

Quality knows *no borders*

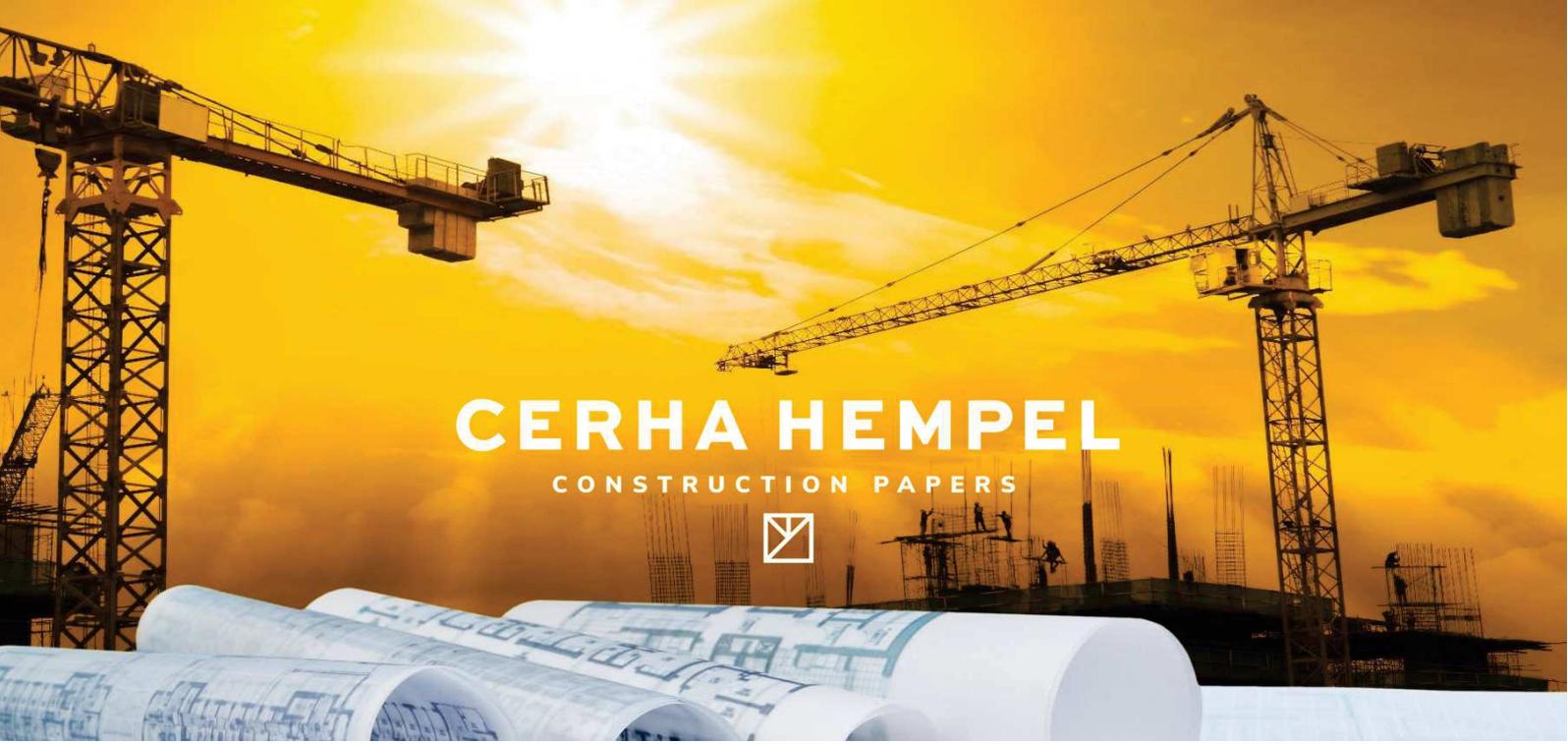
CERHA HEMPEL

CONSTRUCTION PAPERS

CHRISTMAS EDITION

2022



The background image shows a construction site at sunset. Two large tower cranes are visible against a bright orange and yellow sky. In the foreground, several large rolls of blueprints are stacked, showing architectural drawings. The overall scene is industrial and dramatic.

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Investment Protection in case of Breaches of Contract

The relationship between investment protection and the enforcement of claims under civil law – an introduction

- [1] Investment protection is an important segment of international law. It is one of the few areas that is not covered by a general multilateral convention under the auspices of the United Nations. States tend to address these issues in bilateral investment treaties (BITs). BITs between Member States were replaced by a uniform regulation in the European Union on 20 August 2020. Most BITs are based on the same principles with minor variations.
- [2] Almost all BITs include an arbitration clause that states the jurisdiction of the International Centre for Settlement of Investment Disputes (“**ICSID**”). Hungary became a party in 1987 to the 1965 convention that created the Washington-based ICSID. The ICSID is the premier forum for the settlement of investment disputes. The ICSID has developed a body of consistent case law over the years, and while its awards are not formally considered precedents, they nevertheless serve as the benchmark for interpreting the relevant legislation. An examination of ICSID awards shows that a violation of investment protection rules can also be committed by terminating or breaching a contract under civil law.
- [3] BITs include many provisions to protect foreign investors. These provisions are designed to guarantee fair and equal treatment for foreign investors, and to uphold the principles of national treatment (i.e. that they are subject to the same conditions as the investors of the host state) and most favoured nation treatment. Most favoured nation treatment essentially means that each of the two contracting



states must accord treatment to investors from the other state that is not less favourable than treatment it accords to investors from a third country.

- [4] One of the most important areas of investment protection involves the treatment of the consequences of expropriation, where the ICSID has developed rather extensive case law over time.

Expropriation as an investment protection concept

- [5] A nation state as a sovereign subject of international law can expropriate the property of a person or entity, but when it comes to foreign ownership, it can only do so in accordance with the rules of international (customary) law. States generally include such rules in their BITs. Under these rules, a distinction is made between lawful and unlawful expropriation.
- [6] Expropriation is lawful if it serves a public purpose or interest, and if it is not arbitrary or discriminative, followed by prompt, adequate and effective compensation, and performed in accordance with the due process set out in the relevant BIT. However, if one of these conditions is not met, the foreign investor can successfully seek relief from the ICSID.
- [7] One form of expropriation is *direct expropriation*. This essentially means the nationalisation of a company or some of its assets, such as a real property, or even an entire industry, e.g. when Venezuela nationalised the gold industry by requiring the transfer of all assets and rights from relevant businesses to the state. In that particular case, the ICSID ruled that the expropriation was unlawful because no compensation had been paid (**Rusoro v. Venezuela [ARB/12/5]**).
- [8] The other type of expropriation is *indirect expropriation*. It is much harder to adjudge whether an act qualifies as indirect expropriation, and therefore this is the type of expropriation that most disputes before the ICSID involve. In the case of an indirect expropriation, the foreign investor formally retains ownership of the investment but with a diminished value. In most cases, such situations are created by statutes introduced by governments.
- [9] The ICSID ruled against the Hungarian government on the basis of indirect expropriation in connection with a 2011 reform concerning cafeteria benefits. The arbitrators held that with the introduction of new cafeteria schemes and the rules concerning the sale of the related vouchers, the government had set rules which prevented Sodexo, Edenred and Cheque Dejeuner, three French companies, from remaining on the cafeteria market. Consequently, their investments on that market had completely lost their value. (**Edenred v. Hungary [ARB/13/21]**, **Sodexo v. Hungary, [ARB/14/20]**, **Cheque Dejeuner v. Hungary [ARB/13/35]**).

Expropriation by breach of a civil law contract

- [10] In all cases before the ICSID, one party is the investor whose rights have been violated, while the other is the host state. However, this does not mean that expropriation can only be the result of legislative acts by a state. The expropriation of contractual rights can also occur if an investor has a contract with a government entity, a regulatory authority or a government-owned legal entity, or even a



privately owned legal entity, if the latter is authorised to act on behalf of the government in certain commercial situations.

- [11] In such a case, a breach of contract may also qualify as an expropriation if it deprives the investor of its anticipated profits and of its ability to exercise its contractual rights.
- [12] Obviously, not all breaches of contract by state-owned companies qualify as indirect expropriation. The relevant act must be attributable to the state, must be the consequence of the exercise of its sovereign power, and must go beyond what a contracting party under private law would generally do.
- [13] These cases must be distinguished from situations (which are actually more common), where the state, through other entities, acts in the capacity of a commercial entity under private law. The ICSID cannot offer protection in the majority of such situations, and the dispute will have to be settled by competent state courts or another ("private law") court of arbitration specified in the relevant contract.

Investment protection vs. enforcement of rights under private law

- [14] This issue can be quite pressing for construction companies, since they often conclude construction contracts involving government-funded projects. If a legal entity owned or controlled by the state breaches a contract it has with foreign investor, the foreign investor can seek relief from the ICSID if its contractual right qualifies as an investment under the BIT between the relevant countries.
- [15] Therefore, companies may have the option to file a lawsuit with ordinary courts on the grounds of a breach of contract or to bring a claim before the ICSID on the grounds of an expropriation.
- [16] However, the two procedures are different in many ways. In a procedure before the ICSID, only monetary claims can be made. The state must compensate the investor for the damage suffered, including the diminishment of the value of the investment as a result of the breach of contract. The ICSID makes its decisions on the basis of international law and the relevant BIT, and will determine the amount of the damage on the basis of the market value of the investment, while national/international private law can be more restrictive. Consequently, the amounts awarded by the ICSID tend to be greater than what national courts would award. However, in-kind rather than monetary compensation can only be sought from state courts or private law arbitration courts.
- [17] A typical case where a breach of contract can coincide with expropriation is where the state or a state entity terminates a contract and does not perform it thereafter. The termination of a contract can be attributed to the state if it is done for public policy reasons.
- [18] Therefore, it is possible that an expropriation that violates the relevant BIT takes the form of a civil law declaration. Consequently, the related claims can be brought before two forums. It is a key matter of distinction how the two procedures relate to each other in terms of: (i) simultaneous proceedings, (ii) the prohibition of overcompensation, and (iii) the issue of *res judicata*.
- [19] BITs generally do not impose strict conditions for filing a request for arbitration with the ICSID. Local remedies do not necessarily have to be exhausted before



such a request is filed; investors can commence the arbitration process once the relevant deadline specified in the BIT expires.

- [20] Consequently, the two procedures may be in progress at the same time. In fact, under the BIT between France and Hungary (which is no longer in effect due to the recent introduction of the relevant EU legislation), investors could file for arbitration by the ICSID if a dispute could not be settled within 6 months after it was initiated. There was no requirement for seeking relief locally; only an attempt at amicable settlement was required. This is why one of the French investors involved in the cafeteria case filed a civil lawsuit against the Hungarian government after the ICSID procedure was commenced, although it was dismissed on the grounds that it was time-barred. So it remained a theoretical issue what would have happened if the court had upheld the investor's claim.
- [21] In the case of the expropriation of contractual rights, the impact that a private law court's decision in favour of the claimant may have on the ICSID's proceedings can also be an important issue. The ICSID acts in its proceedings in accordance with international law. If it finds that a breach of contract was a result of expropriation, it will also have to examine whether the expropriation was followed by prompt, adequate and effective compensation. If the compensation awarded by the private law court does not meet these conditions, the ICSID may award additional compensation to the foreign investor so as to ensure that it receives proper compensation for the damage suffered in connection with its investment.
- [22] It is simpler to adjudge the issue in the reverse case. One of the basic concepts of law is *res judicata*, or claim preclusion. A case qualifies as *res judicata* if a lawsuit between the same parties - concerning the same right and based on the same facts - has been formally commenced or a final and binding judgment has been issued. Hungarian civil procedure law dictates that in such a case, the court will dismiss the claim or terminate the lawsuit.
- [23] Under the convention that constituted the ICSID, each state that is party to it must recognise the ICSID's awards as binding and enforce the obligations imposed by the awards within its territory as if they were final judgments by the courts of that state. Consequently, the ICSID's awards have a binding force and local courts cannot rule on the merits of any case that the ICSID has ruled on. It should be noted also, that an ICSID arbitration procedure and a private law dispute based on the same issue generally do not take place between the same parties, at least formally.
- [24] The respondent in an ICSID procedure is always a "state"; on the other hand, in a private law court, the respondent is a contracting party that can be the state but it is more often an independent legal entity (typically a state-owned company).
- [25] Additionally, the right sought to be enforced can be different in the two procedures; nevertheless, this does not mean that the private law court can adopt its judgment in complete isolation from the ICSID's award. Most legal systems prohibit overcompensation. Section 6:522(3) of the Hungarian Civil Code expresses this principle by stating that the damage suffered must be reduced by any related pecuniary advantage obtained by the injured party. This means that the compensation paid may not result in a situation where the injured party is in better position than they would be if the damage did not occur. In the same vein, if the ICSID awards compensation for a breach of contract, a Hungarian court may

not ignore that award and rule that further compensation is payable for the same breach.

- [26] The ICSID's awards are based on the market value of investments. The more likely scenario is that the compensation awarded by a Hungarian court will fall short of what the ICSID considers adequate.
- [27] It is important to note from a civil law perspective that ICSID's examination is limited to whether an expropriation took place (investment protection rules were violated). Therefore, if the ICSID does not uphold an investor's claim, this does not necessarily mean that a breach of contract (within the meaning of civil law) was not committed. Consequently, a private law court may still award compensation even if the ICSID has ruled that no investment protection rules were violated.
- [28] Another issue is whether a procedure before a private law court can be suspended with regard to the ICSID's proceedings, as the ICSID's award can have a meaningful impact on the court procedure (at least in terms of determining whether the possibility of overcompensation exists).
- [29] Hungarian civil procedure law does not expressly include the pending ICSID procedure as cause of suspension. Subsection (2) of Section 123 of the Act on Civil Procedures provides, however, that the court shall have power to suspend the judicial proceedings if determining the action requires the preliminary judgment of a prior matter for which an administrative action, another civil action or other administrative or civil proceedings falling within the court's competence *are already pending*.
- [30] It should be noted, however, that it is fairly rare for both procedures to be progress at the same time.

Contract termination as expropriation in the ICSID's case law

- [31] A dispute between ADC, a Cyprus-based company, and Hungary concerned the expropriation of a contractual right (**ADC v. Hungary [ARB/03/16]**). The investor concluded a contract with Hungary's Air Traffic and Airport Administration ("**ATAA**") under which the investor was to build Terminal 2B at Ferihegy Airport in return for the right to operate it.
- [32] The Hungarian government then introduced a reform of airport operations and stated that the privatisation of the right to operate the airport had been unlawful. As a result, the contract was terminated and a national regulatory authority took over the operation of the terminal, while ADC lost its concession rights. The ICSID found that that the ATAA's termination of the contract on the basis of a new Government Decree was the consequence of the exercise of the state's sovereign power rather than an act under private law.
- [33] Although the state has sovereign power to adopt legislation, it is limited in its exercise of that power by its international commitments, such as a BIT. An essential requirement for any legislation resulting in expropriation is that it must serve a public interest. In this case, an otherwise well-functioning system had been modified. The Government Decree did not benefit the public in any demonstrable manner. Therefore, the ATAA's action amounted to the expropriation of ADC's concession right in the form of the termination of the contract.



- [34] Saipem, an Italian company, filed an application with the court of arbitration of the International Chamber of Commerce (“ICC”) against Petrobangla, a Bangladeshi state agency, because the latter had not paid certain extra costs incurred by Saipem in the performance of a contract. The ICC ruled against Petrobangla. However, Petrobangla then sought the nullification of the ICC award from the Bangladeshi Supreme Court. The national court upheld this claim and ruled that the arbitration award was null and void.
- [35] Saipem brought a claim to the ICSID, on the grounds that the actions by both Petrobangla and the Bangladeshi Supreme Court deprived it of its right to seek relief in arbitration and its right under the relevant contract to enforce the ICC’s award. Bangladesh argued that the national court had the authority to void the ICC’s award and that the investor should have exhausted local remedies before filing its application with the ICSID.
- [36] The ICSID firstly ruled that there was no requirement for the exhaustion of local remedies. It also held, however, that Petrobangla’s actions did not constitute an expropriation, because its actions could have been performed by any private entity and were not attributable to the state. On the other hand, the Supreme Court did perform an expropriation by voiding the ICC’s award, because it had overstepped its authority in the review of the case. A non-existent award cannot be enforced. Therefore, Saipem’s contractual right to demand the payment of extra costs, which had been upheld by the ICC, were expropriated by the Supreme Court (**Saipem v. Bangladesh [ARB/05/07]**).
- [37] The ICSID ruled that no expropriation occurred in **Convial v. Peru (ARB/10/2)**. The case involved a 30-year concession agreement that was terminated after six years. The agreement concerned the construction and operation of a motorway in Peru.
- [38] Convial performed parts of the project with delays, and therefore the public interest in the continuation of the project lapsed. The agreement included the possibility of termination on the grounds of public interest. Therefore, although the relevant government entity formally acted in the public interest, its termination of the agreement was not attributable to the Peruvian state’s exercise of its sovereign power. It simply exercised its contractual rights when it terminated the agreement.

Conclusion

- [39] As shown above, it is possible that an act or declaration that would generally have a private law nature will be evaluated as falling under public law, and will therefore qualify as a breach of international public law and as expropriation.
- [40] However, certain strict conditions must be met in order for a particular act or declaration to qualify as such, and the ICSID rules in most cases that the disputed actions are not in violation of the relevant BIT.
- [41] In the determination of whether a BIT has been violated, the following questions must be answered:
- Is the relevant civil legal declaration act attributable to the exercise of a state’s sovereign powers?
 - Can the right that is violated be expropriated?
 - Was the investor deprived of its anticipated profits?



- Does the expropriation, if established, qualify as unlawful under the rules of international law?

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The research carried out by Csongor Fillár paralegal, has contributed to this article significantly.

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