DOI https://doi.org/10.30525/2592-8813-2023-1-8

THE ROLE OF THE STATE IN INTERNATIONAL INVESTMENT ARBITRATION IN CONNECTION WITH THE ARMED CONFLICT

Kateryna Rashevska,
Postgraduate Student at the Department of International Law,
Taras Shevchenko National University of Kyiv (Kyiv, Ukraine)
ORCID ID: 0000-0001-9090-1934
c.rashevska@gmail.com

Abstract. This article deals with the characteristics of using international investment arbitration as a mechanism for obtaining redress for damages caused during Russian aggression. Taking into account certain shortcomings of this legal remedy, the author highlights the State's role in leveling issues related to arbitration costs and protecting the rights of small and medium-sized enterprises. The article contains an analysis of the subrogation clause in the Agreement between the Government of the Russian Federation and Cabinet of Ministers of Ukraine on encouragement and mutual protection of investments of November 27, 1998, as well as an alleged procedure for its implementation. The existing practice of horizontal investment lawsuits is also disclosed as an alternative. The author cites the existing practice of interpreting the Agreement on the example of investment arbitrations in the so-called "Crimean cases," demonstrating its relevance for subjects in the newly occupied territories. The article includes a summary of the advantages and disadvantages of international investment arbitration in the Ukrainian context and the author's recommendations on non-standard methods of obtaining compensation in the context of an international armed conflict.

Key words: international investment arbitration, aggression, subrogation, horizontal lawsuits, compensation.

Introduction. As of November 2022, more than 140 Ukrainian enterprises were damaged due to the full-scale invasion. The losses caused to Ukrainian businesses reached at least $9.9 billion and continue to grow (Bielova Yu., 2022). International law guarantees the protection of property rights in peacetimes and during the war, providing several institutional mechanisms competent to address the issue of reparation for damage. However, such mechanisms are limited in the armed conflict between the Russian Federation and Ukraine since most international institutions lack jurisdiction to consider cases against the aggressor State.

One of the few options is international investment arbitration following the Agreement between the Government of the Russian Federation and Cabinet of Ministers of Ukraine on encouragement and mutual protection of investments of November 27, 1998 (Pro zaokhochennia ta vzaiemnyi zakhyst investytsii, 1998). Nonetheless, even in the case of its application, there remain obstacles to protecting the rights of small and medium-sized enterprises, which requires a more active role of Ukraine as the State of origin of the investment.

The key research question of this study was the international mechanisms of compensation for damage caused in connection with the armed conflict, in particular, investment arbitration under the Agreement between Ukraine and the Russian Federation on encouragement and mutual protection of investments as a means of protecting the rights of Ukrainian entrepreneurs.

Previous studies have reported the role and significance of international investment arbitration as a compensation mechanism, particularly in the context of an international armed conflict. Such surveys were conducted by Gaukrodger D. (2016), Yurlov M. (2018), Bielova Yu. (2022), Klymchuk A. (2022). However, research has consistently shown that these studies lack highlighting the role of the State through the implementation of the subrogation clause and horizontal lawsuits.

The purpose of the work is to analyze options for the State's participation in international investment arbitration to protect investors' rights in armed conflict conditions. The objectives of this research are

– to characterize the Agreement between Ukraine and the Russian Federation;

– to analyze the advantages and disadvantages of using investment arbitration as a compensation mechanism in the context of Russian aggression;

– to determine and provide recommendations regarding the use of subrogation mechanisms and horizontal lawsuits by Ukraine to protect the rights of investors.

Material and research methods. The research is critical in nature. It is conducted in the pragmatic paradigm through economic analysis of law (EAL).A combination of quantitative and qualitative approaches was used in the data analysis. Case studies have been established to present detailed characteristics of the relevance of existing awards of investment arbitrations regarding territories of Ukraine occupied since 2014 for newly occupied territories.

Results of the study. In general, bilateral investment treaties (hereinafter – BIT) provide for two dispute resolution mechanisms:

– between the investor and the host State;

– between the State of origin of the investment and the host State.

The differences between these mechanisms are not only in the subject with *locus standi* but also in the scope of a legal right or obligation: interstate disputes, as a rule, involve the interpretation and application of BIT exclusively. In addition, BITs can also provide for a subrogation mechanism, which transfers the right of claim by the investor to the state that acquired such right. Thus, subrogation allows the state of origin of investments to «stand in the place» of the investor, stating that he is compensated for losses caused by the actions of the host state.

The Agreement between the Government of the Russian Federation and Cabinet of Ministers of Ukraine on encouragement and mutual protection of investments enshrines the possibility of judicial settlement, both between the investor and the host state (Article 9) and contracting states (Article 10) (Pro zaokhochennia ta vzaiemnyi zakhyst investytsii, 1998).

In the case of the international armed conflict caused by the aggression of the Russian Federation against Ukraine, compensation in investment arbitration is one of the most promising mechanisms for covering the damages. The subjects of the initiation of the review are mainly Ukrainian legal entities whose assets were destroyed/expropriated due to the actions of the Russian Federation in occupied territories.

In order to use arbitration as a legal remedy, investors need to prove that the Russian Federation exercised effective control over the temporarily occupied territory where their rights were violated. It will be easier to do if the event giving rise to such a violation occurred after the annexation on September 30, 2022. At the same time, according to Mr. Yurlov, the arbitration court will be able to apply an expanded interpretation of the concept of «territory» in the BIT, taking into account not only the official territory but also de facto controlled territory, similar to the Crimean cases, even without official recognition of such control from the side of the Russian Federation [...]. Accordingly, Russia may be liable for all damages (including lost profits) caused to investors due to expropriation and/or destruction of investments (Yurlov M., 2018).

The advantages of investment arbitration in the Ukrainian context are:

1) full compensation for damages (Factory at Chorzow, 1928), as a principle guiding investment arbitrations, awarding compensation for both the actual amount of lost assets and lost profits;

2) the presence of a methodology for assessing the damage caused («discounted cash flow», «comparison with similar companies») in contrast to other international judicial bodies, in particular, the International Court of Justice of the United Nations;

3) lack of a temporal criterion of admissibility: unlike the European Court of Human Rights, the statute of limitations is not defined by specific terms;

4) the possibility of enforcement of the investment award in 167 states-parties of the UN Convention on the Recognition and Enforcement of Arbitral Awards (the so-called New York Convention of 1958) at the cost of the assets of the Russian Federation;

5) a variety of protection regimes that can be applied to cases of expropriation, forcible seizure of enterprises, theft, and removal of assets, as well as the intentional destruction of property in temporarily occupied territories.

The disadvantages of investment arbitration as a compensation mechanism are:

– the high cost of the legal process, which varies from 4 to 5 million dollars;

– damage caused during the active phase of the armed conflict on the territories controlled by Ukraine, as well as on disputed territories over which neither party has control (the so-called war clause) (Klymchuk A., 2022), is not subject to BIT.

Suppose the circumvention of the war clause is possible only partially in cases where the Russian Federation itself declares at the official level to establish control over some territory (often even when it does not belong to it). In that case, the costs of arbitration, especially for small and medium-sized enterprises, can be circumvented by subrogation.

Article 8 of the BIT between Ukraine and the Russian Federation contains the following provision on subrogation:

"The Contracting Party or an agency duly authorized by it which has made a payment to the investor on the basis of a guarantee against non-commercial risks in connection with its investments on the territory of the other Contracting Party , shall be entitled to exercise by way of subrogation, the investor's rights in the same scope as the investor itself. Such rights shall be exercised in accordance with the legislation of the latter Contracting Party" (Pro zaokhochennia ta vzaiemnyi zakhyst investytsii, 1998).

In the context of subrogation, it is necessary to analyze in more detail the conditions under which the state can buy the right of claim from the investor, in particular, making a payment based on a guarantee against non-commercial risks.

According to Article 19 of the Law of Ukraine «On Investment Activities,» «the governmental guarantees of protection of investments shall be the system of legal norms, which are aimed at protection of investments and which are not connected with the issues of financial and economic activity of participants of the investment activity and with payments of taxes, duties (compulsory payments) by such participants» (Pro investytsiinu diialnist, 1991). The mentioned protection is provided to national and foreign investors, particularly concerning damages (Khrimli O., 2016).

The legislation of Ukraine in the investment sphere does not contain a definition of «non-commercial risks.» However, Article 1 of the Law of Ukraine «On Ensuring the Large-Scale Expansion of the Export of Goods (Works, Services) of Ukrainian Origin through Insurance, Guaranteeing and Cheapening of Export Crediting» foresees among such risks «the emergence of an armed conflict, the conduct of hostilities, an uprising, revolution, mass unrest, strikes» (Pro zabezpechennia masshtabnoi ekspansii eksportu tovariv (robit, posluh) ukrainskoho pokhodzhennia shliakhom strakhuvannia, harantuvannia ta zdeshevlennia kredytuvannia eksportu, 2016).

Ukraine or a body authorized by it, for example, a special fund, can make a payment to the investor based on a guarantee against non-commercial risks and, in the future – demand compensation from the Russian Federation in the same amount as the investor himself. In such a case, the state has the right to file a «consolidated» claim with one of the bodies specified in Part 2 of Article 9 of the BIT, namely:

a) a competent court or an arbitration court of the Contracting Party, on whose territory the investments were carried out;

b) the Arbitration Institute of the Chamber of Commerce in Stockholm,

c) an «ad hoc» arbitration tribunal, in conformity with the Arbitration Regulations of the United Nations Commission for International Trade Law (UNCITRAL).

The final binding decision obtained as a result of the judicial proceedings may become the basis for confiscating sovereign Russian assets frozen on the territory of foreign countries in compliance with the principle of jurisdictional immunity of state property.

It is important to emphasize that states have never initiated legal proceedings under the subrogation mechanism in the BIT. The reason for this was the reluctance to cause such proceedings to harm diplomatic relations. However, the latter have been torn between Ukraine and Russia since the start of the full-scale invasion last February 24, 2022.

The problematic point of using the mechanism of subrogation is the actual conceptual return to the doctrine of diplomatic protection, from which states have deliberately departed in their investment activity. Although the International Court of Justice of the United Nations clarified in the decision on the Avena case that a violation of the rights of an individual could entail a violation of the rights of the State of origin of investment and vice versa, and, therefore, the State of origin of investment can simultaneously file lawsuits both on its behalf and on behalf of its citizens, a more desirable form of protection of the violated right is a vertical lawsuit: from the investor to the host State. Moreover, according to the Drago-Porter doctrine, states cannot impose diplomatic, military, or other sanctions against each other to collect debts.

In this case, an alternative to subrogation is a horizontal lawsuit: from the State of origin of investment to the host State. In the history of international investment arbitration, there have already been relevant cases, among which the most interesting is the process between Peru and Chile. The dispute concerned an alleged violation of the rights of a Chilean investor, the owner of Empresas Lucchetti S.A. It was related to the closure of a pasta factory situated in an area designated by local Peruvian authorities as an ecological reserve. In the early 2000s, Chile initiated arbitration proceedings against Peru. The dispute was based on the interpretation of the BIT dated February 2, 2000. The fundamental goal of Chile was to extend the temporal validity of the Treaty so that the owner of Empresas Lucchetti S.A. was entitled to compensation from Peru. At the same time, the investor himself initiated a vertical proceeding in the Ministry of Internal Affairs and Communications. The last arbitration was faster. The decision was not made in favor of the owner of Empresas Lucchetti S.A., which led to Chile's rejection of its own claims in the interstate dispute (Gaukrodger, D., 2016). At the same time, if the State and the investor chose only one of the mechanisms, the decision could be different.

It should be emphasized that Ukrainian investors have repeatedly used investment arbitration as a means of obtaining compensation for the actions of the Russian Federation aimed at violating property rights. About 10 cases related to the temporary occupation of the Crimean Peninsula were referred for consideration within the framework of the last option provided for in Article 9 of the BIT between Ukraine and Russia, namely to ad hoc arbitration courts. In each of the cases, the investors were awarded compensation. However, the Russian Federation not only did not pay it but is also trying to challenge the arbitration decision in national courts (Yurlov M., 2018). On March 30, 2021, the Paris Court of Appeal rejected the decision of the arbitration tribunal dated November 26, 2018, in the Oschadbank case. For a long time, the Russian Federation tried to pass off this fact as a «precedent,» realizing that arbitrations would continue to award compensation to investors. However, on December 7, 2022, the Court of cassation overturned the Paris Court of Appeal decision. It upheld the award of the arbitration tribunal on the recovery from the Russian Federation in favor of Oschadbank of $1.1 billion, excluding penalties from the moment of the decision until the time of actual compensation (Interfax-Ukraine, 2022).

Conclusions. A significant number of victims of Russian aggression, together with considerable damage caused as a result of international crimes committed by Russians, actualize the search for atypical, sometimes innovative mechanisms for receiving compensation. In the case where the defendant in potential cases is the Russian Federation, the list of possible competent institutions is limited, and those that will provide an effective and operational result are exhaustive. One of these mechanisms is international investment arbitration, which in the Ukrainian context has several advantages and certain disadvantages that can be eliminated by intensifying the State's role.

Subrogation and horizontal lawsuits are specific methods of involving the State of origin of investment in international investment arbitration following the Agreement between the Government of the Russian Federation and Cabinet of Ministers of Ukraine on encouragement and mutual protection of investments. Their use, as evidenced by the existing judicial practice, will contribute to obtaining compensation for a significant number of victims, including small and medium-sized enterprises, which are more vulnerable than large businesses in connection with the cost of proceedings. Russian assets frozen abroad, confiscated, and repurposed in the process of recognition and enforcement of the investment arbitration award can be a source of compensation.

References:

1. Bielova Yu. (2022). Biznes hotuie pozovy proty rosii za znyshchene maino, a Fond derzhmaina dopomahaie otsinyty zbytky. Yak vin tse robyt [The business is preparing lawsuits against Russia for the destroyed property, and the State Property Fund is helping to assess the damage. How does he do it?]. *Ukrinform.* Retrieved from: https://www.ukrinform.ua/rubric-society/3630026-biznes-gotue-pozovi-proti-rosii-za-znisene-majno-a-fond-derzmajna-dopomagae-ociniti-zbitki-ak-vin-ce-robit.html [in Ukrainian].
2. Uhoda mizh Kabinetom Ministriv Ukrainy i Uriadom Rosiiskoi Federatsii pro zaokhochennia ta vzaiemnyi zakhyst investytsii vid 27 lystopada 1998 roku [Agreement between the Government of the Russian Federation and Cabinet of Ministers of Ukraine on encouragement and mutual protection of investments of November 27, 1998]. Retrieved from: https://zakon.rada.gov.ua/laws/show/643_101#Text [in Ukrainian].
3. Yurlov M. (2018). Zakhyst investytsii na okupovanykh terytoriiakh [Protection of investments in occupied territories.]. *Yur-Gazeta*, 21, 623–624. Retrieved from: https://yur-gazeta.com/publications/practice/mizhnarodne-pravo-investiciyi/zahist-investiciy-na-okupovanih-teritoriyah.html [in Ukrainian].
4. Factory at Chorzow (Merits), 1928, P.C.I.J. Series A, № 17, p. 21.
5. Klymchuk A. (2022). Mizhnarodnyi investytsiinyi arbitrazh yak odyn iz mekhanizmiv vidshkoduvannia zbytkiv [International investment arbitration as one of the compensation mechanisms]. *Ukrainska pravda*. Retrieved from: https://www.epravda.com.ua/columns/2022/07/22/689520/ [in Ukrainian].
6. Zakon Ukrainy «Pro investytsiinu diialnist» vid 18 veresnia 1991 roku [Law of Ukraine "On Investment Activity" of September 18, 1991]. Retrieved from: https://zakon.rada.gov.ua/laws/show/1560-12#Text [in Ukrainian].
7. Khrimli O. (2016). Derzhavni harantii yak sposib zakhystu prav investoriv [State guarantees as a way of protecting the rights of investors]. *Pidpryiemnytstvo, hospodarstvo i pravo*, 2/2016. Retrieved from: http://pgp-journal.kiev.ua/archive/2016/02/12.pdf [in Ukrainian].
8. Zakon Ukrainy «Pro zabezpechennia masshtabnoi ekspansii eksportu tovariv (robit, posluh) ukrainskoho pokhodzhennia shliakhom strakhuvannia, harantuvannia ta zdeshevlennia kredytuvannia eksportu» vid 20 hrudnia 2016 roku [Law of Ukraine “On Ensuring the Large-Scale Expansion of the Export of Goods (Works, Services) of Ukrainian Origin through Insurance, Guaranteeing and Cheapening of Export Crediting” of December 20, 2016]. Retrieved from: https://zakon.rada.gov.ua/laws/show/1792-19#Text [in Ukrainian].
9. Gaukrodger D. (2016). State-to-State dispute settlement and the interpretation of investment treaties. *OECD Working Papers on International Investment*, 2016/03, OECD Publishing, Paris. Retrieved from: https://doi.org/10.1787/5jlr71rq1j30-en
10. Verkhovnyi sud Frantsii zalyshyv u syli rishennia Mizhnarodnoho arbitrazhu pro stiahnennia $1,1 mlrd z RF na koryst Oshchadbanku za Krym. Interfax-Україна [The Court of cassation of France upheld the decision of the International Arbitration on the recovery of $1.1 billion from the Russian Federation in favor of Oschadbank for Crimea]. *Interfax*. Retrieved from: https://interfax.com.ua/news/general/876948.html [in Ukrainian].