



School of International Arbitration

School of International Arbitration, Queen Mary,
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International Arbitration Case Law

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SALUKA INVESTMENTS BV (THE NETHERLANDS)

V.

THE CZECH REPUBLIC

PARTIAL AWARD ON JURISDICTION AND LIABILITY

Case Report by Daniel Brawn**

Edited by Ignacio Torterola***

In its Partial Award on jurisdiction and liability rendered on 17 March 2006, the Tribunal held that it had jurisdiction to hear the Claim but not the Counterclaim; that the Respondent had not breached Article 5 of the bilateral investment treaty between the Netherlands and the Czech Republic; that the Respondent had breached Article 3 of that Treaty; that the question of *quantum* should be addressed in a second phase of the arbitration, for which the Tribunal would determine a timetable separately; the Tribunal reserved the question of costs.

Tribunal: Sir Arthur Watts KCMG QC (Chairman), Maitre L Yves Fortier CC QC, Professor Dr Peter Behrens.

Claimant's Counsel: Mr Jan Paulson and Mr Peter J Turner of Freshfields Bruckhaus Deringer LLP (Paris, France); Professor James Crawford of the Lauterpacht Research Centre for International Law (Cambridge, UK).

Respondent's Counsel: Mr George von Mehren of Squire, Sanders & Dempsey LLP (Cleveland, Ohio, USA); Dr Lubos Tichy of Squire, Danders & Dempset LLP (Prague, Czech Republic).

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Digest

1. Facts of the Case

The arbitration arose from the reorganisation and privatisation of the Czech banking sector following the end of the Communist period in 1990. All four of the major Czech banks faced problems arising from bad debts and the lack of effective legal procedures whereby the banks could enforce payment of the debts. By April 1997, Nomura had acquired almost 10% of the shares in IPB, one of the four major Czech banks, and on March 8, 1998 the Czech government agreed to sell its remaining holding of 36% in IPB to a company within the Nomura Group of companies. The Nomura Group is a major Japanese merchant banking and financial services group of companies, which typically act through subsidiaries established in various countries. The Nomura Europe company that bought the IPB shares transferred them in two tranches on October 2, 1998 and February 24, 2000 to another Nomura subsidiary, Saluka Investments BV ("Saluka"), which was established under the law of the Netherlands. In June 2000, Saluka agreed with Nomura to sell some of its shares, but at the time the arbitration was initiated, Saluka continued to be the registered holder of the IPB shares. It was clear, however, that Saluka's rights of ownership were exercised in accordance with directions given by the Nomura Group.

During the process of privatising IPB's competitors (the other three major banks), the Czech Government provided them with assistance in relation to their bad debt problems and discussed with one of them, CSOB, taking over IPB. On June 1, 2000, the Czech Government informed Nomura that state assistance to IPB would only be forthcoming if Nomura raised its stake in IPB from 46% to 51%. In early June 2000, members of the Czech Government made statements which raised speculation that IPB might be placed in forced administration, which triggered a massive run on IPB. On June 16, 2000, IPB was placed in forced administration and armed police entered IPB's headquarters and physically removed all bank managers. On June 19, 2000, IPB was transferred to CSOB, together with a state guarantee and an indemnity. A Parliamentary Investigation Commission found that this had been carried out unlawfully, but the transfer of IPB to CSOB went ahead nonetheless. A police search of Nomura's Prague offices and seizure of documents on January 30, 2001, was held to have violated Nomura's fundamental rights.

By a notice of arbitration dated July 18, 2001, Saluka commenced arbitration proceedings against the Czech Republic under Article 8 of the Agreement on Encouragement and Reciprocal Protection of Investments Between the Kingdom of the Netherlands and the Czech and Slovak Federal Republic of 1991 ("the Treaty"). Following the separation of the Czech and Slovak States in 1992, the Czech Republic confirmed to the Netherlands that the Treaty would remain in force. By Article 8(5) of the Treaty, the UNCITRAL Arbitration Rules applied.

The parties accepted the *ad hoc* Tribunal's proposal that the registry service for the arbitration should be provided by the Permanent Court of Arbitration ("PCA"), and the PCA agreed to provide such service. Geneva, Switzerland, was selected as the place of arbitration, although this did not preclude the Tribunal from holding meetings in any other place when convenient. The agreed language of the arbitration was English. The procedural meeting was held in London on November 2, 2001. In June 2002 and February 2003, two members of the Tribunal resigned and were replaced by Maitre L Yves Fortier CC QC and Sir Arthur Watts KCMG QC (Chairman) respectively. The oral hearing was held in London from April 8 to 20, 2005.

The substance of Saluka's claim was that the Czech Republic had deprived Saluka of its investment contrary to Article 5 of the Treaty, and that the investment had not been treated fairly and equitably, contrary to Article 3.

The parties agreed to postpone issues of *quantum* of the claim and counterclaim, and the present Award related only to jurisdiction and liability for the Claim.

2. *Legal Issues Discussed in the Decision*

(a) *Jurisdiction to Hear the Counterclaim* (¶¶ 179-182).

Saluka alleged that the Tribunal lacked jurisdiction to hear the Czech Republic's Counterclaim. At a previous hearing, the Tribunal had held that it did not have jurisdiction to hear the Counterclaim, as the real Defendant to the Counterclaim was Nomura. When that issue resurfaced at the hearing, the Tribunal concluded that the issues arising in the Counterclaim were not sufficiently closely connected with the subject matter of the Claim to fall within the Tribunal's jurisdiction under Article 8 of the Treaty (which provided for arbitration).

(b) *Jurisdiction - Notice to Dismiss the Claim* (¶¶ 183-244)

The Czech Republic had filed a Notice to Dismiss the Claim alleging that (a) Nomura did not buy the IPB shares to invest in IPB's banking operations but to facilitate the acquisition of Czech breweries in which IPB held a controlling shareholding; (b) Nomura did not disclose this purpose to the Czech authorities when it purchased the IPB shares; (c) Nomura had thus not acted in good faith and was therefore not a *bona fide* investor; and (d) therefore Saluka, to whom Nomura had transferred its IPB shareholding, was precluded from having recourse to arbitration under the Treaty. Such a Notice to Dismiss is not envisaged in the UNCITRAL Rules. At an earlier procedural meeting the Tribunal had ruled that, because the facts alleged in the Notice to Dismiss were so closely related to the facts alleged in the Claim, the two issues should be ruled upon in the Final Award, which the Tribunal was entitled to do under Article 21.4 of the UNCITRAL Rules.

At the hearing, the Czech Republic elaborated and added fresh arguments, to the effect that the Claim should be dismissed because Saluka was not *bona fide*, that it had no real connection with the Netherlands and was therefore not an “investor”, that Saluka had not made an investment and that real investor was Nomura, which was not an eligible claimant under the Treaty.

Although the Notice to Dismiss was unorthodox and was not worded as an objection to the Tribunal’s jurisdiction, the Tribunal took it as an objection to jurisdiction. The Tribunal held that Saluka was lawfully constituted in the Netherlands, the IPB shares were an “investment,” Saluka was an “investor” within the meaning of the Treaty and was entitled to the protection of the Treaty, and therefore the Tribunal had jurisdiction to hear the Claim. It was not appropriate to pierce the corporate veil in the present case, because the allegations against Saluka of fraud, misfeasance, illegality and lack of good faith had not been made out. However, the Tribunal held that it did not have jurisdiction in respect of any damage suffered by Nomura or in respect of the IPB shares before October 1998, when the bulk of Nomura’s shares became vested in Saluka.

(c) *Saluka’s Claims under Article 5 of the Treaty* (¶¶ 245-278)

Saluka claimed that it had been deprived of its investment, contrary to Article 5 of the Treaty and that the only issue before the Tribunal was whether that deprivation was lawful. By Article 5 of the Treaty, neither party may take any measures depriving investors of their investment unless:

- “(a) the measures are taken in the public interest and under due process of law;
- (b) the measures are not discriminatory;
- (c) the measures are accompanied by provision for payment of just compensation. ...”

Saluka argued that the Czech Republic would be liable if one or more of the conditions set out in Article 5 had not been complied with. The Czech Republic denied violating Article 5, because it was entitled to put IPB into forced administration under Czech law and that this was permissible regulatory action.

The Tribunal agreed that the issue was whether these actions were lawful or not. Article 5 is broadly drafted but it encompasses “the customary international law notion that a deprivation can be justified if it results from the exercise of regulatory actions aimed at the maintenance of public order.” Furthermore, “States are not liable to pay compensation to foreign investors when, in the normal exercise of their regulatory functions, they adopt in a non-discriminatory manner *bona fide* regulations that are aimed at the general welfare.” International law had not yet identified what regulations were or were

not permissible and therefore the Tribunal had to determine whether particular conduct “crossed the line” and became expropriation.

The Tribunal held that the Czech Republic had not crossed the line. Saluka had certainly been deprived of its investment, but there was no evidence to establish that the Czech Republic had acted improperly. The Tribunal held that “the Czech Republic adopted measures which were valid and permissible as within its regulatory powers” and there had been no breach of Article 5.

(d) *Saluka’s Claims under Article 3 of the Treaty* (¶¶ 279-505)

i. *Fair and Equitable Treatment* (¶¶ 285-347).

By Article 3.1 of the Treaty:

“Each contracting party shall ensure fair and equitable treatment of investments of investors of the other Contracting Party and shall not impair, by unreasonable or discriminatory measures, the operation, management, maintenance, use, enjoyment or disposal thereof by those investors.”

By Article 31.1 of the 1969 Vienna Convention on the Law of Treaties, a treaty should be interpreted “in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.” The Tribunal felt that the “ordinary meaning” of the “fair and equitable” standard could only be defined vaguely, in terms of what is “just”, “even-handed”, “unbiased”, “legitimate”, and that infringement required treatment that was so unjust or arbitrary that it rose “to the level that is unacceptable from the international perspective”.

The purpose of the Treaty was to provide reciprocal protection for mutual investments between the Netherlands and the Czech Republic. That called for a balanced approach to the interpretation of the treaty, because to exaggerate the protection to be accorded to foreign investments might serve to dissuade host States from admitting foreign investments and thus undermine the overall aim of extending and intensifying the parties’ mutual economic relations.

“Fair and equitable treatment” is therefore treatment which does not deter foreign capital by providing disincentives to foreign investments, which is linked to the legitimate expectations of the investor, which in turn is linked to good faith, due process, non-discrimination and the stability of the legal and business framework. The host State’s legitimate rights must also be taken into account. The investor is entitled to expect that the host State would not act in a way that was manifestly inconsistent, non-transparent, unreasonable or discriminatory.

The Tribunal found that the Czech Republic had not offered a reasonable justification for IPB's differential treatment and had given a discriminatory response to the bad debt problem, especially by providing state financial assistance to IPB's three main competitors to the exclusion of IPB, thereby creating an environment impossible for the survival of IPB.

ii. *Failure to Ensure a Predictable and Transparent Framework (¶¶ 348-360).*

The Czech Republic would have failed to ensure a predictable and transparent framework for Saluka's investment if it had frustrated Saluka's legitimate expectations regarding the treatment of IPB without reasonable justification.

Saluka had no basis for expecting that there would be no future change in the Government's policy towards the banking sector's bad debt problem, but in any event this was in effect the same as the claim under Article 5 that had already been dealt with.

It was true that Saluka could not have anticipated the discriminatory way in which the Government would respond to the distress suffered by the banking sector, by excluding IPB from the state assistance that was accorded to the other three big banks, but this too had already been dealt with under Article 5.

There was no legitimate expectation that the inadequate mechanism in Czech law for enforcing loan security would be fixed quickly and the Czech Republic had not violated the "fair and reasonable treatment" standard in this regard.

iii. *Refusal to Negotiate in Good Faith (¶¶ 361-432).*

The Czech Republic had failed to deal with IPB and Saluka in an unbiased, even-handed, transparent and consistent way and unreasonably refused to communicate in an adequate manner. Indeed, three months before the forced administration was imposed on IPB, the Czech Minister of Finance "simply gave up communicating directly" with Saluka.

iv. *Financial Assistance to IPB after Acquisition by CSOB (¶¶ 433-447).*

The Czech Republic had granted massive financial assistance to IPB after the forced administration, but the Tribunal held that this was not a breach of Article 3.1 of the Treaty. The unlawfulness of a State's measures under its own legislation or under an international agreement by which it is bound is insufficient to establish a breach of Article 3.1 of the Treaty. Instead, the conduct must be assessed in the light of the Treaty's own "fair and equitable treatment" standard. Therefore, the legality of the financial assistance was not relevant and the only question was whether it was fair and equitable. This does not preclude stated aid, but that aid must not frustrate the investor's legitimate expectation to

be treated fairly and equitably. At the time the financial assistance was given, IPB had already lost its banking business to CSOB and therefore its shareholders did not suffer any harm in addition to that already caused by the forced administration and subsequent loss of the banking business.

v. *Unjust Enrichment of CSOB at the Expense of Saluka* (§§ 448-456).

For this, there must be enrichment of one party to the detriment of the other, and both arising as a consequence of the same act or event, with no justification and no contractual or other remedy available to seek compensation from the party enriched. In the present case, it was not the Czech Republic but CSOB that had received IPB's banking business.

However, Saluka argued that the Czech Republic would be liable if it had actively participated in a conspiracy to enrich CSOB at the expense of IPB by using regulatory powers to effect an illegal transfer of ownership in IPB's business. The Tribunal found this argument ill-founded, stretching the principle of unjust enrichment beyond its proper scope.

Since there was no enrichment of the Czech Republic to the detriment of Saluka, it was not for the Tribunal to assess the validity of the transfer of IPB's banking business, questionable though the transfer may be.

vi. *Non-Impairment* (§§ 457-470).

Saluka based its claim not only on the "fair and equitable treatment" provision in Article 3.1 of the Treaty but also on the "non-impairment" provision, which relates to measures taken by the host State that have a negative impact on the operation and enjoyment of the investment without reasonable justification. By violating the "fair and equitable treatment" standard in Article 3, and by its discriminatory response to Saluka, and by its refusal to negotiate in good faith, the Czech Republic had also violated the non-impairment obligation. "There can be no doubt that the Czech Republic's discriminatory response ... and its unfair and inequitable treatment of IPB regarding the provision of state aid as well as its refusal to negotiate in good faith on the proposals made by IPB ... had a detrimental impact upon IPB and Saluka's shareholding in IPB. The unlawful conduct of the Czech government contributed to the aggravation of IPB's financial distress and to its subsequent failure and thereby impaired Saluka's beneficial use of and interest in its shareholding in IPB."

vii. *Triggering the Run on IPB Shares* (§§ 471-481).

The Tribunal held that the Czech Republic unreasonably spread to the public negative information on IPB, which aggravated IPB's financial distress and contributed to its subsequent failure. The question was whether this caused IPB's forced administration. The public would have had some awareness of

IPB's problems but it was quite another matter for them to be informed that IPB's failure was imminent and its forced administration was unavoidable. Furthermore, there was some indication that Government sources deliberately engineered circulation of negative information about IPB in order to precipitate its failure. This conduct of the Government was "unjustifiable and unreasonable and contributed in all probability to the unsustainability of IPB's situation."

viii. *Provision of Full Protection and Security* (¶¶ 482-496).

Saluka claimed that the Czech Republic had also violated its obligation under Article 3.2 of the Treaty, which provides that Contracting States should accord "full security and protection" to investments covered by the Treaty. This standard applies when the foreign investment has been affected by civil strife and physical violence, in relation to which the host State must show that it has taken all measures of precaution to protect the investment. The standard is not one of strict liability but of due diligence and the host State must adopt all reasonable measures to protect the assets from threats or attacks which may target foreigners. Saluka argued that the Czech Republic had breached this requirement by its oppressive use of public powers with a view to depriving Saluka of any residual economic benefit in its investment. The Tribunal held that this claim was without merit. The Czech Republic's actions were not without legitimate concern for the securities market, were justified on regulatory grounds and could not be said to be totally unreasonable and unjustified. There was no procedural denial of justice that violated the Czech Republic's Treaty obligations.

ix. *Conclusion* (¶¶ 497-505).

The Czech Republic had violated the "fair and equitable treatment" obligation by according IPB differential treatment and by unreasonably frustrating IPB's good faith efforts to resolve its bad debt crisis. There was also a violation of the "non-impairment" obligation, firstly on the same grounds that led the Tribunal to find a violation of the "fair and equitable treatment" standard and secondly by the circulation of negative information about IPB.

The Czech Republic had not violated Article 3.1 by a failure to ensure a predictable and transparent framework for Saluka's investment, nor did it violate Saluka's legitimate expectations. The provision of financial assistance to CSOB did not violate the "fair and equitable treatment" obligation and there was no unjust enrichment of CIOB. There was also no breach of the "full security and protection" obligation.

(e) *Other Matters* (¶¶ 506-510)

Saluka had considered it appropriate to postpone issues of the appropriate redress and the *quantum* of the loss it had suffered for the breach of Article 3,

until liability had been decided. It would therefore be necessary to address these questions in a second phase of the arbitration. Pursuant to Article 32.1 of the UNCITRAL Rules, the Tribunal rendered this partial Award and retained jurisdiction for the second phase, arrangements for which would be made.

Bearing in mind Article 38 of the UNCITRAL Rules, the Tribunal would address the question of costs in its final decision at the conclusion of the second phase of the arbitration.

3. *Decision* (¶¶ 511)

For the foregoing reasons, the Tribunal held that:

- a. it had jurisdiction to hear Saluka's claim;
- b. the Czech Republic had not acted in breach of Article 5;
- c. the Czech Republic had acted in breach of Article 3;
- d. questions of redress and *quantum* would be addressed in a second phase of the arbitration;
- e. the Tribunal would separately determine the timetable for the second phase;
- f. the Tribunal reserved questions of costs until final consideration could be given to the costs of the arbitration as a whole.