

This newsletter provides information on issues of current interest and an update on recent developments in international arbitration law and practice. It is written in general terms. The application of the law always depends on the particular facts of the case. If you would like to follow up any of the issues raised, please contact one of the partners listed below:

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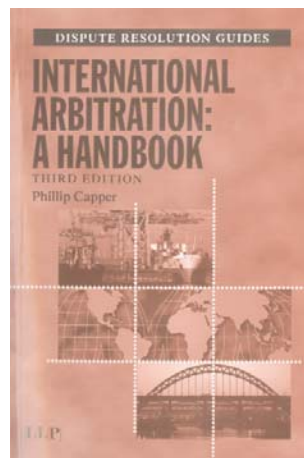
Please refer to the back of this newsletter for office details.

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## In this issue

### ARBITRATION NEWS

Find out what's new in international arbitration, including details of the new edition of Lovells' book "International Arbitration: a Handbook".



See page 2 for details

### THE ENERGY CHARTER TREATY - AN UNTAPPED RESOURCE?

The Energy Charter Treaty is a multi-lateral treaty which regulates the biggest industry in the world, energy. The ECT covers four main areas: investment, trade, transit and dispute resolution. In "The Energy Charter Treaty - an untapped resource?", **John Reynolds** and **Tim Beaumont** consider the protections which the ECT provides to private investors and its dispute resolution provisions, both of which are still an unknown quantity for many businessmen and lawyers.

### SECURITY FOR COSTS IN INTERNATIONAL ARBITRATION

"How much will it cost?" is often the prime concern of parties to international commercial arbitration. "Will I be able to recover any of my costs?" is often the next question. Whilst costs awards are a common feature of international commercial arbitration, such awards provide cold comfort if the paying party is unable to pay. Enter the concept of security for costs. **Jerome Finnis** and **Saira Singh** provide a brief overview of security for costs in international arbitration and, in particular, the availability of security for costs under different institutional rules and in different jurisdictions and the likelihood of success on an application for security for costs.

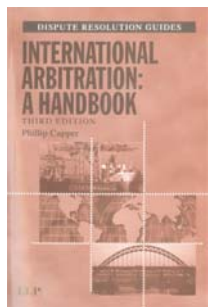
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*If you would prefer to have this newsletter in PDF format, go to [www.lovells.com](http://www.lovells.com) and click on Publications, then Newsletters. Scroll down to International Arbitration and right click on the link and choose "Save target as ..." or "Save link as ..." Please do not open the document and then try to save it.*

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## EVENTS

### New edition of Lovells' International Arbitration handbook



The third edition of "International Arbitration: A Handbook", edited by Professor Phillip Capper of Lovells and written by members of Lovells' international arbitration practice, was published by LLP on 30 September 2004. The book provides an overview of the most important legal and practical matters for each stage of the arbitration process. The third edition includes new chapters on the rapidly developing fields of ADR and investment treaty arbitration. "International Arbitration: A Handbook" is an invaluable guide for lawyers at all levels of practice and anyone contemplating involvement in the international arbitration process. Please contact Saira Singh for further information ([saira.singh@lovells.com](mailto:saira.singh@lovells.com)).

If you would like to purchase a copy of the book at a 10% discount, please contact: Sarah John, Informa Professional Publishing, Informa House, 30-32 Mortimer Street, London, W1W 7RE, UK.  
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### Energy Charter Treaty Seminar

Lovells held a seminar on the Energy Charter Treaty and investment treaty claims on 10 June 2004. For a copy of the papers, or for further information, contact John Reynolds ([john.reynolds@lovells.com](mailto:john.reynolds@lovells.com)).

### INTERNATIONAL TREATIES AND INSTITUTIONS

#### Important ICSID decision on jurisdiction

An ICSID tribunal has accepted jurisdiction over a claim against the Ukraine even though the investors were, effectively, nationals of that state. The investor company, Tokios Tokeles, was incorporated in Lithuania but 99% of its shares were owned by Ukrainian nationals. In *Tokios Tokeles v Ukraine* (ICSID case number Arb/02/18), the tribunal held that the investor met the nationality test contained in the bilateral investment treaty (BIT) between the Ukraine and Lithuania. The tribunal refused to look beyond the legal residence of Tokios Tokeles and pierce the corporate veil by enquiring into the actual control and ownership of the company. The tribunal also held that there was no requirement for the investment to come from capital originating outside the Ukraine. Controversially, the dissenting President of the tribunal (Professor Prosper Weil) resigned over the issue.

#### Energy Charter Treaty

As at July 2004, five claims had been brought under the Energy Charter Treaty; three were brought through the International Centre for the Settlement of Investment Disputes (ICSID) and

two through the Stockholm Chamber of Commerce. The most recent claim has been brought by a UK-based investor against Kyrgyzstan.

#### New IBA conflicts guidelines

The International Bar Association has published Guidelines on Conflicts of Interest in International Arbitration. The guidelines set out standards of independence and disclosure governing the selection, appointment and continuing role of an arbitrator. There are seven general standards of independence and disclosure, which set out conditions in which an arbitrator should not accept appointment. Further guidance is provided in the form of three lists - Red, Orange and Green - which categorise the level of conflict that exists or may exist in certain situations. The Red List sets out clear cases of conflict, both non-waivable (where the arbitrator should not accept appointment) and waivable (once fully disclosed and understood, any conflict may be waived). The Orange List contains situations which may give rise to doubts as to an arbitrator's complete impartiality; these should be disclosed and the parties given an opportunity to object to the choice of arbitrator. The Green List describes situations where disclosure is not necessary, the idea being that the list will help to discourage "over-disclosure" leading to unnecessary challenges and slowing the arbitration process. The guidelines are available at [www.ibanet.org/pdf/InternationalArbitrationGuidelines.pdf](http://www.ibanet.org/pdf/InternationalArbitrationGuidelines.pdf).

### New President of LCIA Court

Jan Paulsson has been appointed President of the LCIA Court, with effect from 1 July 2004. He succeeds Gerold Hermann.

### ICC launches Dispute Board service

The ICC has launched a new Dispute Board service with effect from 1 September 2004. This is a new dispute resolution facility for parties wishing to provide for dispute boards in their contracts. The facility consists of a set of Dispute Board Rules, the model dispute board member agreement and standard dispute board clauses for use by parties in their contracts. There are three alternative standard dispute board clauses, each providing for a different type of a dispute board, followed by ICC arbitration as a last resort if a dispute cannot be resolved by the dispute board. In addition, the ICC Dispute Board Centre is there to help the parties set up and operate a dispute board. The ICC DB Centre may be called upon to appoint dispute board members, decide on challenges to dispute board members and review dispute board decisions as to form.

### UNCITRAL case law digests

UNCITRAL is to produce digests of case law relating to the UNCITRAL Model Law on International Commercial Arbitration. The aim will be to promote the adoption of the Model Law, as well as its uniform interpretation, by means of an objective summary of court decisions and arbitral awards applying the Model Law. The digests will supplement the existing on-line database of case law on the UNCITRAL Model Law (CLOUT)

which contains the text of court decisions and arbitral awards.

### New UNCTAD BITs search engine

How do you find out if there is a bilateral investment treaty (BIT) between, say, the UK and Egypt? Try the new search engine on the UNCTAD website. You can search for BITs between specific countries or "all available" BITs signed by a particular country (although note that this may not provide a definitive list of BITs). The search engine is at [www.unctadxi.org/templates/DocSearch\\_\\_\\_779.aspx](http://www.unctadxi.org/templates/DocSearch___779.aspx).

### DEVELOPMENTS IN NATIONAL LAW

#### English House of Lords to rule on scope of appeal under Section 68

The House of Lords is to consider the proper scope of challenges to arbitral awards on the grounds of serious irregularity affecting the proceedings under Section 68 of the 1996 Arbitration Act.

The applicant in *Lesotho Highlands Development Authority v Impreglio Spa and Others* is challenging an arbitral award on the basis that the tribunal applied the wrong currency and interest rate when making its award. This is arguably a challenge on a point of law, which should ordinarily be brought under Section 69 of the Act. However, a challenge under this section was not possible because the parties had expressly excluded the right to appeal on a point of law in their agreement. The House of Lords will therefore have to consider whether such a challenge can properly be brought under section 68. If they consider that this is

possible, it might undermine the parties' agreement and, consequently, the principle of party autonomy. The House of Lords will also have to clarify which law is applicable to the issues of the currency of an award for damages and the right to interest on damages. At present, it is not clear whether it is the law governing the underlying contract or the procedural law of the seat of arbitration. Given the fluctuation of exchange rates and interest rates, the decision in the *Lesotho* case may be important to multi-national companies.

In *Lesotho*, the contract provided that the currency of account would be the Lesotho Maloti but the payments to the Respondents were to be made in sterling or three other European currencies in stated proportions. The governing law of the contract was that of the Kingdom of Lesotho. The law of Lesotho was to be applied to the merits of any dispute and the arbitrators' award was to be final and binding between the parties. A dispute arose and was referred to arbitration in London.

The arbitrators made an award in favour of the defendants. Although the contract provided that the currency of account was the Maloti, the arbitrators decided that the parties had not agreed on the currency in which an award was to be made and made their award in European currencies. They relied on Section 48(4) of the Arbitration Act 1996. As a result of a fall in the value of the Maloti, the effect of the award was that Lesotho had to pay more than if the tribunal had applied the contract terms.

The tribunal also awarded interest on the sums awarded, relying on Section 49(3) of the 1996 Act.

In relation to the issues of both currency and interest rates, the arbitrators had treated the issue as subject to the procedural law of the seat (English), rather than the substantive law of the contract.

The Court of Appeal decided that the arbitrators had exceeded their powers: the parties had agreed the currency and the arbitrators were bound to give effect to their agreement. Furthermore, the entitlement to interest was a question of substantive law, which is the law of Lesotho, not procedural law. The House of Lords may, of course, take a different view, both on these issues and on the admissibility of the challenge.

We will report on any developments in relation to both issues in due course.

#### **Amendment to Swiss Rules of International Arbitration**

The new Swiss Rules of International Arbitration, which came into effect on 1 January 2004, have been amended to enable parties to agree on a place of arbitration outside Switzerland. Previously, the seat of arbitration had to be in Switzerland. The amendment came into effect on 1 August 2004.

#### **Singapore removes restrictions on foreign lawyers**

The Singapore Legal Profession Act has been amended to remove all restrictions on foreign lawyers representing parties to domestic and international arbitration proceedings in Singapore, the intention being to promote the choice of Singapore as a venue for arbitration. Previously, non-Singaporean lawyers only had unfettered rights of representation where the applicable law was not

Singaporean law. In cases where the applicable law was Singaporean, foreign lawyers had to appear jointly with a Singaporean lawyer. Foreign lawyers may give advice, prepare documents and render assistance in relation to or arising out of arbitration proceedings. However, they will still not be able to appear in the Singapore courts.

#### **Definition of "international arbitration" expanded in Italy (Italian Corte di Cassazione)**

More arbitrations may be classed as "international arbitrations" as a result of a recent decision of the Corte di Cassazione, Italy's final court of appeal. International arbitration awards can be enforced as if they are judgments, instead of having to be enforced through court proceedings. There are also fewer grounds on which an international arbitration award can be challenged.

To qualify as an "international arbitration", at least one of the parties must reside or have its place of business abroad, or the contract between the parties must provide for the performance of a significant part of the parties' obligations outside Italy. However, in *Ministry of Foreign Affairs v Spazio Verde Srl* and others (16 January 2004), the Corte di Cassazione clarified that this does not mean that the predominant part of the parties' obligations must be performed outside Italy. Furthermore, there is no need to carry out a comparison or evaluation of the value or importance of the obligations to be carried out abroad with those to be performed in Italy.

As well as making international arbitration available for more Italian

parties, this decision may also be significant for international businesses entering into contracts with Italian companies through their local operations.

#### **Scope of arbitration agreement depends on governing law (English Commercial Court)**

It is not unusual for a contract to specify the governing law of the contract and for the arbitration clause to be silent. Whilst this is common, a recent English case highlights the uncertainty which can arise when it comes to interpreting the scope of the arbitration clause. In *Peterson Farms Inc v C&M Farming Ltd* [2004] EWHC 121 (Comm), the court set aside part of an ICC award which benefited companies which were not parties to the arbitration agreement on the ground that the tribunal lacked jurisdiction (section 67 Arbitration Act 1996). In accepting jurisdiction, the tribunal had applied the "group of companies" doctrine. This doctrine, which originated in the ICC award in the *Dow Chemical* case in 1982, effectively provides that where a group of companies constitute the same "economic reality", one company in the group can bind the other members to an agreement if this accords with the mutual intentions of all the parties and reflects the good usage of international commerce.

In *Peterson* the contract between the parties was expressly governed by Arkansas law; the arbitration clause itself was silent as to choice of law. After noting that an arbitration agreement, being separable and autonomous from the underlying contract, can be governed by a different applicable law, the tribunal went on to decide that it could determine the question of who

was a party to the arbitration agreement by reference to the common intentions of the parties. The evidence supported a finding that the parties had intended that the contract between them would cover all entities in the claimant's group (C&M Farming).

The English court disagreed: the arbitration agreement was plainly governed by Arkansas law and there was no basis for the tribunal to apply any other law, whether governed by the "common intent of the parties" or not. It was agreed, for the purposes of the application, that Arkansas law was the same as English law. The "group of companies" doctrine formed no part of English law (and, by implication, Arkansas law). There was therefore no basis for applying the doctrine to the claim.

The approach of the English court was that, if the arbitration clause is silent, the governing law of the contract applied to that clause as much as to any other contractual provision. The advantage of this approach is that parties know what they are agreeing to when they conclude their agreement. However, this is not necessarily the approach that would be taken by the courts in other jurisdictions. For example, the Paris Cour d'appel (Court of Appeal) upheld the decision of the tribunal in *Dow Chemicals* to determine its own jurisdiction by reference to the common intent of the parties and without obliging it to apply any national law, so long as the decision did not contradict any rule of "international public policy" or of the French legal system in particular.

The only way to be certain of the law that will be applied to the interpretation

of an arbitration agreement is to specify the applicable law of the arbitration clause itself.

#### **ICC Pre-arbitral Referee's order is not an arbitration award (Paris Cour d'appel)**

The ICC Pre-arbitral Referee Rules, in force since 1990, provide parties with a procedure for the rapid, temporary resolution of disputes by a referee, who has power to order urgent provisional measures. The referee's order is binding until either he or a court or arbitral tribunal decides otherwise. There is no provision in the rules for the referee's "order" to be challenged, except by pursuing court or arbitration proceedings for a binding decision on the dispute. In *Republic of Congo and Société Nationale des Pétroles du Congo v Société Total Fina Elf E&P Congo* (Paris Cour d'appel, 29 April 2003), the defendant sought to have an order by a pre-arbitral referee set aside, as if it were an arbitration award. The application was dismissed by the court: an order of a pre-arbitral referee does not qualify as an arbitration award. The order was not made on the merits of the dispute and was only provisional. Furthermore, the ICC Pre-arbitral Referee procedure was just "a contractual mechanism which [notwithstanding the use of the word "order"] is only contractual in nature, and is binding only according to what the parties have agreed".

This decision clarifies that ICC pre-arbitral orders cannot be set aside. It also means that compliance with such orders cannot be compelled by enforcement proceedings. Successful claimants will just have to hope that the defendant will voluntarily comply with the referee's order.

#### **New Japanese Arbitration Act**

As part of the reform of its civil justice system, Japan has implemented a new Arbitration Act with effect from 1 March 2004. The new law is based on the UNCITRAL Model Law on International Commercial Arbitration and applies to domestic and international arbitrations with their seat in Japan. Like most modern arbitral laws, the new Japanese Act empowers the tribunal to rule on its jurisdiction (*Kompetenz-Kompetenz*) and requires the court to dismiss court proceedings, on the defendant's application, if there is a valid arbitration agreement. The tribunal also has power to order interim measures of protection and appropriate security. Unusually, the Act allows the tribunal to attempt to settle the dispute, if the parties consent. An official translation of the Japanese Arbitration Act is now available at: [www.kantei.go.jp/foreign/policy/sihou/arbitrationlaw.pdf](http://www.kantei.go.jp/foreign/policy/sihou/arbitrationlaw.pdf).

#### **Mediation Bill adopted in Belgium**

As the European Commission prepares to issue a directive on civil and commercial mediation, in a move to promote the use of mediation, the Belgian House of Representatives has adopted a bill adding a new section on mediation to its Code of Civil Procedure. The bill has been sent to the Senate for approval. Key provisions in the bill include the recognition of the validity of contractual mediation clauses; suspension of the limitation period once the parties have agreed to mediate, for the duration of the mediation; enforcement of any settlement agreement as a judgment; and confidentiality of mediation.

# The Energy Charter Treaty: an untapped resource?

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*The Energy Charter Treaty ("ECT") is a multilateral treaty which regulates the biggest industry in the world, energy. The ECT covers four main areas: investment, trade, transit and dispute resolution, and to date has been signed by over 50 countries (and the European Communities). The treaty's transit provisions have recently been in the headlines, following the Russian Federation's announcement that it would not sign the Transit Protocol negotiated under the ECT. This article, however, focuses on two of the other chapters of the ECT, in particular, the protections provided to private investors and the dispute resolution provisions. Surprisingly, many businessmen and lawyers active in the industry remain unaware of the potential of these provisions.*

Imagine for a moment that you have been seconded to a project company by a major European multinational oil company, "Solcampoil" (admittedly, this may be easier for some readers to imagine than others!). Solcampoil is in the fortunate position of having recently won a concession from a former Soviet state, the "Republic", to build, own and operate an oil pipeline using a project finance structure. The pipeline has now been completed. However, a number of problems have emerged.

In fact, the problems which have recently come to light are but the tip of the iceberg on a job that ran into difficulty from day one. During the initial stages of work, key employees from Solcampoil's head office were denied entry visas into the Republic, and were consequently unable to assist with the project as planned. As construction progressed, the Republic also failed to provide contractually

agreed materials to Solcampoil. The resultant combination of a lack of skilled employees and materials has caused delay and increased costs for the company. Although Solcampoil has been able to absorb these costs to date, there is pressure from the directors to recover full compensation.

To make matters worse, the Republic has recently published two legislative proposals, which, on an initial assessment, could have a material adverse effect on the project and therefore raise the difficult question for Solcampoil as to what disclosure it should make to the project's lenders. The first proposal is to introduce new financial measures for foreign oil companies in a way that will significantly increase Solcampoil's operating costs. The second comes in the form of mooted environmental regulations, which will require compliance with arduous new procedures and will again have a dramatic impact on costs. Curiously, although a number of domestic pipeline firms use less environmentally-friendly methods, Solcampoil appears to be the only company in the industry sector affected by the new environmental laws.

On consultation with Solcampoil's legal counsel, the outlook seems to grow gloomier by the minute. Counsel's pessimistic opinion is that there do not appear to be any clear solutions to these problems. In the first place, there is no solace in the terms of the concession contract between Solcampoil and the Republic, as the contractual dispute resolution clause refers all disputes to the exclusive jurisdiction of the Republic's courts, which will apply the laws of the Republic. This is of some

concern, as recent decisions of the Republic's courts have not been favourable to foreign investors. Further, there are legitimate anxieties over the independence of the judiciary in the Republic, which cast doubt on the ability of any domestic tribunal to produce a fair result.

Examination of the bilateral investment treaty, or "BIT", between the Republic and Solcampoil's country of incorporation leads to another apparent dead-end. While the BIT affords some protection to foreign investors, it does not appear to cover any of the specific problems that Solcampoil faces. For example, the anti-discrimination provisions of the BIT seem to be too vague to found a cause of action. And although the Republic is obliged by one of the BIT's provisions to keep any "commitments" that it has entered into with an investor, case law suggests that these "commitments" may not include contractual obligations. Finally, and most significantly, Solcampoil's pipeline project is almost certainly not protected by the BIT, which expressly excludes investments in the energy projects sector.

The situation is clearly not promising. Thankfully, all is not lost. What Solcampoil's legal counsel has overlooked is that there is a treaty that may provide solutions to the problems the company faces: the Energy Charter Treaty, or "ECT". However, before security escorts Solcampoil's counsel to the nearest exit, replete with a small cardboard box of his personal effects, it is worth noting that his oversight is not unusual. On the contrary, many in the energy projects industry have yet to catch on to the substantial potential of the ECT.

## WHAT IS THE ECT?

The ECT grew out of the emergence after the fall of the Berlin Wall of two complementary needs. On the one hand, resource-rich former Soviet bloc countries needed increasing amounts of foreign direct investment. On the other hand, the industrialised countries of Western Europe demanded stable energy supplies from an increasingly wide diversity of sources. With the end of the Cold War, the opportunity arose to create new ways of meeting these symbiotic needs.

In 1991, negotiations between the former Soviet bloc and the West led to a non-binding agreement between 54 countries to cooperate in the energy sector. The agreement was known as the European Energy Charter, or the "Charter". One of the Charter's primary aims was to institute a legal framework for those involved in the energy sector; this goal was reached when the ECT was signed in Lisbon in 1994. The treaty has since been ratified by around 50 countries; including countries such as Iceland in the west, through the countries of the European Communities and the former Soviet bloc, to Mongolia and Japan in the east. The ECT entered into force on 16 April 1998.

## THE AIMS OF THE ECT

The ECT draws on the political agreement set out in the Charter, and develops this agreement by creating binding obligations on governments with regard to the energy sector. In so doing, the ECT serves a number of functions. As it seeks to strengthen the rule of law in resource-rich countries, it increases investor

confidence in host States. The theory is that this will lead to securing stable energy supplies to industrialised countries, and will also provide a consistent flow of funds into developing countries. The ECT aims to achieve these goals through one simple concept; protection.

## WHO DOES THE ECT PROTECT?

Under the terms of the ECT, signatory States have promised to provide certain protections to investors of other signatory States. This begs the question, 'what type of investors are protected?'

Under Article 1, the ECT covers *'Investments Associated with Economic Activity in the Energy Sector concerning certain Energy Materials and Products'*.<sup>1</sup> Essentially, this description is made up of 3 components, as follows:

- Firstly, *'Investments'*. Investments are widely defined in the ECT in a non-exhaustive, asset-based list.<sup>2</sup> Investments include most kinds of property, shares, claims, intellectual property and any contractual rights related to energy investments. This last category highlights the broad scope of the ECT definition of Investments, as related contractual rights could include, for example, a technology company supplying IT equipment to an oil refinery.
- Second, *'Economic Activity in the Energy Sector'*. Again, this is a broad definition, including exploration, extraction, refining, production, storage, land transport, transmission, distribution, trade, marketing or sale of any energy materials and products.<sup>3</sup>

- Third, *'Energy Materials and Products'*. Such materials and products include most of the important types of energy resources: nuclear, coal, gas, petroleum and electrical.

As a result of the ECT's generous definitions, very few energy-related investments are in fact excluded from the protections afforded by the ECT.

## WHAT PROTECTION IS ON OFFER?

The ECT contains a range of robust legal protections for foreign energy investments. In the first instance, the ECT aims to ensure basic general standards of treatment for investors. These standards provide that States will endeavour to encourage and create *'stable, equitable, favourable and transparent conditions'* for investors. States also commit to accord investors' investments *'fair and equitable treatment'*. Further, investors are given the right to *'enjoy the most constant protection and security'*, and are guaranteed *'freedom from unreasonable or discriminatory measures'*.<sup>4</sup>

The ECT develops these basic standards of treatment and provides more specific protections for investors. Most of these protections relate to the investment once contracts have been agreed; this is known as the "Post-Establishment" phase. However, there are also some very limited protections at the pre-contractual or "Pre-Establishment" stage.<sup>5</sup> During this phase, contracting States have a non-binding obligation to "endeavour" not to discriminate against foreign investors competing for domestic contracts. States should also enforce a

1 "The Energy Charter Treaty: A Reader's Guide", Energy Charter Treaty Secretariat, p.20

2 Article 1(6).

3 Article 1(5)

4 Article 10(1)

5 Article 10(2)

"standstill" on the imposition of new restrictions against foreign investors during the Pre-Establishment stage, and should aim to "roll back" existing restrictions relating to pre-contractual negotiations.

In contrast with the Pre-Establishment phase, Post-Establishment protection is substantial. Protection during this latter phase of a project rests on seven pillars, as follows:

- Firstly, protection against expropriation. While direct, politically motivated expropriations have declined in recent years, indirect or "creeping" expropriations remain a problem. Examples of creeping expropriations include forced sale of property; excessive taxation; and/or appointing a State-sponsored manager (thus rendering share rights worthless). Each of these practices is outlawed under the ECT<sup>6</sup>. However, expropriation may be permitted if certain conditions are met, although investors retain rights of review. The State is also obliged to provide prompt compensation for any expropriated assets, at fair market value.
- Second, protection from violence or political instability. In the event of strife or extreme political unrest, such as the imposition of a state of national emergency, compensation must be provided to investors, to the same levels as those given to domestic investors or to investors from a "most favoured" third State.<sup>7</sup>

- Third, protection of free transfer of capital. With limited exceptions, foreign investors are to be permitted to transfer capital out of the State in which their investment is situated.<sup>8</sup>
- Fourth, protection from loss of subrogation rights. Where a foreign investor has been compensated under an insurance policy, the State must recognise any assignment of rights to the insuring party.<sup>9</sup>
- Fifth, protection from discrimination against key personnel. Investors are to enjoy the right to good faith examination of requests to employ foreign key personnel.<sup>10</sup>
- Sixth, protection from less favourable treatment than that conferred by other international obligations. That is to say, investors are to enjoy rights that are equal to the highest level of protection afforded under international law. For example, if a BIT gave an investor greater rights than those under the ECT, the BIT rights would apply.<sup>11</sup>
- Seventh, protection from breaches of the investment contract.<sup>12</sup> In contrast to the fierce debate in this area regarding BITs, the ECT includes a clause which appears to place contractual obligations of contracting States squarely under the umbrella of ECT obligations (the so-called "umbrella clause"). The practical effect of this umbrella clause is to render breaches of contract as breaches

of the ECT, which will in turn trigger the ECT's dispute settlement mechanism. In essence, this means that an investor can in most cases choose not to bring contractual claims under any applicable contractual dispute resolution procedure; rather, the ECT's provisions can be utilised.<sup>13</sup>

These investment protections do not extend to so-called "mailbox" companies, ie, those companies whose parent is not incorporated in an ECT contracting State, and are set up merely to take advantage of the ECT's provisions.<sup>14</sup> Investors should also take note that the definition of "the State" itself is wide; the ECT applies to State-owned enterprises, and not simply to agencies of the State itself.<sup>15</sup>

#### HOW DOES THE ECT PROTECT INVESTORS?

The great strength of the ECT is that its obligations are backed up by muscular dispute settlement provisions. The foundation of these provisions is that foreign investors have a direct right to sue a contracting State in the event of a breach of any one or all of the obligations set out above.<sup>16</sup> All specific rights rest on this basis.

In terms of the particular rights given by the ECT, the dispute settlement process begins with a cooling-off period of 3 months. During this time, the investor and the State are to attempt amicable settlement.<sup>17</sup> If these negotiations draw a blank, however, a foreign investor has three options. It can take its claim to the domestic

6 Article 13

7 Article 12

8 Article 14

9 Article 15

10 Article 11

11 Article 16

12 Last sentence of Article 10(1)

13 However, it should be noted that 4 States have excluded certain dispute settlement options ordinarily available to investors regarding such contract-based claims. A list of these States is set out in Annex IA: Australia, Canada, Hungary, Norway.

14 Article 17

15 Article 22

16 Article 26. Note that the obligations above are those contained in Part III of the ECT; not all obligations contained in the ECT have the same protections.

courts of the host State. Alternatively, it can use any previously agreed (whether under the terms of the investment contract or any applicable BIT) procedure. Finally, it can avail itself of certain international arbitration procedures. Each of these three options exists no matter what the terms of any other agreement between the State and the investor. This appears to render contractual exclusive jurisdiction clauses worthless.

If, as is most likely, an investor plumps for the option of international arbitration, there is also a choice of forum.<sup>18</sup> The investor can take its case to the International Centre for the Settlement of Investment Disputes ("ICSID") under the Washington Convention (or under the ICSID Additional Facility Rules); or to an ad hoc tribunal constituted under the UNCITRAL Arbitration Rules; or to the Arbitration Institute of the Stockholm Chamber of Commerce. This choice gives investors a wide discretion to decide the most appropriate venue and set of rules in their eyes for settling disputes with a host State.

As far as the relevant host State is concerned, it has no option but to consent to the investor's choice of dispute settlement procedure,<sup>19</sup> unless it has taken advantage of one of the two exceptions in the ECT. In the first instance, certain States have excluded an investor's right to choose international arbitration if that investor has previously chosen another forum of dispute settlement, such as domestic court proceedings.<sup>20</sup> In addition, there are also a small number of States that have not consented to referring

contract-based claims to international arbitration.<sup>21</sup>

Once any award is obtained under the ECT's dispute settlement provisions, it is binding, final and may include interest.<sup>22</sup> One great advantage of choosing arbitration under the Washington Convention is that ICSID arbitral awards are required to be recognised by contracting States as if they were final judgments of the highest courts of the State in question.

#### WHAT DO THE PROTECTIONS OFFER IN PRACTICE?

So, back to Solcampoil's predicament. Can the company find assistance under the ECT?

The project certainly appears to be covered by the ECT's protections, as a concession contract for an oil pipeline clearly falls within the definition of investments in the energy sector. The Republic is also, as a former Soviet state, a member of the ECT and can therefore be sued by Solcampoil (as a European company) if it has breached relevant terms of the ECT.

As far as the specific problems that the company faces are concerned, the ECT may provide a way of recovering the additional costs incurred by Solcampoil. By denying visas to various staff from head office, the Republic may have breached its obligation to examine in good faith a request to employ key personnel. Further, the failure to provide materials to Solcampoil suggests a breach of the concession contract. This may be a basis for a claim under the ECT's umbrella clause, which serves to impose an obligation on the Republic to honour its contractual

commitments.<sup>23</sup> Solcampoil will therefore be in a strong negotiating position to recover its costs, and will be able to resort to international arbitration after three months of discussions if the Republic fails to provide adequate compensation.

The ECT also gives Solcampoil some options in the face of the Republic's legislative proposals. If implemented in a way that affects only Solcampoil, the new environmental legislation may be an example of discrimination, which would not be permitted under the ECT. There is also the matter of the new financial measures which would substantially reduce the value of the investment, and may therefore be an example of creeping expropriation. In light of these potential breaches of the ECT, any disclosure made by Solcampoil to its lenders need not be entirely negative. The company can also immediately take steps to impress upon the Republic's lawmakers the grave effects of introducing the new measures. And if the worst did happen and the proposed legislation was enacted, Solcampoil may be able to offer some comfort to its lenders that it could not only exert pressure to reverse the legislation, but also could seek compensation for losses in an effective manner.

This may also be an appropriate juncture at which to mention transit concerns, as the success of Solcampoil's project depends on the unimpeded movement of energy resources through the pipeline. Although the ECT contains some energy transit provisions, there is in fact a consensus that existing protection in this area needs to be

17 Article 26(11)

18 Article 26(4)

19 Article 26(3)

20 Annex ID

21 Annex IA

22 Article 26(8)

23 The umbrella clause will apply in this instance as former Soviet states are not among those that have excluded such contractual claims from being referred to international arbitration

strengthened. As a result, the ECT has sought to persuade contracting States to sign an ECT "Transit Protocol". The draft Protocol includes terms relating to non-discrimination, transparent tariff setting, and no unlawful taking of energy in transit. After several years of negotiation, the Russian Federation stunned the European Union by announcing in December 2003 that it would not accept what, at that time, was considered a final draft of the Protocol. All is not lost, however, as the ECT Secretariat announced on 16 June 2004 that discussions have now resumed.

#### FINAL POINTS

The ECT represents a leap forward in the legal protection provided to investors in signatory States. As with many international instruments, however, there appears to be a time-lag between the ECT coming into force and industry players appreciating its significance. Indeed, to illustrate this point, there have only been four or five cases filed to date by investors under the dispute resolution provisions of the ECT. Of these cases that have been filed, only one award has thus far been made.<sup>24</sup> In that case, a tribunal of the Arbitration Institute of the Stockholm Chamber of Commerce found that Latvia had violated its obligations of non-discrimination under the ECT and awarded the Swedish investor compensation amounting to approximately two thirds of the amount invested.

The only other case for which information is publicly available concerned a claim brought before the ICSID by a UK subsidiary of a US company for breach of a privatisation contract.<sup>25</sup> Although the arbitral

tribunal was constituted in this case, the parties subsequently agreed a settlement.

While there have been admittedly few ECT cases to date, this statistic is likely to change as investors become au fait with the protections available. This has certainly been the experience with cases brought under bilateral investment treaties. On a cautionary note, some commentators have suggested that if an increased number of cases contribute to a developing awareness among governments regarding the far-reaching consequences of the protections offered to investors under the ECT, there may be moves to withdraw from the treaty. Significantly, however, a contracting State may only withdraw from the ECT once the treaty has been in force in that State for a period of five years. And while a withdrawal notice is effective one year from the date of notification, the State retains its treaty obligations to all investments made prior to the date of withdrawal for a further 20 years.<sup>26</sup> It should therefore be some time before this particular energy resource is exhausted.

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<sup>24</sup> *Nykomb Synergetics Technology Holding AB v The Republic of Latvia* (unpublished), award made 16 December 2003

<sup>25</sup> *AES Summit Generation Limited (UK) v. Republic of Hungary*, Case No. Arb./01/04,

ICSID (proceedings commenced 25 April 2001)

<sup>26</sup> Article 47

# Security for costs in international arbitration

The costs of international commercial arbitration can be considerable. Recoverability of those costs is likely to be of prime concern to parties to arbitration. Reflecting this, the rules of the major arbitration institutions, as well as the UNCITRAL Rules, give the tribunal the power to make costs awards and where that power is exercised, it is usually to award the successful party its legal costs (an exception being in arbitration involving states, where the parties usually bear their own costs). This in itself may be a culture shock for a party unfamiliar with the concept of the unsuccessful party paying the winner's costs (for example, a party from the US where the parties usually bear their own costs in litigation proceedings). Of course, a costs award is only as good as the paying party's ability to pay. Enter the concept of security for costs. If the idea of the loser paying the winner's legal costs at the end of the arbitration is unfamiliar, the notion that the claimant might be ordered to provide security for the respondent's (estimated) costs before the tribunal has even made its decision on the merits of the case may be downright unwelcome.

The issue of security for costs is always contentious. It is also often the source of a major culture clash between, on the one hand, parties and lawyers from jurisdictions favouring security for costs, and England and Wales in particular, and those from jurisdictions where security for costs is less familiar, such as France and Germany. In this article we provide a brief overview of security for costs in international arbitration, focusing on:

- the availability of security for costs under different institutional

rules and in different jurisdictions; and

- key factors in considering whether an application for security for costs is likely to be successful.

In practice, orders for security for costs in international arbitrations are few and far between. The tribunal first has to satisfy itself that it has jurisdiction. If it does have jurisdiction, it then has a wide discretion which it will generally only exercise in exceptional circumstances.

## DOES THE TRIBUNAL HAVE JURISDICTION?

In determining whether a tribunal has jurisdiction to order security for costs, there are two key questions:

- First, did the parties intend (to the extent that their intentions may be discerned from the terms of the arbitration agreement) to confer such jurisdiction?
- Secondly, does the arbitral law of the seat of the arbitration permit a tribunal to order security for costs?

These two questions are considered further below.

## THE PARTIES' INTENTIONS

In most arbitration agreements, the parties will not have addressed the question of security for costs. In such cases, the parties' intentions will have to be inferred from the choices that they have made, including the following:

- Which (if any) institutional rules have the parties chosen to adopt? Do those rules provide for the possibility of an order for

security for costs? Note that, of the ICC, LCIA and UNCITRAL Rules, only the LCIA Rules explicitly provide for security for costs (although arguably Article 23(1) of the ICC Rules - giving the tribunal power to order interim or conservatory measures - is in theory wide enough to cover security for costs, as is Article 26(1) of the UNCITRAL Rules - empowering the tribunal to take interim measures in respect of the subject matter of the dispute).

- Does the arbitration agreement contain any provision that is incompatible with security for costs? An obvious example would be a provision saying: "In the event of arbitration, neither party shall apply for security for costs." In one recent ICC case, where England was the arbitral seat, the arbitration agreement provided that "each party shall bear its own costs of the arbitration". Whilst such a provision, if made before the dispute arose, is invalid under section 60 of the English Arbitration Act 1996, it could be argued that it is nevertheless indicative of the parties' intention that security for costs should not be ordered: security for costs assumes that a party will be ordered to pay the other party's costs - not what the parties intended. Had the seat of the arbitration been outside England, no question of the tribunal having the power to order security would even have arisen.

## THE IMPACT OF THE LAW OF THE SEAT

Parties might be forgiven for thinking that, in adopting institutional rules that provide for security for costs, that is the end of the matter - that they may obtain remedies that the institutional rules state to be available.

In fact, the arbitral law of the seat of arbitration is critical in determining whether security for costs will be granted. Institutional rules do not float in a vacuum; they must be read in the light of the arbitral law of the seat. The following factors, in particular, should be borne in mind:

- The arbitral law of the seat may **prohibit** the granting of security for costs by tribunals, thereby overriding a provision in the institutional rules.
- Conversely, the arbitral law of the seat may expressly give the tribunal the power to order security for costs (for example, section 38(3) of the **English Arbitration Act 1996** and section 12(1)(a) of the **Singapore International Arbitration Act 1994**). If the arbitral rules which apply do not contain any provision, the applicant can rely on the power conferred by the arbitral law of the seat in these circumstances.
- The arbitral law of the seat may be silent on the issue of security for costs, as under **French** and **German** law (although **German** law gives the courts and the tribunal power to order interim measures of protection). If the arbitral law is silent, it will be necessary to look at the applicable arbitral rules.

- The legal "culture" of the seat or of the chosen arbitration institution may influence the tribunal's decision. Especially in arbitrations where none of the parties is resident in the seat and where the subject matter of the contract has nothing to do with the seat, the tribunal may infer that the parties have chosen a particular seat because they want to tap into its legal culture. Tribunals in **England** may be (but often are not!) more willing to order security for costs as such orders are routinely made in English court proceedings. This inclination is reflected in the LCIA Rules, which as already mentioned expressly provide for security for costs. Conversely, the courts of the seat may be hostile to granting security (as, for example, in **Switzerland**) or there may simply be no tradition of (and no provision for) such orders in some jurisdictions (such as **France** and **Germany**). Tribunals appointed under the rules of institutions associated with such jurisdictions may accordingly be more reluctant to order security for costs, even if they find that they have jurisdiction to do so.

### WILL THE TRIBUNAL ORDER SECURITY?

Having satisfied itself that it has jurisdiction, the tribunal will take a number of factors into account in deciding whether to order security. The tribunal will generally have a wide discretion. Key factors will include the following:

- Is there a serious risk that the claimant would be unable to

meet an award of costs against it? If so, are there any indications as to whether the shareholders or backers of the claimant would pay out? (See the "arbitral hit and run" concept described below.)

- Might the claimant's alleged want of means be the result of the defendant's conduct?
- Would the effect of an order for security be that the claim would be stifled?
- Has the application been brought (only) for tactical reasons, to obtain an interim victory in the arbitration and/or to impede a meritorious claim? The timing of the application may be relevant in this regard.
- Issues relating to the potential difficulty of enforcing an award of costs made against the claimant might arise when its assets are situated in a state that is not a signatory to the New York Convention.
- The identity of the members of the tribunal: some arbitrators may carry with them the legal and procedural "baggage" of their home jurisdiction. Thus, an English arbitrator may be more inclined to order security for costs, whilst a Swiss arbitrator may be predisposed not to do so, in each case based on whether security for costs is a feature of "their" legal system.

The tribunal should not, in the ordinary course, consider the merits of the substantive claim. Sometimes, however, it may be essential to consider the merits in very general terms, for example where the claimant asserts that it has a good claim that

would be stifled were security to be granted.

In some arbitrations, the tribunal may decide to award security for costs on the basis that the claimant company is a "man of straw" or "nominal claimant" which is being supported by a non-party that would be the beneficiary of the award in the event of the claimant's victory but that would (as a non-party) not pay out in the event of the claimant's defeat. The use of a shell company as the contracting party in an arbitration agreement to reap the possible benefits, but avoid the burdens, of arbitration is sometimes referred to as "arbitral hit and run".

- a copy of the claimant's most recently published accounts; and
- details of the form in which security is to be provided: banker's draft; bank guarantee; deposit into a bank account opened in the joint names of the parties or in the name of a third party (including details of whether payment is to be made in tranches or in a lump sum); a floating or fixed charge on assets.

*Jerome Finnis and Saira Singh*

## PRACTICAL CONSIDERATIONS

Several practical points arise, both at the stage at which an arbitration agreement is being drafted and at the stage when one party is preparing an application for security for costs.

In view of the uncertainties outlined above, at the drafting stage:

- parties should consider including specific authorisation of security for costs, especially if they are adopting institutional rules that do not expressly provide for security for costs;
- parties may wish to choose a seat whose arbitral law specifically provides for security for costs.

The application for security for costs should include/set out:

- the total sum in respect of which security is sought - an itemised list of the costs which have been incurred to the date of the application, together with an estimate of those likely to be incurred in the future;

If you have any queries in relation to this newsletter, would like to add colleagues to the mailing list, amend details or arrange deletions, or would like to receive an electronic copy of this newsletter in future, please contact Saira Singh at [saira.singh@lovells.com](mailto:saira.singh@lovells.com).

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