup>

The award became subject to annulment proceedings in 2002.<sup>116</sup> In principle, the Committee agreed with the Tribunal in view of its decision that it had jurisdiction over treaty claims even in the face of the existence of a contractual jurisdiction clause. Yet the Committee held that the Tribunal had manifestly exceeded its powers by not exercising its' (in the Committees' opinion given) jurisdiction over the treaty claims arising out of the investment contract with the province.<sup>117</sup> The Committee further stressed that, if a breach of international law was involved, the jurisdiction of an international tribunal is

<sup>111</sup> *Vivendi (Compania de Aguas del Aconquija S.A. and Vivendi Universal S.A.v the Argentine Republic (Award))* (2000) 5 ICSID Reports 296.

<sup>112</sup> *Vivendi (Compania de Aguas del Aconquija S.A. and Vivendi Universal S.A.v the Argentine Republic (Award))*, above n 112, para 53.

<sup>113</sup> *Ibid*, para 77.

<sup>114</sup> *Ibid*, para 79.

<sup>115</sup> *Ibid*, para 80.

<sup>116</sup> *Vivendi (Compania de Aguas del Aconquija S.A. and Vivendi Universal S.A.v the Argentine Republic(Annulment))* (2002) 6 ICSID Reports 340.

<sup>117</sup> *Ibid*, para 111.



not dispositive and does not preclude a tribunal from considering the merits of the dispute.<sup>118</sup> It is noteworthy that the Committee strictly distinguished between the legal groundings of the claims. In case of the contractual claims, the Committee expressly criticized the Tribunal for not deciding on the question of whether they constituted a breach of the BIT, strictly separating the legal bases of the claim.<sup>119</sup> Thus it avoided the question of what to do in a situation in which a contractual breach constituted a breach of treaty at the same time, and a tribunal needed to refer to the merits of the claim which are governed by domestic law, thus falling under the jurisdiction of municipal courts as well.<sup>120</sup>

(ii) *Aguas del Tunari*<sup>121</sup>

Aguas del Tunari, a locally incorporated company acting on behalf of a foreign investment consortium concluded a concession contract with Bolivia. The contract contained an exclusive forum selection clause providing for dispute settlement by local Bolivian courts. The concession was terminated early in 2000 due to violent public opposition, and Aguas del Tunari alleged that it would have been Bolivia's duty under the concession contract to respond in order to secure the performance of the contract.<sup>122</sup> Bolivia claimed that there was the Tribunal did not have jurisdiction over the dispute because the dispute settlement clause in the concession contract precluded ICSID jurisdiction. The Tribunal held that a jurisdiction clause in the contract will not exclude ICSID jurisdiction unless it is clear and unequivocal that the parties intended to waive its jurisdiction.<sup>123</sup> Furthermore, the Tribunal stressed that the agreement to an investment contract containing an exclusive forum selection clause does not amount to an implied waiver of the right to bring a claim before ICSID.<sup>124</sup> The Tribunal set out a number of threshold requirements in order for a forum selection clause to be applicable over the

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<sup>118</sup> Ibid, para 113.

<sup>119</sup> Ibid, para 111.

<sup>120</sup> See also Michael Pauli "ICSID: The Relationship Between Foreign Investment Protection Dispute Settlement and Contractual Claims (LLM Research Paper, Victoria University of Wellington, 2004) 23.

<sup>121</sup> *Aguas del Tunari (Aguas del Tunari, S.A. v. Republic of Bolivia(Award))* (2006) 18 World Trade and Arbitration Materials 271.

<sup>122</sup> Ibid, para 73.

<sup>123</sup> Ibid, para 119.

<sup>124</sup> Ibid, para 120.



jurisdiction of a treaty-based tribunal. Firstly, the investment contract should involve the same parties, secondly deal with the same matters and thirdly, contain mandatory conflicting obligations.<sup>125</sup> If these threshold requirements were fulfilled, only an explicit waiver of the investor's entitlement to ICSID arbitration to hear contract claims could give a contractual forum selection clause the effect of precluding the former.<sup>126</sup>

(iii) The *SGS* cases

In both *SGS v Pakistan* and *SGS v Philippines*, the Tribunals had to deal with the question of whether contractual jurisdiction clauses had the effect of precluding their jurisdiction under ICSID. In *SGS v Pakistan*, the Tribunal decided that it had jurisdiction over SGS' claims despite the existence of the forum selection clause, if they weren't of a purely contractual nature. The argument was that, due to the fact that the BIT between Switzerland and Pakistan was signed a year later than the investment contract between SGS and Pakistan, it could not have been the parties' intention to conduct local arbitration over BIT claims.<sup>127</sup> Regarding claims arising out of the investment agreement, which, according to the Tribunal, were not encompassed by the umbrella clause, the Tribunal concluded that it did not have jurisdiction.<sup>128</sup> The Tribunal in *SGS v Philippines* found that an umbrella clause in the BIT did not have the effect of overriding the contractual forum selection clause regarding the pursuit of contractual claims. The Tribunal argued with *lex specialis derogat lex generali*, stating that general BIT provisions could not preclude special agreements in investment contracts. Secondly, the Tribunal argued that the protection of the BIT is meant to support, not supplant specifically negotiated investment conditions agreed on by the parties.<sup>129</sup> Rather, in case of competing jurisdictions, the contractual provision should be given priority, and only if domestic remedies fail the treaty-based tribunals jurisdiction should be taken up again.<sup>130</sup> According to the tribunal, these situations are not strictly a question of jurisdiction but of

<sup>125</sup> Ibid, para 111.

<sup>126</sup> Ibid, para 119.

<sup>127</sup> *SGS v Pakistan (SGS Société Générale de Surveillance v. Islamic Republic of Pakistan (Decision on Objections to Jurisdiction))*, above n 5, para 153.

<sup>128</sup> Ibid, para 162.

<sup>129</sup> *SGS v Philippines (SGS Société Générale de Surveillance v. Republic of the Philippines (Decision on Objections to Jurisdiction))* above n 5, para 142.

<sup>130</sup> Ibid, para 155.



the admissibility of a claim to a treaty-based tribunal. In any way, an investor could not claim a breach of contract but then depart from the contractual agreement in order to enforce that very same contract.<sup>131</sup>

Antonio Crivellaro, one of the members of the Tribunal, did not agree with this conclusion and submitted a dissenting opinion.<sup>132</sup> In Crivellaro's opinion, the BIT between Switzerland and Pakistan offered an investor an "unconditional right"<sup>133</sup> to submit a dispute to either domestic or international arbitration. He argues that the most significant advantage of a BIT is to grant the investor the right to select the dispute settlement forum provided in the BIT that seems to be most convenient.<sup>134</sup> He characterized as a special asset of the BIT in question that the choice of the respective dispute settlement forum could be chosen by the investor after the dispute had arisen, and without such an option the practical significance of BITs would diminish.<sup>135</sup> Furthermore he contended the applicability of the *lex specialis* rule could be applied to both treaty and contract, as they were not of the same legal nature and didn't bind the same parties.<sup>136</sup> Finally, he asserted that Article VIII(2) of the Swiss-Pakistani BIT<sup>137</sup> granted the investor more favourable treatment regarding dispute settlement in the sense that the right to choose a forum was created after SGS already accepted local jurisdiction. He argued that this choice was not irrevocable, since the principle of law stating that a provision giving an advantage to a certain party could be given several meaning, the most favourable should be retained should apply.<sup>138</sup>

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<sup>131</sup> Ibid, para 154.

<sup>132</sup> Antonio Crivellaro *SGS v Philippines (SGS Société Générale de Surveillance v. Republic of the Philippines (Declaration))* 8 ICSID Reports 568.

<sup>133</sup> Ibid, para 3.

<sup>134</sup> Ibid, para 5.

<sup>135</sup> Ibid, para 6.

<sup>136</sup> Ibid, para 9.

<sup>137</sup> Accord entre la Confédération suisse et la République islamique du Pakistan concernant la promotion et la protection réciproque des investissements, available at [www.unctadxi.org](http://www.unctadxi.org) (last accessed 15.09.2008).

<sup>138</sup> Antonio Crivellaro *SGS v Philippines (SGS Société Générale de Surveillance v. Republic of the Philippines (Declaration))* above n 132, para 10.



(b) Analysis

ICSID jurisprudence seems to be fairly steady on the issue in question. The Tribunal in *SGS v Philippines* specified the notion already denoted in *Aguas del Tunari* and *Vivendi*, that if there are overlapping claims, there are two jurisdictions which do not exclude each other but which are only applicable in a certain order or under certain terms. The Tribunal in *Aguas del Tunari* even demanded an explicit or unequivocally implicit waiver of the right to arbitrate before an international tribunal. Finally, the Tribunal in *SGS v Philippines* even dismissed the issue as a problem of admissibility rather than jurisdiction.

In this context, it has been contested that there is no real competition between jurisdictions at all. Reinisch argued that an umbrella clause applied to a contract claim gives rise to two different jurisdictions.<sup>139</sup> Reinisch reckons that the emergence of a BIT claim under ICSID jurisdiction does not annul the underlying contract claim, thus he basically asserts that the existence of an umbrella clause creates two parallel jurisdictions, one for the treaty claim and one for the contract claim.<sup>140</sup> It is true that the nature of a claim is not changed by virtue of an umbrella clause, and that there are two separate legal bases. But according to this reasoning, there would be two parallel proceedings, both potentially dealing with the merits of the dispute. The danger of the inconsistency of the awards is evident.

The reasoning presented in *SGS v Philippines* has certain advantages. A domestic court or arbitration tribunal might be more effective in solving a contractual dispute governed by domestic law. Nonetheless the accessibility to the treaty-based tribunal is not waived (unless an express waiver exists), but suspended. Yet this approach can not be accepted without criticism. For one thing, the lack of clarity regarding the re-initiation of the ICSID tribunal's proceedings is critically mentioned.<sup>141</sup> Crivellaro pointed out that this could be the situation in case of a denial of justice or other severe procedural

<sup>139</sup> August Reinisch "Umbrella Clauses" (2006 Seminar on Investment Protection, Vienna, 12 September 2006), 29.

<sup>140</sup> Ibid.

<sup>141</sup> Thomas Waelde "The 'Umbrella' Clause in Investment Arbitration – A Comment on Original Intentions and Recent Cases" above n 19, 230.



grievances.<sup>142</sup> He touches upon another drawback for the investor regarding the judgement on the merits. ICSID tribunals are not meant to be a supplementary court of appeal and thus, in the above-mentioned case of reinitiating ICSID proceedings, could not render a judgement on the merits.<sup>143</sup> Furthermore, giving a contractual forum selection clause priority would deprive an umbrella clause of its function and purpose to add extra protection of foreign investments by “forcing” the investor to first initiate proceedings before domestic courts.<sup>144</sup>

Yet this argument is not convincing as access to a treaty-based tribunal is not blocked but merely suspended. It can be required of the investor first to live up to his part of a deal before bringing a contract claim before a treaty tribunal. Crivellaro’s argument regarding the most favourable treatment of the investor in context with Article VIII(2) of the Swiss-Philippines BIT does not seem convincing as this would open the door for “forum shopping” on part of the investor, as probably every investor would rather select ICSID over local arbitration. This would deprive the contractual forum selection clause of any meaning and might even prevent countries from concluding BITs for fear of invalidating such clauses in all investment contracts.<sup>145</sup> Also, it is not quite clear to the author how a principle of law such as the “more favourable treatment” rule drawn on by Crivellaro should apply to two agreements based on totally different sources of law. It seems contradictory to the criticism applied before with regards to the *lex specialis* rule.

While there are compelling reasons supporting the prior reference of the investor to the juridical remedies spelt out in the investment contract, there are cases in which ICSID jurisdiction should prevail. In situations where there is an evident misuse of governmental power the investor be allowed should to directly refer to an ICSID tribunal. This is, for example, the case in which the state party to a contract thwarts the

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<sup>142</sup> Antonio Crivellaro *SGS v Philippines* (*SGS Société Générale de Surveillance v. Republic of the Philippines (Declaration)*) above n 132, para 12.

<sup>143</sup> *Ibid.*, para 12.

<sup>144</sup> *Ibid.*

<sup>145</sup> Compare Michael Pauli “ICSID: The Relationship Between Foreign Investment Protection Dispute Settlement and Contractual Claims”, above n 120, 43.



enforcement of an award by a domestic court rendered in favour of the investor.<sup>146</sup> This idea is supported by the finding of the Tribunal in *Vivendi*, which held that prior recourse to ICSID would only be allowed in the case of denial of procedural justice or denial of substantive justice.<sup>147</sup> In such a case, the investor has fully exhausted local remedies and there is no denial of justice. The umbrella clause would have the relevance of an independent, substantive treaty standard, as one could see the preceding breach of contract as "amended" through the domestic court's award, but the realization of justice is prevented through sovereign acts of the state.

The same effect could take place in the case of a change in municipal law that completely frustrates the investment contract.<sup>148</sup> At first glance, this might seem arguable, as the maintenance of a predictable and stable legal framework is already protected, with regard to the investors' legitimate expectations, by the requirement to accord fair and equitable treatment to foreign investments. The difficulty of giving the umbrella clause an independent, free-standing meaning is illustrated in the *CMS Award*, where the Tribunal came to the conclusion that the "fair and equitable treatment" standard in the BIT had been breached, depriving the subsequent considerations regarding the violation of the umbrella clause of practical significance.<sup>149</sup> Yet there are a few leads in the Tribunal's reasoning that might help to draw the fine line between the situations in which a change in municipal law concerns the "fair and equitable treatment" standard, and when the umbrella clause might potentially be affected. The Tribunal derived from the BIT's preamble that a "stable legal and business environment is an essential element of fair and equitable treatment".<sup>150</sup> The Tribunal grounded its findings on the fact that the legal framework guaranteed to the investor regarding the tariff regime in connection with the dollar standard was basically abolished, and thus the investment crucially affected.<sup>151</sup>

<sup>146</sup> McLachlan/Shore/Weiniger *International Investment Arbitration: substantive principles*, above n 6, 4.157.

<sup>147</sup> *Vivendi (Compania de Aguas del Aconquija S.A. and Vivendi Universal S.A. v the Argentine Republic (Award))*, above n 111, para 80.

<sup>148</sup> McLachlan/Shore/Weiniger *International Investment Arbitration: substantive principles*, above n 6, 4.157.

<sup>149</sup> *CMS (CMS Gas Transmission Company v the Argentine Republic (Award))*, above n 66, para 303.

<sup>150</sup> *Ibid*, para 274.

<sup>151</sup> *Ibid*, para 275.



Referring to the stabilization clauses, the Tribunal pointed out that not the fact that the law was not “frozen” amounted to a breach of “fair and equitable”, as it “can always evolve and be adapted to changing circumstances”.<sup>152</sup> Rather, it argued that foreign investment protection was designed to avoid the situation that a legal framework is dispensed as a whole when contrary commitments have been made to investors. With a view to the function of an umbrella clause to protect the commitments made to an investor with regard to a specific contract or a specific investment, it seems that the line regarding the application of either standard needs to be drawn where there is a change in municipal law that potentially affects foreign investment on a wide scale, or just a contractual framework as such. This result is supported by a remark made by the Committee in the decision on annulment, stating that the obligations covered by the umbrella clause are “specific obligations concerning the investment. They do not cover general requirements imposed by the law of the host State.”<sup>153</sup> In effect, an umbrella clause could only obtain freestanding relevance if the change in municipal law as a consequence invalidates or severely impairs the contract and thus negatively impacts on the specific foreign investment as such. Such an interpretation would allow the umbrella clause to operate independently and would live up to its function as a protective standard for a specific undertaking. There is one point of concern, though. In practice, it is will be very difficult to draw this fine boundary between acts affecting the contract and acts affecting investments comprehensively. This is demonstrated by the interpretation the Tribunal in *CMS* attributed to the stabilization clauses in the concession contracts. The Tribunal recognized the rise of individual rights out of the stabilization clauses which could be invoked by the investor.<sup>154</sup> As these clauses promise the preservation of a whole legal framework, any alteration to the point of abolishment constitutes a breach of fair and equitable treatment, according to the Tribunal’s reasoning. As noted by Kunoy,<sup>155</sup> it would have been more fruitful for the analysis of umbrella clauses in relation to “fair and

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<sup>152</sup> Ibid, para 277.

<sup>153</sup> *CMS (CMS Gas Transmission Company v the Argentine Republic (Decision on Annulment))*, above n 9, para 95(a).

<sup>154</sup> *CMS (CMS Gas Transmission Company v the Argentine Republic (Award))*, above n 66, para 151.

<sup>155</sup> Bjorn Kunoy “Singing in the Rain – Developments in the Interpretation of Umbrella Clauses”, above n 4, 299.



equitable treatment” had the Tribunal in regarded the stabilization clauses as a general guarantee for investors as such.

Overall, if both contract and treaty remedies are applicable to a contractual claim, a valid contractual forum selection clause should not be overridden by the jurisdiction of a treaty tribunal obtained through an umbrella clause. Tribunals should require the observance of contractual obligations of both parties to the respective contract in order to prevent a complete invalidation of a legally valid contractual provision that the foreign investor has explicitly agreed to. Only in case of an abuse of sovereign power that frustrates the effectiveness and the function of domestic courts should the investor be allowed to recur upon a treaty-based tribunal via the umbrella clause in the respective BIT in order not to be denied justice.

#### **D      *Left Standing in the Rain: What about the Subsidiaries?***

##### **1      *Introduction***

It is common practice in the field of international investment that investors operate through locally incorporated subsidiaries or have contractual a contractual relationship not directly with a state, but with a sub-state entity. This may cause some problems when it comes to the operation of an umbrella clause. Recent decisions of ICSID tribunals have given rise to the question of whether contractual relationships between a foreign investor and a sub-state entity or between a state and a local subsidiary of a foreign investor fall within the protective scope of an umbrella clause.

##### **2      *Outlining the problem***

Once the question of whether a contractual dispute falls within the scope of an umbrella clause at all has been clarified, the further question remains of whether the contract is concluded by parties who are addressees of the umbrella clause. This might be difficult to determine if the foreign investor does not operate directly within the host state’s premises, but through locally incorporated subsidiaries. Is this still a “foreign investment” and is thus a breach of contract concluded with such a subsidy still a



violation of an umbrella clause? If a state does not directly conclude a contract with the foreign investor but through a wholly or largely state-owned sub-entity, is this still a contract between the host state and the investor? These questions are highly relevant since especially large transnational corporations operate through subsidiary corporations, which poses several advantages, for example the distribution of risk and flexibility in a global market.<sup>156</sup> As usual, there is no common direction within ICSID jurisprudence regarding this issue, ICSID case law demonstrates that tribunals may decide either way. The tribunals in *Azurix*<sup>157</sup> and *Siemens*<sup>158</sup> rejected contractual claims from a foreign investor's subsidiary, while the tribunals in *CMS*,<sup>159</sup> *Enron*<sup>160</sup> and *Sempra*<sup>161</sup> held that a breach of contract concluded between a state and an investor's subsidiary was a violation of the respective umbrella clause.

### 3 *ICSID jurisprudence on local subsidiary corporations*

A similar feature in the cases at hand was the operation of foreign companies through local subsidiaries because either it was required by the bidding terms and conditions in order to obtain a license<sup>162</sup> or the local corporations already owned licenses with convenient provisions for foreign investors.<sup>163</sup> Furthermore, Argentina had established a network of bilateral investment treaties ensuring investment-friendly conditions in order to attract investors.

<sup>156</sup> Stephen Bottomley "Corporations and Human Rights" Stephen Bottomley/David Kinley (eds) *Commercial Law and Human Rights* (Ashgate, Burlington USA, 2002) 47, 51.

<sup>157</sup> *Azurix (Azurix Corp. v the Argentine Republic (Award))* (2006) 18 World Trade and Arbitration Materials 199.

<sup>158</sup> *Siemens (Siemens AG v the Argentine Republic (Award))* (2007) 19 World Trade and Arbitration Materials 103.

<sup>159</sup> *CMS (CMS Gas Transmission Company v the Argentine Republic (Award))* above n 66.

<sup>160</sup> *Enron (Enron Corporation and Ponderosa Assets, L.P. v the Argentine Republic (Award))* (2004) 11 ICSID Reports 268.

<sup>161</sup> *Sempra (Sempra Energy International v the Argentine Republic (Award))* (2008) 20 World Trade and Arbitration Materials 117.

<sup>162</sup> *Siemens (Siemens AG v the Argentine Republic (Award))* (2007), above n 158, para 81.

<sup>163</sup> *Enron (Enron Corporation and Ponderosa Assets, L.P. v the Argentine Republic (Award))*, above n 160, para 44; *Sempra (Sempra Energy International v the Argentine Republic (Award))*, above n 161, para 85; *CMS (CMS Gas Transmission Company v the Argentine Republic (Decision on Annulment))*, above n 9, para 32.



(a) *Azurix Corp v Argentina*

In the course of the privatization of water services in an Argentine province, *Azurix*, a US company, founded a local subsidiary called ABA. ABA signed a concession agreement with the Province in order to provide the services. The act of incorporating ABA as a local subsidiary was necessary as, according to the provinces' law, the concessionary was required to be a company incorporated in Argentina.<sup>164</sup> The dispute arose when *Azurix* claimed that the Province failed to comply with its obligations under the concession agreement, thus in turn preventing ABA from fulfilling its obligations. *Azurix* alleged that this was in breach of Argentina's obligations under the Argentina-US BIT, especially of Article II(2)(c): "Each Party shall observe any obligation it may have entered into with regards to investments".<sup>165</sup> Without further explanation, the Tribunal held in response to the Claimant's argument that Argentina had failed to observe its obligations under Article II(2)(c) that the parties to the concession contract were not parties to the proceedings under ICSID, thus not parties to the bilateral investment treaty. Even if Argentina were liable of a breach of the investment treaty, the concession contract could not be considered as being a contract between Argentina and *Azurix*.<sup>166</sup>

(b) *Siemens v Argentina*

In 1996, Argentina and SITS, a domestic Argentine company but fully owned and controlled by the German company Siemens, entered into a contractual relationship which concerned the implementation of several electronic systems. After several changes regarding the circumstances of the project, which led to a suspension of the production twice, Argentina renegotiated the conditions of the contract with Siemens and SITS. After a personnel change in the government, contract was eventually terminated under Argentine Emergency Law.<sup>167</sup> Siemens tried to invoke Article 7(2) of the Germany-Argentine BIT, which provided that

<sup>164</sup> *Azurix (Azurix Corp. v the Argentine Republic (Decision on Jurisdiction))* (2004) 16 World Trade and Arbitration Materials 111, para 19.

<sup>165</sup> Treaty between the United States of America and the Argentine Republic concerning the Reciprocal Encouragement and Protection of Investment, available at [www.unctadxi.org](http://www.unctadxi.org) (last accessed 10.09.2008).

<sup>166</sup> *Azurix (Azurix Corp. v the Argentine Republic (Decision on Jurisdiction))* above n 164, para 384.

<sup>167</sup> *Siemens (Siemens AG v the Argentine Republic (Award))* (2007), above n 158, para 97.



*"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."*<sup>168</sup>

The tribunal simply stated that there was no claim as Siemens was not party to the investment contract, and SITS not a party protected under the German-Argentine BIT, without providing further explanation, thus barely mentioning the problems in relation to the umbrella clause, but declaring them irrelevant in the present case.<sup>169</sup>

(c) *Enron v Argentina*

During Argentina's privatization programme, the US company Enron invested in TGS, a local transportation company, in order to take advantage of the favourable conditions of TGS' licensing agreement. Whilst the economic crisis was pending, Argentina altered the conditions of the license as a measure to cope with the crisis. In the view of Enron, this was, amongst other allegations, in breach of the stabilization clause contained in the license. The US-Argentine BIT contained an umbrella clause in Article II(2)(c).<sup>170</sup> In its decision on jurisdiction, the Tribunal found that Enron, despite operating through a local subsidiary, was the owner of the investment, and the fact of ownership was a right protected under the investment treaty. Furthermore, the fact that foreign shareholders may have other contractual claims does not affect their direct right of action under an investment treaty.<sup>171</sup> The Tribunal noted that Enron's participation in the investment was specifically sought by Argentina, which, in the Tribunal's view extended Argentina's consent to arbitration on Enron.<sup>172</sup> The Tribunal did not elaborate this point any further in its award but merely referred to its decision on jurisdiction when discussing whether stability clauses in the license had been breached. It then went on to examine whether BIT standards had been breached, and applied the umbrella clause to Argentina's

<sup>168</sup> Vertrag zwischen der Bundesrepublik Deutschland und der Argentinischen Republik ueber die Foerderung und den gegenseitigen Schutz von Kapitalanlagen, available at [www.unctadxi.org](http://www.unctadxi.org) (last accessed 10.09.2008).

<sup>169</sup> *Siemens (Siemens AG v the Argentine Republic (Award))* (2007), above n 158, para 204.

<sup>170</sup> See above n 164.

<sup>171</sup> *Enron (Enron Corporation and Ponderosa Assets, L.P. v the Argentine Republic (Decision on Jurisdiction))* above n 160, para 49.

<sup>172</sup> *Ibid*, para 56.



acts without further discussion. In the end, it concluded that through the legislation abolishing the favourable conditions for the investor under the license Argentina represented a breach of contract, which, by virtue of the umbrella clause, resulted in a breach of the investment treaty.<sup>173</sup>

(d) *Sempra v Argentina*

This case is very similar to the former cases as it also concerns measures undertaken by the Argentinian government with regards to the economic crisis, and the effect of these measures on foreign investors. Sempra International invested in two local distribution companies in order to obtain licenses in the course of the privatization of the gas sector. Sempra alleged that the measures adopted by the government in order to cope with the crisis led to a permanent abrogation and repudiation of the conditions of its rights under the license.<sup>174</sup> In the view of Sempra, this violated the umbrella clause, Article 25(2)(b) of the United States-Argentina BIT, which provides that the provisions are also applicable to

*"and the juridical persons who, having...the nationality of the State that is a party in the dispute, ... and which, because of foreign control, the parties have agreed should be treated as a national of another Contracting State for purposes of this Convention."*

The tribunal concurred with the decision in Enron, which stated that even claims of minority shareholders were admissible to ICSID arbitration.<sup>175</sup> The Tribunal based this conclusion on the broad definition of "investment" in the treaty, and found that object and purpose of the treaty support this argument.

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<sup>173</sup> Ibid, para 277.

<sup>174</sup> *Sempra (Sempra Energy International v the Argentine Republic (Award))*, above n 161, para 93.

<sup>175</sup> *Sempra (Sempra Energy International v the Argentine Republic (Decision on Jurisdiction))* (2005), [www.asil.org](http://www.asil.org) (last accessed 13.08.2008), 94.



(e) *CMS v Argentina*

(i) Award

The main facts of the case are outlined above.<sup>176</sup> In its award the Tribunal merely referred to its decision on jurisdiction, where the problem was just mentioned. During the process of determining the Tribunal's jurisdiction, Argentina argued that CMS could not invoke the protective provisions of the investment treaty as these were only relevant in relation to the foreign investor itself and not regarding local corporations. The Tribunal rejected this argument, merely referring to its statement in the decision on jurisdiction which claimed that for the protection of the investment treaty it was irrelevant if the foreign investor was but part of a party to a concession agreement.<sup>177</sup>

(ii) Decision on Annulment

The failure to explain why the Tribunal applied the umbrella clause to a local subsidiary eventually was one of the reasons the decision was annulled for failure to state reasons.<sup>178</sup> In this regard, the Committee identified several issues it would have expected the tribunal to address, some of which concerned the question of the applicability of the clause to subsidiaries. The Committee argued that contractual obligations and the performance of such obligations are *inter partes*, and as an umbrella clause does not change the nature of a contractual obligation it also does not change the parties to the obligation.<sup>179</sup> With regards to the Tribunal's interpretation of the umbrella clause in the BIT, the Committee found that it was impossible for any reader to follow the reasoning of the Tribunal at this point, leading to an annulment of the award. Even though the Committee does not give an answer to the question of whether contracts with local subsidiaries are included in the treaty protection, the issues pointed out by the Committee provide a useful starting point for further discussion, which can not easily be avoided by future tribunals faced with this problem.

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<sup>176</sup> See 3 *Only certain contracts covered?* .

<sup>177</sup> CMS (*CMS Gas Transmission Company v the Argentine Republic (Award)*), above n 66, para 65.

<sup>178</sup> CMS (*CMS Gas Transmission Company v the Argentine Republic (Decision on Annulment)*) (2007), above n 9.

<sup>179</sup> Ibid, para 95(c).



In the context of problems occurring on connection with the operation of an umbrella clause in a bilateral investment treaty, the issue dealt with by these tribunals is yet another source of ambiguity, which is displayed by the outcome of the decisions. When looking at the Tribunals' lack of explanation for their decisions, one has the impression that the relevant points of thought as outlined in the CMS Decision on Annulment are either not recognized or deliberately avoided by Tribunals. These points should be considered as it does not seem satisfactory just to apply an umbrella clause in the case of a local subsidiary as well as to deny application without proper reasoning.

(a) Issues identified by the Committee in *CMS*

(i) Article 25(2)(b) of the ICSID Convention

Article 25(1) of the Convention extends the jurisdiction of the Centre to "a national of another Contracting State", and Article 25(2) defines the term "national of another Contracting State". According to Article 25(2)(b), a national of a contracting state is also a juridical person which is a national of the state party to the dispute, but under foreign control, and if the parties have agreed that this juridical person should be treated like a national of another contracting state.<sup>180</sup> Article 25(2)(b) is designed to widen the scope of the tribunal's jurisdiction in order to cover investments made by foreign investors through locally incorporated companies.<sup>181</sup> If that is the case, no recourse is needed to an umbrella clause in the first place as a mechanism to bring breaches of investment contracts between host states and foreign investor's local subsidiaries before ICSID. The *CMS* Committee noted that, when interpreting an observance of obligation clause, tribunals should consider whether a broad interpretation and the application to local subsidiaries makes Article 25(2)(b) unnecessary.<sup>182</sup> If the provisions of Article 25(2)(b) are not met, for example when there is no or little foreign

<sup>180</sup> Convention on the International Centre for the Settlement of Investment Disputes, [www.worldbank.org](http://www.worldbank.org) (last accessed 14.08.2008)

<sup>181</sup> Christoph H. Schreuer *The ICSID Convention: A Commentary* (Cambridge University Press, Cambridge, 2001), 291.

<sup>182</sup> *CMS (CMS Gas Transmission Company v the Argentine Republic (Decision on Annulment))*, above n 9, para 95



control or no consent regarding nationality, the question is if these deficiencies could be circumnavigated through a broad interpretation of an umbrella clause.

(ii) Requirements of Article 25(2)(b)

Article 25(2)(b) requires that a juridical person has the nationality of the host state that is under foreign control. This element of foreign control is crucial to the application of Article 25(2)(b), and the actual fact of foreign control cannot be assumed through the existence of an agreement of foreign nationality of a company.<sup>183</sup> Furthermore, there needs to be an agreement between the parties of the dispute, that is the host state and the foreign investor. Especially the criterion of an agreement between the parties deserves a closer inspection, as Schreuer states that "A provision in a treaty or in national legislation does not amount to an agreement between the parties to the dispute".<sup>184</sup> Whilst this statement refers to a clause in a treaty that provides for the treatment of a company incorporated under the host state's law but controlled by nationals of other parties, in essence it supports the *CMS* Committee's conclusion that a treaty provision cannot be interpreted to the effect of replacing or modifying Article 25(2)(b) of the ICSID convention in a way that invalidates the provision.<sup>185</sup> While Article 25 allows the parties to narrow the scope of consent regarding who is party in proceedings to ICSID,<sup>186</sup> *e contrario* they may not widen the boundaries of the centre's jurisdiction,<sup>187</sup> especially in a way that contravenes the Convention's purpose. Consequently, this means that if a requirement of Article 25(2)(b) is not fulfilled, an umbrella clause can not be extended onto a local corporation controlled by a foreign investor, since the mere existence of the clause does not supplant the agreement required by Article 25(2)(b) of the ICSID convention.

<sup>183</sup> Christoph H. Schreuer *The ICSID Convention: A Commentary*, above n 182, 312.

<sup>184</sup> *Ibid*, 308.

<sup>185</sup> C.F. Amerasinghe "Jurisdiction *Ratione Personae* Under the Convention on the Settlement of Investment Disputes Between States and Nationals of other States" (1974-1975) 47 BYIL 227, 228.

<sup>186</sup> *Ibid*, 234.

<sup>187</sup> *Ibid*, 91.



These considerations show that an umbrella clause can not be given such a broad interpretation as to apply to locally incorporated companies under foreign control directly as a party to the dispute.

(b) Local corporations as “investments made by a foreign investor”

If the foreign investor’s subsidiaries cannot bring claims directly under ICSID by virtue of an umbrella clause, it might be considered to regard the local subsidy as an “investment” made by the foreign investor, and the breach of contract with the subsidy a breach of the host state’s obligations to the foreign investor to “observe any obligation with regard to the investment”. A lot will depend again on the wording of the clause in question. A broad clause including “*any obligation entered into with an investor or an investment of an investor*”<sup>188</sup> permits the conclusion that domestic subsidiaries are included.<sup>189</sup> When this is not the case, the question that needs to be discussed in this regard is whether through the breach of the investment contract with the local subsidy, the foreign investor has the right to enforce the obligations under the investment contract without having duties under the contract himself. According to the CMS Committee, the findings of the Tribunal that Argentina had entered into obligations with regard to investments made by a foreign investor lead to the strange situation that CMS, being a minority shareholder, could not invoke these obligations under national law but instead by virtue of the umbrella clause in the BIT before ICSID.<sup>190</sup> The Committee thought that this approach was highly problematic, and one of the issues identified is the question of who is actually bound by a contractual obligation and who in turn can demand performance of obligations.<sup>191</sup> The Committee pointed out that claims protected under the umbrella clause are usually bilateral, yet may be linked to obligations of an investment company.<sup>192</sup> Whether this link leads to the necessary obligation of the host state under a

<sup>188</sup> For example Article 10(1) of the Energy Charter Treaty, [www.encharter.org](http://www.encharter.org) (last accessed 19.08.2008); Article 24(1)(b)(C) of the 2004 US Model BIT.

<sup>189</sup> Thomas Waelde “The “Umbrella” Clause in Investment Arbitration – A Comment on Original Intentions and Recent Cases” above n 19, 203.

<sup>190</sup> CMS (*CMS Gas Transmission Company v the Argentine Republic (Decision on Annulment)*), above n 9, para 92.

<sup>191</sup> Ibid, para 96; *Azurix (Azurix Corp. v the Argentine Republic (Award))* above n 157, para 38.

<sup>192</sup> CMS (*CMS Gas Transmission Company v the Argentine Republic (Decision on Annulment)*), above n 9, para 96 (d).



BIT to the investor was left open. It seems that it all comes down to the question of whether a foreign investor needs to be a further obligee of an investment contract in order to bring claims arising out of contractual breaches before ICSID. The Committee noted that observance obligation clauses do not change content and proper law of an obligation and thus do not change the parties to an agreement. In the case of a legally separated parent corporation and a subsidiary, it will be difficult to argue that the parent is party to a contract if the contract has been concluded between the subsidiary and the host state. But, regarding the applicability of the umbrella clause, it is not relevant who is party to a particular contract under domestic law, rather, the question if there is an investment of a foreign investor is of importance. Some clarity might again be reached by comparing umbrella clauses with a broad wording as mentioned above, and umbrella clauses referring only to obligations entered into with "*respect/regards to an investment*". It has been suggested that the difference in the wording demonstrates that the latter covers only investment agreements between the host state and the investor.<sup>193</sup> Yet this doesn't really convince as the parties could have well intended to regard a domestic subsidiary itself as investment.<sup>194</sup>

The reluctance of tribunals to justify their decisions either in favour of or against the inclusion of domestic legal subsidiaries under the protective scope of umbrella clauses demonstrates that there is yet another issue which drafters of such clauses need to consider.<sup>195</sup> The outcome will depend on the parties' definition of "investment"

### III CONCLUSION

The effect of umbrella clauses in bilateral investment treaties remains a field of intense discussion. The very great diversity of opinions, approaches, interpretations and solutions will continue to make it difficult to predict further developments. Up to this day, the awards of treaty-based ICSID tribunals tend to sympathise with either of the SGS-

<sup>193</sup> Thomas Waelde "The "Umbrella" Clause in Investment Arbitration – A Comment on Original Intentions and Recent Cases" above n 19, 203.

<sup>194</sup> Ibid..

<sup>195</sup> Compare Nick Gallus "An Umbrella just for Two? BIT Obligations Observance Clauses and the Parties to a Contract" (2008) 24 Arb Int'l 157, 169.



decisions, which leaves both investors and host states in uncertainty regarding future developments and the outcome of future proceedings. This can be ascribed, for the greater part, to the many variations in the texts of BITs, but also to the different approaches to and interpretations of arbitrators of the positions of states and investors in the system of investment protection. The obvious advice for States would be to take extreme care when drafting new investment treaties, and to clearly state their intentions and interpretation in case of the inclusion of an umbrella clause. But as Tribunals have to resolve disputes over already existing treaties, and their number is great, controversies over the effect of the umbrella clause and its scope will remain. An end to these discussions is not in sight.

When it comes to the examination of the effect of umbrella clauses on claims resulting out of breaches of contracts through states, most tribunals established under ICSID are reluctant to give the clause the widest possible scope, that is, to give ICSID tribunals jurisdiction over purely contractual claims. In this sense, most tribunals seem to try to find a middle way between *SGS v Pakistan* and *SGS v Philippines* and try to address the problems identified but not solved by these two conflicting awards. This seems to be sensible as on the one hand, allowing the clause to apply only to treaty claims would deprive it of any independent significance, on the other hand, letting it apply to both treaty and purely contractual claims is too expansive, as this might lead to the application of international law to claims of which domestic law is the proper law. The general intention of states guaranteeing certain standards of protection to foreign investors is to attract foreign capital, foreign investment and to profit from the transfer of technology often involved with it, in a nutshell, to improve their own economic performance. Yet the system of investment protection is not meant to serve as an "all-purpose remedy" or a "supranational legal system" for disputes in foreign countries,<sup>196</sup> and investment arbitration should not completely replace domestic judicial or arbitral remedies. Therefore, it is legitimate to strike a balance between the protection of foreign investors against arbitrary measures based on nationalistic or protectionist motives and

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<sup>196</sup> Thomas Waelde "The 'Umbrella' Clause in Investment Arbitration – A Comment on Original Intentions and Recent Cases" above n 19, 188.



conducted under the pretext of sovereignty, and the expectation that investors accept the fact that a certain domestic legal framework applies to their investment which may not be as sophisticated as their home country's. Furthermore, investors should always be aware of the fact that they operate in economies that may not be as stable and predictable as their home state's economy.

Thus it is only sensible to argue that foreign investors should only benefit from supplementary protection where domestic remedies and domestic legal systems fail ultimately. For this reason, the distinction between acts of the state as a merchant or as a sovereign in abuse of its sovereign powers developed by tribunals and scholars when it comes to the applicability of an umbrella clause is a step towards finding the balance between conflicting interests of host states and investors.

Furthermore, this conclusion is supported by the original intentions of the early drafters of the clause, who envisaged the internationalization of transnational investment protection against the abuse of governmental power in order to constrict the investment. The beginning of this development is marked by the *Lena Goldfield* arbitration, which initiated a process that was furthered in the Abs-Shawcross convention and the OECD draft convention. Even nowadays, where the system of investment protection has changed in a way that it is no longer strictly inter-governmental, but arbitral proceedings can be initiated by the investor, the original concept has not lost its validity.

In this regard, the BIT and umbrella clauses do not play any role whatsoever when state behaviour affecting the contract is purely commercial and does not involve sovereign powers, thus acting as any other investor would and could act. If a state uses its sovereign powers in order to influence the contractual agreement, and if this involves an abuse of governmental powers with the intention to invalidate the original agreement, the protective mechanism of the BIT is invoked by virtue of the umbrella clause.

The idea of a balance of investor protection and the preservation of certain areas where state remedies need to be invoked also impacts on the issue of whether an umbrella



clause, if applicable, overrides domestic remedies if their jurisdiction collides with the jurisdiction of an ICSID tribunal. The author concludes that this cannot be the case, as here the limits of investor protection need to be highlighted as well. If there is a valid clause in the investment agreement providing for the jurisdiction of domestic courts or arbitration, then this cannot be swept aside by an umbrella clause, as not only the State, but also the investor must be held to comply with its obligations. Any other result would undermine host states' readiness to internationally guarantee a certain amount of rights to foreign investors that may exceed the rights of their national investors, and also to accept the jurisdiction of a tribunal established under a foreign dispute resolution mechanism such as ICSID.

An exception to the primary applicability of contractual jurisdiction clauses must be made in situations where an investor cannot find sufficient protection of investments through domestic remedies. This is the case when either the investor is denied the enforcement of valid domestic awards by the host state, or when the host state's measures specifically target the investment as such through certain measures in order to derail the investment agreement. Thus it is assured that the umbrella clause is established as a substantive treaty standard in an investment contract.

Another aspect of umbrella clauses that has not been resolved yet is the question of whether locally incorporated subsidiaries of foreign investors are included in the protective scope of the BIT through the application of an umbrella clause. At first glance, this seems somewhat strange as strictly speaking they are not "foreign" investors. On the other hand, there are good arguments for why locally incorporated subsidiaries should be regarded at least as an "investment" of a foreign investor. For one thing, as the legislation in connection with the privatization of certain economic sectors in Argentina has demonstrated, host states sometimes set up the requirement for concessions that only local corporations are entitled to bid for them. Thus, an investor may not have a choice but to operate through such a subsidiary, which could be regarded as the investor's "extended arm". It should be kept in mind that Article 25(2)(b) of the ICSID convention is a means to explicitly negotiate and agree on this point of question in either direction,



be it the exclusion of the inclusion of locally incorporated subsidiaries under a BIT. If such an agreement does not exist, then Article 25(2)(b) of the ICSID convention should not be rendered useless by a broad application of an umbrella clause in order to let the local subsidiary file a treaty claim before an ICSID tribunal. Yet it seems possible to treat a locally incorporated subsidiary as an "investment" and thus to consider any acts negatively affecting a state contract with the local corporation a potential breach of treaty.

In a way, the disputes arising out of the legal issues in connection with the applicability, the effect, and the significance of umbrella or observance of obligation clauses is representative for the tasks that ICSID tribunals generally face when dealing with substantive treaty standards. As the intention of the parties is rarely clear and the BIT provisions are vague and obscure, it is their job to fill them with meaning and to shape them. The bulk of cases dealing with the umbrella clause since *SGS v Pakistan* and *SGS v Philippines* has achieved much in shedding some light on the issues that need to be resolved and have presented solutions that future tribunals, but also future drafters of BITs can use as a valuable source of information and support.



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