

**THE SCOPE OF APPLICATION OF ARTICLE 17 OF THE ENERGY  
CHARTER TREATY**

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The *Energy Charter Treaty* (the “ECT” or the “Treaty”) is a distinct multilateral treaty confined to the energy sector. The *ECT* was negotiated in a relatively short period of time - given the importance and scope of the Treaty (less than three years) - and contains, besides the provisions on trade and transit in the energy sector, modern provisions regarding protection of investments and dispute resolution settlement. *Part III* of the *ECT* on the investment promotion and protection recalls the substantive protection offered by modern bilateral and multilateral investment/trade agreements. The article examines the so-called “denial of benefits” clause under Article 17 of the *ECT*. The “denial of benefits” clause was inserted in investment treaties for at least two purposes: to maintain reciprocity or asymmetry with regard to the benefits arising out of the protection offered by investment treaties; and to exclude from the protection of the treaties the so called “shell companies”. The first part of the article will take a brief look at the historical evolution of the clause and how it was approached by the *ICSID* tribunals. In the second part will be found succinct considerations as to the scope and interpretation of the Article 17 of the *ECT*, as well as the approach taken by the arbitral tribunals on the application of the “denial of benefits” clause under the *ECT*.

**I. “Denial of benefits” clause: An overview**

**1. *Evolution of the “denial of benefits” clause in international law on foreign investments. Treaties of Friendship, Commerce and Navigation. Bilateral and Multilateral Investment/Trade Treaties***

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From the historical perspective of the international law on foreign investments, the purpose of the “denial of benefits” clause was to exclude third-parties claiming the benefits of the Treaty without assuming the obligations therein, including the “enemy companies”. Originally used to deny diplomatic protection, the clause was later imported in the treaties concerning protection of foreign investments.

In 1956, *Walker Jr.*, while discussing the provision on companies in the US treaties, explained the “denial of benefits” provision as a safeguard against “free riders” – nationals of third countries - who would gain rights or interests despite the fact that the Contracting States to the treaty did not wish to accord them.<sup>1</sup> Referring to the “denial of benefits” clause contained in the early *Treaties of Friendship, Commerce and Navigation* (FCNs) signed by the US, *Walker Jr.* described them as “a latent protective clause which a party may utilize if it wishes to take the initiative of so doing.”<sup>2</sup> In 1990, *Salacuse* noted that it is a basic task of the *Bilateral Investment Treaties* (BITs) to determine whether an investor has a sufficient link to a treaty country. Determining which investors are covered by the treaty “also reveals the asymmetry in the relationship between the two countries”<sup>3</sup>. According to *Salacuse*, allowing the benefits of the *BITs* to nationals of thirds countries or which are “primarily associated” with these countries and with which the denying country has no relationship, would be “to abandon [...] right to negotiate corresponding privileges and obligations from those countries.”<sup>4</sup> The “denial of benefits” clause is therefore seen as a safety measure for safeguarding the principle of reciprocity embodied in investment treaties.

In 2008, *Dolzer and Schreuer* consider the “denial of benefits” right as a “method to counteract nationality planning”.<sup>5</sup> States often oppose investor’s nationality planning by inserting certain requirement in the *BITs*. Some *BITs* “require a bond of economic

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<sup>1</sup> *Provisions on Companies in United States Commercial Treaties*, Walker Jr., H, The American Journal of International Law, vol. 50, no. 2, April 1956, p. 388.

<sup>2</sup> *Idem. Walker Jr.* also points out that the clause (or “reservation”, as he calls it) is “directed primarily at the exercise by a company of its “functional” rather than its “civil” capacity.” That is to say, the fact that the State denies the benefits of the investment treaty does not trigger the denial of nationality or existence of the respective entity, nor – as expressly mentioned in some *FCNs*, as it will shown below – the access of these entities to courts.

<sup>3</sup> *BIT by BIT: The Growth of Bilateral Investment Treaties and Their Impact of Foreign Investment in Developing Countries*, Salacuse, J.W., The International Lawyer, vol. 24, no. 3, p. 665.

<sup>4</sup> *Idem.*

<sup>5</sup> *Principles of International Investment Law*, Dolzer, R, Schreuer, C, Oxford University Press, 2008, p. 55.

substance between the corporation and the state”<sup>6</sup>, while others insert the “denial of benefits” clause. *Dolzer and Schreuer* explain the denial clause as follows:

Under such a clause the states reserve the right to deny the benefits of the treaty to a company that does not have an economic connection to the state on whose nationality it relies. The economic connection would consist in control by nationals of the state of nationality or in substantial business activities in that state.<sup>7</sup>

The “denial of benefits” clause seems to have its origins in the *FCNs* concluded by the US after 1945.<sup>8</sup> Later on, the clause was introduced in modern bilateral and multilateral investment treaties.

The *Treaty of Friendship, Commerce and Navigation between US and China* signed in 1946 states that

[...] each High Contracting Party reserves the right to deny any of the rights and privileges accorded by this Treaty to any corporation or association created or organized under the laws and regulations of the other High Contracting Party which is directly or indirectly owned or controlled, through majority stock ownership or otherwise, by nationals, corporations or associations of any third country or countries.<sup>9</sup>

Similarly, the *Treaty of Amity and Economic Relations with Thailand* signed in 1966 provides that nothing shall preclude the denial of the advantages of the Treaty to

[...] any company in the ownership or direction of which nationals of any third country or countries have directly or indirectly the controlling interest.<sup>10</sup>

However, this denial of benefits clause does not apply to

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<sup>6</sup> *Principles of International Investment Law, Supra*, p. 55.

<sup>7</sup> *Principles of International Investment Law, Supra*, p. 55.

<sup>8</sup> In pre-1945 *FCNs* we can find incipient forms of the “denial of benefits” clause. For example, *The Treaty of Friendship, Commerce and Navigation, with Final Protocol between the United States of America and Siam*, signed on 13 November 1937, provides in Article 1(8) that “neither High Contracting Party shall be required by anything in this paragraph to grant any application for any such right or privilege [exploration and exploitation of mineral resources] if at any time such application is presented the grating of all similar applications shall have been suspended or discontinued.”

<sup>9</sup> *Treaty of Friendship, Commerce and Navigation between the United States of America and the Republic of China*, signed on 4 November 1946 and entered into force on 30 November 1948; *The American Journal of International Law*, vol. 43, no. 1, Supplement: Official Documents, January 1949, pp. 27-52, Article XXVI(5).

<sup>10</sup> *Thailand – U.S. Treaty of Amity and Economic Relations*, signed on 29 May 1966, 5 *International Legal Materials* 1966, Article XII(1)(f).

[...] recognition of judicial status and with respect to access to courts of justice and administrative tribunals and agencies.<sup>11</sup>

In an early commentary of the US BITs it is mentioned that the purpose of the “denial of benefits” clause is to “allow either party to determine whether to extend treaty benefits when involvement by nationals of either party is relatively minor”.<sup>12</sup> The clause is often inserted in the definition part of the Treaties or sometimes as a distinct article.<sup>13</sup>

The “denial of benefits” clause was included in the *1994 US Model BIT* and reads as follows:

Each Party reserves the right to deny to a company of the other Party the benefits of this Treaty if nationals of a third country own or control the company and

- a) the denying Party does not maintain normal economic relations with the third country; or
- b) the company has no substantial business activities in the territory of the Party under whose laws it is constituted or organized.<sup>14</sup>

In a commentary preceding the text of the *US-Jordan BIT*, concluded based on the *1994 US Model BIT*, the US explains that “a non-Party country with which the denying Party does not have normal economic relations” include, for example, a country to which US is applying economic sanctions (e.g. Cuba).<sup>15</sup> A clarification is provided for the second paragraph of the clause. According to the commentary, “this

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<sup>11</sup> *Idem*. The same provision can be found in Article XIII(1)(e) of the *Treaty of Amity and Economic Relations between the United States of America and the Togolese Republic*, signed on 8 February 1966.

<sup>12</sup> *The U.S. Bilateral Investment Treaty Program*, Gann, P.B., 21 *Stanford Journal of International Law* 1985, p. 379-380.

<sup>13</sup> For instance, both *1994 and 2004 US Model BIT* assigned a separate article for this clause (Article XXII and Article 17, respectively). However, some *BITs* signed by the US in 1993-1994 contain the “denial of benefits” clause in the article reserved for definitions. For example, *The Treaty between United States of America and the Republic of Kyrgyzstan concerning the Encouragement and Reciprocal Protection of Investment* signed on 19 January 1993 provides under Article I(2) that “[e]ach party reserves the right to deny to any company the advantages of this Treaty if nationals of any third country control such company and, in the case of a company of the other Party, that company has no substantial business activities in the territory of the other Party or is controlled by nationals of a third country with which the denying Party does not maintain normal economic relations.”

<sup>14</sup> *1994 US Model BIT in International Investment Arbitration. Substantive Principles*, McLachlan, C, Shore, L, Weiniger, M, Oxford University Press, 2007, Appendix 5, pp. 386-392.

<sup>15</sup> The commentary and the text of the *Treaty between the Government of the United States of America and the Government of the Hashemite Kingdom of Jordan concerning the Encouragement and Reciprocal Protection of Investment*, signed on 2 July 1995, are available at <http://www.state.gov/documents/organization/43565.pdf>.

provision would not generally permit the United States to deny benefits to a company of Jordan that maintains its central administration or principal place of business in the territory of, or has a real and continuous link with, Jordan”.<sup>16</sup>

The *2004 US Model BIT* provides for a more elaborate clause, in line with the provisions of the *FTAs* signed by the US after 1994:

1. A Party may deny the benefits of this Treaty to an investor of the other Party that is an enterprise of such other Party and to investments of that investor if persons of a non-Party own or control the enterprise and the denying Party:
  - a) does not maintain diplomatic relations with the non-Party; or
  - b) adopts or maintains measures with respect to the non-Party or a person of the non-Party that prohibit transactions with the enterprise or that would be violated or circumvented if the benefits of this Treaty were accorded to the enterprise or to its investments.
2. A Party may deny the benefits of this Treaty to an investor of the other Party that is an enterprise of such other Party and to investments of that investor if the enterprise has no substantial business activities in the territory of the other Party and persons of a non-Party, or of the denying Party, own or control the enterprise.

Both *US Model BITs* deny the benefits of the Treaty. The wording can be explained bearing in mind the structure and content of a *BIT*. Unlike *Free Trade Agreements* (FTAs) or other Multilateral Treaties which contain only limited provisions in respect to investments<sup>17</sup>, *BITs* include exclusively provisions with regard to investments. This is the reason why the first ones limit the applicability of the clause only to the section or chapter regulating the investment related issues. Quite often, these treaties include the investor-state dispute resolution mechanism with regard to protection of investments in the same section or chapter with the “denial of benefits” clause.

In line with the US policy, the *United States-Australia Free Trade Agreement* (US-Australia FTA) provides for the same “denial of benefits” clause as the one contained in the *2004 US Model BIT*.<sup>18</sup>

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<sup>16</sup> *Idem*.

<sup>17</sup> For example, the Energy Charter Treaty regulates four areas in the energy sector: investments, trade, transit and dispute settlement.

<sup>18</sup> *The United States-Australia Free Trade Agreement* signed on 18 May 2004 and entered into force on 1 January 2005, Article 11.12. It should be mentioned that the “denial of benefits” provision is contained in Chapter 11 of the *FTA*, while the dispute settlement provisions are laid down in Chapter 21. Interesting however, Chapter 11 makes an indirect reference to Chapter 21 by including a provision regarding consultations to be carried out by the Parties prior to any investor-state dispute settlement.

A similar provision is found in the *Agreement between Japan and the United Mexican States for the Strengthening of the Economic Relationship* (Japan-Mexico FTA). The *Japan-Mexico FTA* contains an additional requirement on behalf of the Contracting Parties: the denial of benefits clause where the investor has no substantial business in the territory of the Contracting Party may only operate subject to prior notification and consultation.<sup>19</sup> An identical “denial of benefits” clause is contained in the *CAFTA/DR*.<sup>20</sup>

The “denial of benefits” clause is no longer a feature of investment treaties signed by the US. For instance, the *Jordan-Austria BIT* provides that a Contracting Party may deny the benefits of the Agreement to investors and investments of the other Contracting Party if such investor is owned or controlled by investors of a third party and has no substantial business activity in the territory of the denying Party.<sup>21</sup> The *2004 Canadian Model BIT* incorporates in Article 18 a denial of benefits clause similar with the one found in the *2004 US Model BIT*.<sup>22</sup> The *2004 Canadian Model BIT* allows the denial of benefits to companies with no substantial business activity subject to prior notification and consultation.<sup>23</sup>

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<sup>19</sup> *The Agreement between Japan and the United Mexican States for the Strengthening of the Economic Relations* signed on 17 September 2004 and entered into force on 1 April 2005, Article 70. The *FTA* does not contain a detailed procedure for notification and consultation. The *FTA* refers to the denial of benefits “of this Chapter”. Different from the *US-Australia FTA*, the “denial of benefits” clause under the *JAPAN-Mexico FTA* is contained in the same chapter as the dispute settlement provisions.

<sup>20</sup> *Central American/Dominican Republic Free Trade Agreement*, entered into force as follows: between US and El Salvador, on 1 March 2006, between US and Honduras, on 1 April 2006, between US and Guatemala, on 1 July 2006, between US and the Dominican Republic, on 1 March 2007; the ratification by Costa Rica is still pending; Article 10.12. Unlike the *Japan-Mexico FTA*, the *CAFTA/DR* has special provisions regarding notification (Art. 18.3) and consultation (Art. 20.4). Also, the investor-state dispute settlement is contained in the same Chapter with the “denial of benefits” clause.

<sup>21</sup> *The Agreement between the Hashemite Kingdom of Jordan and the Republic of Austria for the Promotion and Protection of Investments*, signed on 23 January 2001, Article 10. Other BITs include the reference to the substantial business activity in the definition of investor. For example, the *Agreement between the Government of Romania and the Government of the Republic of Argentina on the Promotion and Reciprocal Protection of Investments*, signed on 29 July 1993, provides, among others, for the applicability of the BIT to “any legal person constituted in accordance with the laws and regulations of a Contracting Party and having its seat together with real economic activities in the territory of that Contracting Party” [emphasis added] and to “any legal person wherever located which is effectively controlled by natural persons of a Contracting Party or by legal persons having its seat together with real economic activities in the territory of that Contracting Party” [emphasis added].

<sup>22</sup> *The 2004 Canadian Model BIT*, available at <http://ita.law.uvic.ca/documents/Canadian2004-FIPA-model-en.pdf>; Article 18.

<sup>23</sup> The “denial of benefits” clause makes reference to “notification and consultation in accordance with Article 19. Article 19 does not provide *per se* for such procedure, as it mainly regulates transparency issues. Nevertheless, Article 19(2) reads as follows:

To the extent possible, each Party shall:

- (a) publish in advance any such [*laws, regulations, procedures, and administrative rulings of general application respecting any matter covered by this Agreement*] measure that it proposes to adopt; and
- (b) provide interested persons and the other Party a reasonable opportunity to comment on such proposed measures.

The “denial of benefits” clause can be found in Article 1113 of the *NAFTA*<sup>24</sup> and serves two main purposes: to deny benefits to entities with which the Contracting States have no diplomatic relations or to which it is applying economic sanctions; and to deny benefits to enterprises with no substantial activity in the Contracting State.<sup>25</sup> The application of Article 1113 of the *NAFTA* is subject to prior notification and consultation. The Contracting State denying the benefits must give prior notification to the Contracting State of which the entity in question is asserting to be a national. Further, consultations must be conducted as provided for by Articles 1803 and 2006 of the *NAFTA*. The commentators of the *NAFTA* see the consultation requirement as “a safeguard preventing a too-hasty decision on the real nationality of an enterprise by permitting the other Party to provide information about the alleged “sham” corporation [...]”<sup>26</sup> The “denial of benefits” clause operates for the benefits contained in Chapter Eleven of the *NAFTA*. One remark must be added in this respect: the investor-state dispute resolution mechanism is included in Chapter Eleven.

The “denial of benefits” clause was also imported in the *Draft Articles on Diplomatic Protection*.<sup>27</sup> After establishing that for the purposes of diplomatic protection the State of nationality is the State where the entity is incorporated, Article 9 of the *Draft Articles* provides an exception which reads as follows:

[...] when a corporation is controlled by nationals of another State or States and has no substantial business activities in the State of incorporation, and the seat of

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<sup>24</sup> *The North American Free Trade Agreement* entered into force on 1 January 1994. Article 1113 of the *NAFTA* provides the following:

1. A Party may deny the benefits of this Chapter to an investor of another Party that is an enterprise of such Party and to investments of such investor if investors of a non-Party own or control the enterprise and the denying Party:
  - a. does not maintain diplomatic relations with the non-Party; or
  - b. adopts or maintains measures with respect to the non-Party that prohibit transactions with the enterprise or that would be violated or circumvented if the benefits of this Chapter were accorded to the enterprise or to its investments.
2. Subject to prior notification and consultation in accordance with Articles 1803 (Notification and Provision of Information) and 2006 (Consultations), a Party may deny the benefits of this Chapter to an investor of another Party that is an enterprise of such Party and to investments of such investors if investors of a non-Party own or control the enterprise and the enterprise has no substantial business activities in the territory of the Party under whose law it is constituted or organized. [emphasis added]

<sup>25</sup> *Investment Disputes under NAFTA: An Annotated Guide to NAFTA Chapter 11*, Kinnear, Meg; Bjorklund, Andrea; Hannaford, John F.G., Kluwer Law, June 2006, para. 1113-5.

<sup>26</sup> *Idem*, para. 1113-6. Nevertheless, the commentators acknowledge that the requirement of such prior notification is “somehow unclear” and it “most likely means that, before asserting Article 1113 as a defense before a tribunal, the respondent Party must notify, and commence consultations with, the Party in which the claimant is located”.

<sup>27</sup> *Draft Articles on Diplomatic Protection*, adopted in 2006 by the International Law Commission, available at [http://untreaty.un.org/ilc/texts/instruments/english/draft%20articles/9\\_8\\_2006.pdf](http://untreaty.un.org/ilc/texts/instruments/english/draft%20articles/9_8_2006.pdf).

management and the financial control of the corporation are both located in another State, that State shall be regarded as the State of nationality.<sup>28</sup>

It is worth mentioning that unlike *FCNs* and other investment treaties, Article 9 mentioned above imposes three cumulative conditions for denying the diplomatic protection to an entity incorporated in the denying State: a. the corporation is controlled by nationals of other States; b. the corporation has no substantial business activity in the State of incorporation; and c. the seat located in the State of incorporation is not the seat of management, nor the seat of financial control.

## **2. The scope of the “denial of benefits” clause under the case law of the international law of foreign investments**

The “denial of benefits” provision was discussed by *ICSID* arbitral tribunals in disputes based on *BITs* and *NAFTA*. Article 17(1) of the *ECT* was invoked in the *ICSID* case *Plama v. Bulgaria*<sup>29</sup>. As *Plama v. Bulgaria* is one of the central points of discussion for this study, the Decision on Jurisdiction and the Award<sup>30</sup> shall be discussed in Section II.2 below.

In *Waste Management II v. Mexico*, the Tribunal referred to the “denial of benefits” clause in Article 1113 of the *NAFTA* while discussing the status of the Claimant as “investor”. The Tribunal viewed Article 1113 as including a condition for commencing arbitration under *NAFTA*.<sup>31</sup> The clause was seen by the tribunal as addressing

[...] situations where the investor is simply an intermediary for interests substantially foreign and it allows *NAFTA* protections to be withdrawn in such cases (subject to prior notification and consultation)<sup>32</sup>

The Tribunal in *Pan American Energy and BP Argentina Exploration v. Argentina* and *BP America Production Company v. Argentina*<sup>33</sup> addressed the issue of the

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<sup>28</sup> *Draft Articles on Diplomatic Protection, Supra*, Article 9.

<sup>29</sup> *Plama Consortium Limited v. the Republic of Bulgaria*, ICSID Case No. ARB/03/24 [C.F. Salans, President, A. J. van den Berg, V.V. Veeder], Decision on Jurisdiction of 8 February 2005.

<sup>30</sup> *Plama Consortium Limited v. the Republic of Bulgaria*, ICSID Case No. ARB/03/24 [C.F. Salans, President, A. J. van den Berg, V.V. Veeder], Award of 27 August 2008.

<sup>31</sup> *Waste Management, Inc. v. United Mexican States*, ICSID Case No. ARB(AF)/00/3 [J. Crawford, President, E.M. Gómez, B.R. Civiletti], Award of 30 April 2004, 43 *ILM* 967 (2004), para. 80

<sup>32</sup> *Idem*.

<sup>33</sup> *Pan American Energy LLC and BP Argentina Exploration Company v. The Argentine Republic*, ICSID Case No. ARB/03/13, and *BP America Production Company, Pan American Sur SRL, Pan American Fueguina SRL and Pan American Continental SRL v. The Argentine Republic*, ICSID Case

denial of benefits under Article I(2) of the *US-Argentina BIT*<sup>34</sup>, but rejected its application as *Pan American Energy* was directly and indirectly controlled by two US companies (BP Argentina and BP America) which had substantial business activity in the US. It is noteworthy to mention that the Tribunal discussed the clause as part of preliminary objections.<sup>35</sup>

The Tribunal in *Generation Ukraine v. Ukraine*<sup>36</sup> also discussed the applicability of the “denial of benefits” provision. The Respondent invoked the clause under Article I(2) of the *US-Ukraine BIT*<sup>37</sup>, which provides that a Contracting Party may deny the benefits of the *BIT* to companies established in either Contracting Party, controlled by nationals of third countries, if these companies have no substantial business activity in the denying State or the third countries are the ones which the denying Party maintain no normal economic relations. The Tribunal addressed the “denial of benefits” clause as a preliminary issue and dismissed Respondent’s claims as to the applicability of the “denial of benefits” clause since a US citizen owned 100% of the share capital of the Claimant. The Tribunal briefly touched upon the burden of proof under these circumstances and held that

[...] the burden of proof to establish the factual basis of the “third country control”, together with the other conditions, falls upon the State as the party invoking the “right to deny” conferred by Article I(2).<sup>38</sup>

In *Tokios Tokelès v. Ukraine*<sup>39</sup>, Ukraine argued that the Claimant has no “genuine link” with Lithuania, the country of incorporation, as it is owned and controlled by Ukrainian nationals. Additionally, the Claimant has no substantial business activities in Lithuania and has its administrative headquarters in Ukraine, rather than in Lithuania. Based on this, the Tribunal should find that the Claimant is not entitled to

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No. ARB/04/8 [L. Caflisch, President, A.J. van den Berg, B. Stern], Decision on Preliminary Objections of 27 July 2006, Section III(8).

<sup>34</sup> *The Treaty concerning the Reciprocal Encouragement and Protection of Investments between the Argentine Republic and the United States of America*, signed on 14 November 1991.

<sup>35</sup> *Pan American Energy and BP Argentina Exploration v. Argentina and BP America Production Company v. Argentina*, *Supra*, para. 205.

<sup>36</sup> *Generation Ukraine Inc. v. Ukraine*, ICSID Case No. ARB/00/9 [J. Paulsson, President, E. Salpius, J. Voss], Award of 16 September 2003, 44 *ILM* 404 (2005), Section II.15.

<sup>37</sup> *Treaty between the United States of America and Ukraine concerning the Encouragement and Reciprocal Protection of Investment* signed on 4 March 1994.

<sup>38</sup> *Generation Ukraine Inc. v. Ukraine*, *Supra*, para. 15.7.

<sup>39</sup> *Tokios Tokelès v. Ukraine*, ICSID Case No. ARB/02/18 [M. Mustill, President (replacing P. Weil), D.M. Price, P. Bernardini], Decision on Jurisdiction of 29 April 2004.

the protection offered by the *Ukraine Lithuania BIT*<sup>40</sup> and the *ICSID* Convention. The Tribunal held that the *Ukraine-Lithuania BIT* contains no “denial of benefits” provision. The Tribunal saw the absence of this clause as “deliberate choice of the Contracting Parties.”<sup>41</sup> It was further noted that

[...] it is not for tribunals to impose limits on the scope of BITs not found in the text [...]. An international tribunal of defined jurisdiction should not reach out to exercise a jurisdiction beyond the borders of the definition.<sup>42</sup>

The purpose of the “denial of benefits” clause, as seen by the above Tribunals, is to exclude from the protection of investment treaties investors with no real economic link to the denying State. The Tribunals considered the clause and its application as a preliminary issue, either pertaining to jurisdiction or to admissibility.<sup>43</sup> The Tribunal in *Waste Management II v. Mexico* considered the “denial of benefits” provision as a condition for commencing the arbitration proceedings. On the burden of proof, the Tribunal in *Generation Ukraine Inc. v. Ukraine* concluded that the burden of proof lies on the State relying on the “denial of benefits” clause. Nonetheless, it seems that no major controversies related to the application of the “denial of benefits” clause occurred in cases where investors relied on *BITs* or the *NAFTA*.

## II. “Denial of benefits” provision and the Energy Charter Treaty

### 1. *Denial of benefits clause and the ECT: Scope and Interpretation*

Before discussing the provisions of Article 17 of the *ECT*, let us take a brief look at the jurisdiction *ratione materiae* and *ratione personae* of the *ECT*.

The definition of investor under the *ECT* is provided in Article 1(7) and includes, with respect to a Contracting Party, besides natural persons,

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<sup>40</sup> *Agreement between the Government of Ukraine and the Government of the Republic of Lithuania for the Promotion and Reciprocal Protection of Investments* signed on 8 February 1994.

<sup>41</sup> *Tokios Tokelès v. Ukraine*, *Supra*, para. 36

<sup>42</sup> *Idem*.

<sup>43</sup> Some of the tribunals make no distinction between jurisdiction and admissibility. *Cf. Generation Ukraine Inc. v. Ukraine*, *Supra*.

[...] company or other organization organized in accordance with the law applicable at that Contracting Party; [...]<sup>44</sup>

Investment is broadly defined in Article 1(6) of the *ECT* as virtually encompassing “every kind of asset, owned or controlled directly or indirectly by an Investor.” Further, notion of “direct or indirect control” is explained in *Understandings no. 3* of the *ECT* as being “control in fact, determined after an examination of the actual circumstances in each situation.” The *Understandings no. 3* further refers to the burden of proof in cases where there is doubt as to such control; in these cases, the investor claiming the control has the burden of proof that such control exists.

Article 17 of the *ECT* in exchange, deals with the specific case of denial of benefits:

#### **Article 17**

##### **Non-Application of Part III in Certain Circumstances**

Each Contracting Party reserves the rights to deny the advantages of this part to:

- (1) a legal entity if citizens or nationals of a third state own or control such entity and if that entity has no substantial business activities in the Area of the Contracting Party in which it is organized; or
- (2) an Investment, if the denying Contracting Party establishes that such Investment is an Investment of an Investor of a third state with or as to which the denying Contracting Party:
  - (a) does not maintain a diplomatic relationship; or
  - (b) adopts or maintains measures that:
    - (i) prohibit transactions with Investors of that state; or
    - (ii) would be violated or circumvented if the benefits of this Part were accorded to Investors of that state or to their Investments.

Unlike Articles 1(6) and 1(7) of the *ECT* which are placed in *Part I. Definitions and Purpose*, Article 17 is inserted in *Part III. Investment Promotion and Protection*.

The scope of Article 17(1) is to give Contracting States the right to exclude from the benefits conferred by *Part III* of the *ECT* alleged investors owned or controlled by citizens or nationals of third countries, which are not economically bound to the Host State. This is the typical situation of the so-called “mailbox companies”. Article 17(2),

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<sup>44</sup> Article 1(7)(a)(ii) of the *ECT*. With respect to a third state, the *ECT* sets forth the same requirements for a company to qualify as an investor (Article 1(7)(b)).

in turn, refers to the right of Contracting States to deny such benefits to investments – as defined in Article 1(6) of the *ECT* –, if the denying Contracting Party establishes that the investment belongs to an investor of a third country with which the denying State (x) maintains no diplomatic protection, or (y) adopts or maintains certain detrimental economic measures. The “denial of benefits” clause under the *ECT* corresponds to the principle of reciprocity found in international law on foreign investments. The wording of the clause evokes Article 1113 of *NAFTA* - except for the absence of the notification and consultation procedure - and similar provisions found in modern *BITs*<sup>45</sup> and *FTAs*.

Few succinct comments on Article 17 which will be further elaborated in the next subsection. Article 17 of the *ECT* repeatedly refers to investors “controlled” by citizens or nationals of a third country. What does “control” under Article 17 mean? The only explanation of the notion of “control” under the *ECT* is found in *Understandings no. 3*, as mentioned above. While it is true that Article 1(6) is in itself an explanation of notion of “investment” under the *ECT*, one could wonder whether the notion of “control” – as well as “ownership” – has different meanings throughout the Treaty, or it has only one, as provided for in *Understandings no. 3*. Should we import the explanation of “control” under *Understandings no. 3* into Article 17? The answer to be question is crucial, as *Understandings no. 3*, as already mentioned, place the burden of proof in investor, should there be doubts as to such control. One commentator of the Decision in *Plama v. Bulgaria* considered that the clarification under *Understandings no. 3* “cannot be generalized as containing a rule that for all questions concerning the control over an investment the burden of proof is borne by the investor”.<sup>46</sup> The Award in *Plama v. Bulgaria* clearly stated that

[...] the burden of proof to establish ownership and control [of the Claimant] is on Claimant.<sup>47</sup>

When can a State invoke the denial right under Article 17? Is there a special requirement for such exercise to have full effect on investors? Is there an automatic application of the “denial of benefits” clause as soon as the requirements under Article 17 are met? Or should the denying State proceed with a thoroughly review of

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<sup>45</sup> In fact, there is a striking resemblance with the “denial of benefits” clause under the *2004 US Model BIT*. Of, course, the *2004 US Model BIT* was drafted 10 years after the *ECT*.

<sup>46</sup> *Balancing Investors; Interests and State Sovereignty: The ICSID-Decision on Jurisdiction Plama Consortium Ltd. v. Republic of Bulgaria*, Essig, H., Oil , Gas & Energy Law Intelligence, vol. 5, issue 2, April 2007, p. 13.

<sup>47</sup> *Plama Consortium Limited v. the Republic of Bulgaria, Supra, Award*, para. 89.

each and every investment made in its territory and then notify the investors falling under the situation envisaged in Article 17 of the *ECT* that they shall not receive the protection and benefits of the *Treaty*? This seems to be an impossible task to be achieved by States, especially since States usually become aware of the circumstances justifying the denial of benefits only when faced with a claim from the presumptive investor. Should an objection to the jurisdiction of the arbitral tribunal based on Article 17 be sufficient to prevent the alleged investor to benefit the protection of the *ECT*? The Tribunal in *Plama v. Bulgaria* dealt with these issues in the Decision on Jurisdiction and concluded that the denying State must exercise the “denial of benefits” right in a public manner which must be reasonable made available to investors. In any case, such exercise has prospective effect on investors and their investments.

What does the *ECT* mean by “substantial business”? The concept of “substantial business” is not defined by the *ECT*, but one can assume, based on the “mailbox company” typology, that such entity has no life of its own, i.e. existing only on papers, without engaging into any activity. Undoubtedly, such assessment should be conducted based on the specific facts of each case.

Article 17(2) seems to be as controversial as Article 17(1), although not yet invoked in the *ECT* practice. Nevertheless, Article 17(2) makes it clear that the State has the burden of proof for establishing that an alleged investor falls under one of the situations mentioned under this “denial of benefits” provision: “the denying Contracting Party establishes”.

## **2. Article 17 and the ECT case law**

The Decision on Jurisdiction in *Plama v. Bulgaria* is the first decision under the *ECT* to address in detail the “denial of benefits” provision under Article 17 of the *ECT*. The Tribunal in *Plama v. Bulgaria* ultimately rejected the application on Article 17(1), as the Claimant was controlled by a national of a Contracting State, and not by a national of a third state, as required by Article 17(1) of the *ECT*.<sup>48</sup>

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<sup>48</sup> *Plama Consortium Limited v. the Republic of Bulgaria, Supra, Award*. The Tribunal found that Plama Consortium Limited was ultimately owned and controlled by Mr. Vautrin, a French national. As France is a Contracting Party to the *ECT*, *Bulgaria* could not rely on Article 17(1) of the *ECT* to deny to Claimant the benefits of Part III of the *ECT*.

Before *Plama v. Bulgaria*, the Tribunal in *Petrobart v. Kyrgyzstan*<sup>49</sup> rejected Respondent’s allegation as to the applicability of Article 17(1) to *Petrobart*. The Tribunal held that the information about *Petrobart* “contradicts the view that Petrobart is a company owned or controlled by citizens or nationals of a state other than the United Kingdom and that Petrobart has no substantial business in the United Kingdom”.<sup>50</sup>

a. Jurisdiction or merits?

The first issue in connection with Article 17(1) of the *ECT* raised in the Decision on Jurisdiction in *Plama v. Bulgaria* was whether the “denial of benefits” clause belongs to the jurisdiction or to the merits of the dispute.

The Tribunal interpreted Article 17(1) of the *ECT* in the light of Article 31(1) of the *Vienna Convention on the Law of the Treaties* (VCLT):

The express terms of Article 17 refer to a denial of the advantages “of this Part”, thereby referring to the substantive advantages conferred upon an investor by Part III of the *ECT*. The language is unambiguous; but it is confirmed by the title to Article 17: “Non-application of *Part III* in Certain Circumstances” (emphasis added). [...] From these terms, interpreted in good faith in accordance with their ordinary contextual meaning, the denial applies only to advantages under Part III.<sup>51</sup>

Consequently, the Tribunal held that the “denial of benefits” clause concerns only the benefits under Part III and does not, in any way, deny the applicability of Article 26 of the *ECT*:

Article 26 provides a procedural remedy for a covered investor’s claims; and it is not physically or juridically part of the *ECT*’s advantages enjoyed by that investor under Part III. As a matter of language, it would have been simple to exclude a class of investors completely from the scope of the *ECT* as a whole [...] This limited exclusion from Part III for a covered investor [...] clearly requires Article 26 to be unaffected by the operation of Article 17(1).<sup>52</sup>

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<sup>49</sup> *Petrobart Ltd. v. Kyrgyzstan*, SCC Case No. 126.2003 [H. Danelius, president J. Smets, O. Bring], Award of 29 March 2005, Section VIII.3.

<sup>50</sup> *Petrobart Ltd. v. Kyrgyzstan*, *Supra*, p. 63.

<sup>51</sup> *Plama Consortium Limited v. the Republic of Bulgaria*, *Supra*, *Decision on Jurisdiction*, para. 147.

<sup>52</sup> *Plama Consortium Limited v. the Republic of Bulgaria*, *Supra*, *Decision on Jurisdiction*, para. 148.

In the Tribunal’s view, to exclude Article 26 of the *ECT* by way of the “denial of benefits” clause would mean that

[...] the Contracting State invoking the application of Article 17(1) is the judge in its own cause. That is a license for injustice; and it treats a covered investor as if it were not covered under the *ECT* at all.<sup>53</sup>

The reference to “this part” is a clear indication that the drafters of the *ECT* intended to refer to *Part III* of the *ECT*, to which Article 17 belongs. One could also argue that there is no clear indication that such wording would exclude the provisions of *Part V* from the sphere of Article 17 of the *ECT*. For instance, comparing the wording of Article 17 of the *ECT* and Article 1113 of the *NAFTA*, the latter contains the reference to “this Chapter”. However, there seems to be at least one visible difference between Article 17 of the *ECT* and Article 1113 of the *NAFTA: Chapter Eleven* of the *NAFTA* which contains Article 1113 also encompasses the dispute resolution mechanism. This is not the case under the *ECT*, as the dispute settlement is contained in *Part V*. Nonetheless, the *ECT* does not regulate the protection of investments only in *Part III*, but also throughout the entire Treaty and especially in *Parts IV* and *V*. Additionally, the arbitration mechanism under Article 26 of *Part V* is available only in case of breaches of *Part III* of the *ECT*; while other specific resolution mechanisms are dealt with in the particular parts of the *ECT* (for instance, conciliation under Article 7 of the *ECT. Transit*). One could also take a different approach, based on the *ICSID* case law on the “denial of benefits” clause. It seems that the *ICSID* tribunals considered the “denial of benefits” provision as a preliminary objection based on the fact that the dispute resolution mechanism contained in investment treaties is part of the protection offered to investors. The substantive rights of investors would not be effective without the remedies contained in the dispute resolution provision. In *Siemens v. Argentina*, the Tribunal stated that

Access to these mechanisms is part of the protection offered under the Treaty. It is part of the treatment of foreign investors [...]<sup>54</sup>

The Award in *Plama v. Bulgaria* restated that

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<sup>53</sup> *Plama Consortium Limited v. the Republic of Bulgaria, Supra, Decision on Jurisdiction*, para. 149.

<sup>54</sup> *Siemens AG v. the Argentine Republic*, ICSID Case No. ARB/02/8 [A.R. Sureda, President, C.N. Brower, D.B. Janeiro], Decision on Jurisdiction of 3 August 2004, at para. 102.

[...] Article 17(1) of the ECT has no relevance to the Tribunal’s jurisdiction to determine Claimant’s claims against Respondent under Part III of the Treaty [...].<sup>55</sup>

Some could see Article 17(1) of the *ECT* as part of the nationality requirements or as a “genuine nationality link” pursuant to the *Nottebohm* case.<sup>56</sup> For instance, the *Draft Articles on Diplomatic Protection* included the “denial of benefits” clause under the nationality provision.<sup>57</sup> One commentator considers that Article 17 is not an issue concerning nationality, as the nationality of investor must be qualified according to Article 1(7)(a)(ii) of the *ECT*.<sup>58</sup>

At jurisdictional stage, *Bulgaria* argued that the intention of the *ECT*’s drafters was to confer on Contracting State “a direct and unconditional right of denial which may be exercised at any time and in any manner”.<sup>59</sup> The Tribunal rejected this view considering that it is crucial for the investor to be able to address to a forum which would be able to determine whether Article 17(1) of the *ECT* is applicable. But is an investor barred from bringing a claim under Article 26 of the *ECT* if one adopts *Bulgaria*’s point of view? Some commentators consider that this is not the case: even considering Article 17 of the *ECT* as a jurisdictional issue, the potential investor has an available remedy, which is also arbitration, and the arbitral tribunal has the competence to determine whether the conditions under Article 17 are met or not.<sup>60</sup>

b. Exercise of the denial of benefits right

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<sup>55</sup> *Plama Consortium Limited v. the Republic of Bulgaria, Supra, Award*, para. 89.

<sup>56</sup> *Affaire Nottebohm (Liechtenstein v. Guatemala)*, Arrêt du 6 avril 1955, C.I.J Recueil 1955, p. 4.

<sup>57</sup> *Supra*, FN 27 and 28.

<sup>58</sup> But could one draw a parallel between the “denial of benefits” clause and the requirement for investments made in accordance with the laws of the host state? Such qualification appears sometimes in the definition of investment, while other *BITs* have a special provision on this qualification of investments.<sup>58</sup> However, the effect of such provision is the same, irrespective of where it is placed: to restrict the benefits of the *BIT* only to investments which are made in accordance with the laws of the Host State. The same function – only that with regard to investors – has the “denial of benefits” clause, irrespective where it is placed. The requirement for investments to be made in accordance with the laws of the Host State restricts the definition of investment and, consequently, the applicability *ratione materiae* of the *BIT*. Potential investors, qualified as such pursuant to Article 1(7) of the *ECT* must satisfy the requirement under Article 17 of the *ECT*. It appears, at least from this perspective, that one could argue – leaving aside the case law and commentaries - that the purpose of the “denial of benefits” clause is to restrict the applicability *ratione personae* of the *ECT*.

<sup>59</sup> *Plama Consortium Limited v. the Republic of Bulgaria, Supra, Decision on Jurisdiction*, para. 144.

<sup>60</sup> *Cf. The jurisdiction problem in Energy Charter Treaty claims*, Shore, L., 10(3) International Arbitration Law Review, 2007, p. 63; *Making the Energy Charter Treaty Too Investor Friendly: Plama Consortium Limited v. the Republic of Bulgaria*, Chalker, J., TDM, vol. 3, issue 5, December 2006, p. 15.

On jurisdiction, the Tribunal had to decide on whether the right conferred upon the States under Article 17(1) must be first exercised by the denying State in order to produce effects or it operates automatically, as contended by *Bulgaria*.

The Tribunal departed from the fact that the existence of a mere right is different than the exercise of that right and held that the right of the Contracting Parties under Article 17(1) of the *ECT* must be exercised in order to have full effects:

[...] a Contracting Party has a right under Article 17(1) *ECT* to deny a covered investor the advantages under Part III; but it is not required to exercise that right; and it may never do so.<sup>61</sup>

As to the options a State has for exercising such right, the arbitrators, relying on the *ECT*'s object and purpose, considered that

[t]he exercise would necessarily be associated with publicity or other notice so as to become reasonably available to investors and their advisers. To this end, a declaration in a Contracting State's official gazette could suffice; or a statutory provision in a Contracting State's investment or other laws; or even an exchange of letters with a particular investor or class of investors. [...] By itself, Article 17(1) *ECT* is at best only half a notice; without further reasonable notice of its exercise by the host state, its terms tell investor little; and for all practical purposes, something more is needed.<sup>62</sup>

There is no doubt that the “denial of benefits” right must be exercised by the denying State. The silent issue of Article 17 is how and when to exercise this right. The Decision on Jurisdiction in *Plama v. Bulgaria* suggests that such exercise must be made publicly and in an effective way so it becomes available to investors. In any case, the exercise of the denial right may only have prospective effect, as suggested by the scope and purpose of the *ECT*. The Tribunal relied on the provision of Article 1113 of the *NAFTA* concluding that this solution is supported by the wording of the “denial of benefits” clause under the *NAFTA*. Article 1113 of the *NAFTA* requires for the denying Contracting State to give prior notification to the Contracting State of which the entity in question is asserting to be a national of and to initiate the consultation proceedings. Article 17 of the *ECT* contains no such requirements. While the Tribunal saw Article 1113 as supporting its finding, one could also see the absence of the

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<sup>61</sup> *Plama Consortium Limited v. the Republic of Bulgaria, Supra, Decision on Jurisdiction*, para. 155.

<sup>62</sup> *Plama Consortium Limited v. the Republic of Bulgaria, Supra, Decision on Jurisdiction*, para. 157. The Tribunal then referred to the notification and consultation procedure provided for by Article 1113 of the *NAFTA* and found that this supports its interpretation of Article 17(1).

notification and consultation requirement in Article 17 as the intention of Contracting Parties to the *ECT* to increase the prerogatives of the denying Contracting Party.

One commentator of the *Plama* Decision suggested that States should enact “a law containing an abstract and general denial of benefits provision”.<sup>63</sup> One could wonder why a State should enact such law when the *ECT* – which is part of the legislation of the respective State – contains the same abstract provision in Article 17. The Tribunal in *Plama v. Bulgaria* considered Article 17 to be “at best only half a notice”.<sup>64</sup> One critic sees this approach of the Tribunal as guidance for Contracting States: a prudent State will make a declaration in its official gazette regarding the exercise of the rights under Article 17 of the *ECT*.<sup>65</sup> On the other hand, could one consider this blanket “denial of benefits” clause as conflicting with Article 46 of the *ECT* which states that “[n]o reservations may be made to this Treaty”?<sup>66</sup>

c. Retrospective or prospective effect

On determining whether the exercise of the denial right under Article 17(1) of the *ECT* has retrospective or prospective effect, the Decision in *Plama v. Bulgaria* referred to the purpose of the *ECT* as stated in Article 2, i.e. to promote long-term cooperation in the energy field. As a result, an investor cannot plan its “long-term” investment if the exercise of the denial of benefits right has retrospective effect:

In the Tribunal’s view, therefore, the object and purpose of the *ECT* suggest that the right’s exercise should not have retrospective effect.<sup>67</sup>

[...]

For the Investor, the practical difference between prospective and retrospective effect is sharp. The former accords with the good faith interpretation of the relevant wording of Article 17(1) in the light of the *ECT*’s object and purpose, but the latter does not.<sup>68</sup>

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<sup>63</sup> *Balancing Investors; Interests and State Sovereignty: The ICSID-Decision on Jurisdiction Plama Consortium Ltd. v. Republic of Bulgaria, Supra*, p. 10.

<sup>64</sup> *Plama Consortium Limited v. the Republic of Bulgaria, Supra, Decision on Jurisdiction*, para. 157.

<sup>65</sup> *The jurisdiction problem in Energy Charter Treaty claims, Supra*, p. 63.

<sup>66</sup> Article 46 of the *ECT. Reservations*.

<sup>67</sup> *Plama Consortium Limited v. the Republic of Bulgaria, Supra, Decision on Jurisdiction*, para. 162.

<sup>68</sup> *Plama Consortium Limited v. the Republic of Bulgaria, Supra, Decision on Jurisdiction*, para. 164.

According to the Tribunal, to give retrospective effect to the “denial of benefits” clause would breach investor’s legitimate expectations and would contradict the object and purpose of the *ECT* as stated in Article 2. It would also discourage potential investors and the “long-term cooperation” envisaged by the Treaty. But one could also read Article 2 of the *ECT* in the sense that it is encouraging the retrospective effect of Article 17(1) of the *ECT*. As one critic of the *Plama* Decision asserts, “[o]ne could argue that the retrospective effect of Article 17(1) would benefit “long-term cooperation” by encouraging investors to be upfront about ownership, nationality and citizenship”.<sup>69</sup> Article 2 states that the purpose of the *ECT* is to promote long-term cooperation in the energy field, based on complementarities and mutual benefits“. In this sense, one may see the availability of the substantive and procedural rights under the *ECT* as a reciprocal privilege conferred only by the accession to the *ECT*.

## **Conclusions**

The “denial of benefits” clause was seen as a safeguard against “free riders” or as a “method to counteract nationality planning” or to preserve the reciprocity in the relationship between two countries. Irrespective of how ones calls it, the end purpose of the clause is to exclude from the protection offered by investment/trade treaties those investors to whom, in normal circumstances, Contracting States would not accord protection. Article 17 of the *ECT* providing for the denial of benefits right of the Contracting States is in line with similar clauses found in modern bilateral and multilateral investment/trade treaties. It was recently tested in practice in the dispute between *Plama Consortium Limited* and *Bulgaria*. The Decision in *Plama v. Bulgaria* it is at least interesting as it is the first decision under the *ECT* to discuss in detail the scope and application of Article 17(1) and it takes a different approach than the previous *ICSID* tribunals. If future *ECT* tribunals will take a similar attitude on the “denial of benefits” provision, this remains to be seen. For investors, the decision seems to protect them against arbitrary and unfair conduct of the State in exercising the denial right; for States, it might force them to adopt blanket clauses in application of Article 17(1) of the *ECT* in order to meet the threshold laid down in the *Plama* Decision.

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<sup>69</sup> *Making the Energy Charter Treaty Too Investor Friendly: Plama Consortium Limited v. the Republic of Bulgaria, Supra*, p. 17.