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Insolvency Law and Investment Protection Treaties – A Conflict of Laws and Jurisdictions to Be Addressed

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I. Introduction

This lecture is to conclude the Forum's program but its subject is a new problem that has been emerging only recently and to which the insolvency law profession may be forced to pay attention to in the near future.

Insolvency law is concerned with protection of investments and investors – of creditors having contributed money to businesses, and of business owners having put money into their own business. The protective feature of insolvency law is to collectivize the enforcement of claims and the disposition of the debtor's assets. Originally, the protection was meant to serve only the creditors – by preserving and enhancing the overall value of the property available for the satisfaction of the claims. Nowadays, with rescue proceedings forming a

normal part of insolvency law, the protection includes the investment of the owners of the business.

During the last 50 years or so, investment protection has become the subject also of international treaties, mostly bilateral ones between individual states. It is a different kind of investment protection. While insolvency law is to protect investors at the instance of debtors' economic difficulties, the aim of the treaties is to protect investors against governmental action in the foreign country where the investment has been made. Originally, the investment protection treaties had been invented for developing countries wishing to attract foreign capital without having a reliable domestic legal system to protect foreign investors against expropriation and other unwelcome political action. Meanwhile, investment protection treaties have been concluded, or are about to be concluded, between states with legal systems beyond reproach, that is, with systems that can be trusted to protect the expectations of investors, domestic and foreign. The most prominent ones of this kind are the envisaged treaties between the European Union and the United States of America (called *Transatlantic Trade and Investment Partnership* – TTIP) and between the EU and Canada (called *Comprehensive Economic Trade Agreement* – CETA).

Insolvency law is about owners and creditors, both being investors, the international treaties are about investors and governments. Where is the conflict, to be addressed? The conflict emerges from the ambition in the treaties to protect foreign investors comprehensively, that is: against governmental action of any kind – legislation, executive and administrative action, judicial action, and thus also against insolvency laws and proceedings. The conduct and the results of an insolvency proceeding may be questioned by individual investors invoking the protection promised by the treaty. That is the conflict I am going to explain.

First, I will describe the typical investment protection treaty and its possible impact on insolvency law and practice. I will then illustrate the conflict by three prominent insolvency cases and point to the lesson we can draw from them. Finally, I will attempt to give an assessment of the treaties and will conclude with an outlook on what stand the insolvency and restructuring law profession should take towards the investment protection treaties oncoming in Europe – TTIP and CETA.

II. Investment Treaties Described

The typical investment treaty traditionally provided investors of the contracting states with free access to their domestic markets and with an assurance of equal treatment with the

nationals of the respective state. Modern investment treaties, however, go further. They give a promise of the treaty state to the protected foreign investors of *generally* not to disturb the investment indecently. The promise is, as a rule, framed as an express obligation to accord investors of the other state "fair and equitable treatment" and further by a provision against expropriation of the investment unless it is made for a public purpose, under due process of law, in a non-discriminatory manner and against prompt compensation. In modern treaties like CETA, the cases of unfair and inequitable treatment are exclusively listed in the treaty. In CETA, these cases are 1) Denial of justice, 2) Fundamental breach of due process, 3) Manifest arbitrariness, 4) Targeted discrimination on manifestly wrongful grounds, such as gender, race or religious belief, 5) Abusive treatment of investors such as coercion, duress and harassment, or 6) any other treatment the contracting parties may have later agreed under the treaty to constitute such unfair and inequitable treatment.

The salient feature of the treaties is that impairment of an investment by measures of the host state not compatible with the treaty entitles the investor himself or herself, not only the other contracting state, to damages or compensation that can be claimed against the host state at an arbitration tribunal set up for the case under the treaty rules; the decision of the tribunal is then binding on the defendant state and it is enforceable internationally. In other words: The treaty places the enforcement of its investment protection into the hands of the investors themselves providing them with readily enforceable money claims against the state in breach. Complaints can be made against any governmental "measure", whether the measure is one of the legislature, of the executive branch or the judicial branch of government. Measures of the judicial branch include, of course, insolvency proceedings. They can be challenged and given a price tag by binding awards of money compensation to complaining investors.

III. Illustration

I am now going to illustrate the working of such treaties by three prominent insolvency cases, partly real, partly hypothetical.

1. Suhrkamp

My first case is the *Suhrkamp* insolvency. Suhrkamp is one of the most prestigious book publishing houses in Germany. It publishes high brow literature and has been called a pillar of literary and intellectual life in the German speaking world. With its program it has for long times been at the head of intellectual moods and developments in Germany.

Suhrkamp was owned and run by a limited partnership of two, the one partner being a foundation with a 60% share of the capital and the votes, the other partner being a Swiss holding company, with 40%. In truth, there were two natural persons acting in the drama. On the side of the foundation, there was the widow of the former majority owner of the business who had left his share to the foundation and made his widow, a former theatre actress, the foundation's president. On the Swiss side stood a German art dealer, son of a famous German sculptor, who had bought his minority share from a Swiss family who had been on friendly terms with the business which they wanted to support by investing and taking that minority share. The widow and the art dealer soon got into a permanent and bitter war over management and policy. Over the years, they fought against each other in numerous law suits. The war escalated when one year the parties argued about the distribution of profits which he minority partner wanted to be distributed and the majority partner to be retained in the business. The minority partner sued the partnership for his share and got a judgment in his favour. The majority partner thereupon had the managers of the partnership file for a restructuring proceeding in the insolvency court, the petition alleging that the partnership lacked the liquidity to satisfy the enforceable judgment and that insolvency was consequently imminent. The insolvency court opened the proceeding, in which then the debtor partnership presented a reorganization plan (in German *Insolvenzplan*), which provided for full satisfaction of the creditor claims and for the conversion of the partnership into a stock company in which the existing partners would be shareholders of, again, 60 and 40% respectively, but with a restriction on the transfer of shares and with a bar to a subscription of new shares at an envisaged increase of share capital. In other words: The partners in the existing partnership had a voice also in the management of the business. By the plan they were going to be made mere shareholders in a company , the minority shareholder thus without any influence on the management and with the risk of its shares being watered down by a future increase of capital and with no right to freely sell the shares allotted to it by the plan.

The plan was approved in the creditor groups and by the majority partner, and the insolvency court confirmed it. The minority partner, the Swiss company, had fiercely opposed the plan and twice appealed against its confirmation up to the Federal Supreme Court, the *Bundesgerichtshof*. It alleged an abuse of the insolvency proceeding as such and particularly of the insolvency plan provisions of the Insolvency Act, because they were used not for a restructuring of debt at an insolvency – the debts were indeed to be satisfied in full - but solely for fettering and annoying a tiresome partner in the business without a showing of real insolvency.

On the first appeal, the Supreme Court remanded the case to the appeal court below for procedural reasons, on the second appeal the Supreme Court denied further review on the ground that the court below had now based its decision on a special provision in the Insolvency Act the application of which, in the eyes of the Supreme Court, was not subject to appeals. The Swiss company has now lodged a complaint with the Federal Constitutional Court (the *Bundesverfassungsgericht*) alleging abuse of proceedings, denial of justice, unlawful expropriation and violation of the freedom of association.

The case is pending. It touches upon an investment made. To make it illustrate international investment protection, I am now switching from the real to the hypothetical. Let us assume that the investor is not a Swiss company but a company coming from Canada. Then it would come within the scope of CETA, the investment treaty between the European Union and Canada which is awaiting ratification. And let us further assume that the Constitutional Court dismisses the complaint, in other words: approves of the insolvency proceeding and its results. Can the Canadian company then invoke CETA to make Germany or the EU liable in damages for this proceeding?

It is clear from the outset that insolvency proceedings, as any other governmental activity, are covered by the treaty – which attaches a possible financial state liability on any "measure" (ch. 10 art. 3–m). There is no exemption for the judicial branch of government in any investment treaty. Indeed, the very gist of those investment treaties is a general distrust towards national judges in their treatment of foreign investors. So, in our supposed case, we have to look to the standards CETA is going to establish for the EU and Canada.

Is there a risk of the Suhrkamp proceeding to be regarded as unfair and inequitable or as an unjustified expropriation under CETA? When we look at the catalogue of instances of such behaviour which I mentioned in the beginning we find exactly those charges that have been addressed by the minority shareholder company to the German courts – denial of justice, breach of due process, abusive treatment of an investor, expropriation. To be sure, all German courts, in our assumed case, have found the charges to be unfounded. But the three arbitrators far away in Washington DC or somewhere else might think differently and may thus impose financial liability on Germany or the EU for what the arbitrators think to be a misbehaviour of the German courts – and that would be the final word in this case. The possible conflict between German insolvency law, as applied by the German courts, and the treaty standards, as applied by the arbitrators, would be obvious, it is a conflict of laws and of jurisdictions.

I am not going to comment about this hypothetical conflict or on the actual Suhrkamp case, but will switch over to my next case, the case of the Hypo Alpe Adria Bank – for simplicity's sake and in order to stay in the English sound track, I will call it the Hypo Bank.

2. Hypo Alpe Adria

Hypo was an Austrian bank with a turbulent history since the nineties of last century. It grew from a small state-owned mortgage bank in Carinthia, a state in the Austrian federal sytem of government, into one of the 5 or 6 big banks in Austria, benefitting from close links to party politics . After the opening of the East of Europe, it expanded heavily in South Eastern Europe. Beginning with the financial crisis of 2008 and later, it got into troubles with many of its investments and loans that decreased sharply in value or failed altogether. In 2009, the Austrian government felt the need to come to help. They bought all the shares in the company, among them a majority of 70% held by the Bavarian State Bank, they invested a good 5 billion Euros into the bank over the next five years, and then concluded in 2014 that the prospects were hopeless, the business untenable. They could have sent the bank into a normal insolvency proceeding, but for various economic and political reasons, the government decided to liquidate the business by their own hands. The bank was renamed and converted into a winding up institution (what one often calls a 'bad bank'), and legislation was passed to liquidate its assets smoothly and slowly and with support of the liquidation process by government funds.

One of the government's concerns was to protect the winding up institution against insolvency until it had assembled liquidity sufficient to satisfy claims when falling due. They thought that roughly five years of liquidating would be needed to yield the funds necessary for regularly serving claims on maturity. So, provisions were enacted in 2014 that declared lower ranking claims to be extinguished which would fall due before a fixed date in 2019, that is: 5 years later. The bank had incurred in its former business a good number of lower ranking liabilities within its total debt of about 10 billions. The lower ranking claims hit by this law made up about 800 millions.

The whole legislative winding up scheme was attacked in the Austrian Constitutional Court (*Verfassungsgerichtshof*) by a group of dissenting members of Parliament big enough to have standing in the court, and by a regional civil court of first instance (*Landesgericht*) in Carinthia where an insurance company tried to recover under bonds that were subject to that special law. Only two months ago, on 29 July 2015, the Constitutional Court rendered its

decision. It held that the purported extinction of those claims was an arbitrary expropriation of the creditors, being incompatible with the property guaranty in the Austrian Constitution, and the Court consequently invalidated the whole legislative scheme. It expressly acknowledged the power of the legislature to impose sacrifices on creditors of a bank of systemic relevance, and it particularly noted that in any ordinary liquidation at insolvency the junior creditors like the ones affected here carried a special risk of being wiped out because of their lower rank. The Court did not, however, accept that within the lower ranking class the law could make a difference between claims according to their date of maturity, with no regard to the nature of the claims but with the intent only of getting the liquidation under way.

When we look at the scheme, it was an insolvency proceeding, to be sure not under general or banking insolvency law, but having all the ingredients of a legal insolvency measure, that is: an insolvent debtor and its creditors, with no hope of the debtor's survival, a statutory mandate for its liquidation – albeit a slow and smooth one – and a cutting off of creditor claims to help the process achieve its aims. And the Constitutional Court intervened with classical insolvency law arguments, although dressed in constitutional terms, by pointing to creditor ranks deserving respect and to the equality of creditors within a given rank.

If we now look to whether the affected creditors could have been protected under a given investment treaty, the Constitutional Court in this case, to be sure, has rendered the treaty irrelevant by providing by itself the looked for protection. But what if it had decided otherwise? The arguments of the Austrian government for imposing that sacrifice were by no means far fetched or utterly mistaken. In case they had persuaded the Constitutional Court to dismiss the complaint, the arbitration tribunal under the investment treaty could be seized and the Republic of Austria would again had to defend itself against the arguments that had been rejected previously in its constitutional court. Again, the potential conflict between the statutory insolvency treatment and the investment protection mechanism is coming into sight here.

In Austria, the conflict is actually not even safely averted in the Hypo case. Austria has meanwhile enacted a new Bank Reorganization and Resolution Act in accordance with European Union prescriptions. Under the new Act, the lower ranking creditors in this case – this time all of them – have been set under a moratorium until 2016. This moratorium, of course, is also open to an attack under the constitution or under the assumed investment treaty. Whether it would stand constitutional or – alternatively - investment treaty attacks is by no means certain.

3. Yukos

I am now turning to my last illustration case, the Yukos saga. Unlike Suhrkamp and Hypo, the conflict between the investment treaty and insolvency law is here not hypothetical but has been very real. The case has been widely covered by the media, but mostly with regard to the criminal proceedings in Russia against the controlling shareholder of Yukos, Mikhail Chodorkowsky, who was roughly treated by the authorities and was twice sent to jail for a number of years. But part of the story was an insolvency proceeding through which Yukos was eventually dissolved but which subsequently resulted in an investment protection claim against Russia in an arbitration organized by the Permanent International Court of Arbitration at the Hague in the Netherlands. The arbitrators have rendered their judgment on 14 July 2014. My report of the case is taken exclusively, no media in between, from the facts stated in that judgment, and I will focus on the proceedings against Yukos, not on the criminal charges against Chodorkowsky.

Yukos was founded as a joint stock company by the Russian government after the dissolution of the Soviet Union. It was to run a number of the formerly state-owned oil and gas fields. In the mid-nineties, under President Yeltsin, large parts of the economy were privatised, and so were the shares in Yukos. They were sold by auction, Chodorkowsky and some associates acquired about 70% of the shares. He had been a high ranking leader in a communist youth organisation in Soviet times, later he became vice-minister in a government under President Yeltsin. This background seems to have enabled him to marshall the funds needed to bid successfully at the auction. Under the management of Chodorkowsky, Yukos flourished. By the turn of the century it had become the biggest Russian oil company, also a worldwide player with an estimated market capitalization of 33 billion USD, it was engaged in negotiations with Exxon and ChevronTexaco for a merger or other form of combination.

In 2003, the Russian authorities held a field tax audit at Yukos. They discovered what the aforementioned arbitrators later called a huge tax evasion scheme with taxes of hundreds of millions of Dollars withheld, what Yukos called a tax optimization scheme, and the Russian authorities simply called wilful and persistent tax fraud. Russia had established in the nineties a number of low tax areas where investments were to be especially encouraged. Yukos used mailbox firms in those territories and also a subsidiary in the republic of Cyprus with which Russia had a double tax agreement to avoid taxes by clever in-group selling and pricing, the technique so familiar to many in the corporate world. Chodorkowsky was arrested and twice convicted for long prison terms, and the tax authorities reassessed Yukos for the years 2000 to 2004 with taxes and interest amounting to a total of 16 billion USD. They added fines for

the tax fraud in the amount of 8 billions so that in 2006, when the last assessment had been made, Yukos had a tax liability of 24 billion Dollars. Yukos appealed against the assessments up to the highest court, but without success. When the assessments were not paid, the authorities enforced them very quickly with freezing assets and then seizing and selling by auction the core production facilities of Yukos for 9 billion Dollars. The asset basis of Yukos was thereby reduced to 40% of the previous level.

Now, at last, comes the insolvency proceeding. Yukos had, in 2003, taken up a loan of 1 billion Dollars from a syndicate of Western banks. After the aforementioned auction of the greater part of its assets, Yukos failed to serve the loan. The syndicate obtained a judgment against Yukos in the High Court in London and they tried to enforce it in the Netherlands where Yukos held its foreign assets. The enforcement failed because the assets had been rashly placed in two newly formed foundations that held them for the controlling shareholders of Yukos. The syndicate then achieved recognition of the London judgment in Russia and eventually petitioned for an insolvency proceeding which was opened in 2006. In the proceeding, the tax liabilities not satisfied by the previous auction made up 70% of the admitted claims. Yukos offered a restructuring plan, it was rejected in the creditors' meeting, and liquidation of the remaining assets followed in several steps with a total yield of 31 billion Dollars, 9 billion Dollars in taxes remaining unpaid. In 2007, Yukos was struck from the company register.

Already in 2005, the controlling shareholders of Yukos sought investment protection against the Russian Federation by starting mediation and then arbitration under the Energy Charter Treaty. That treaty is a consequence of the dissolution of the Soviet Union and of the political opening of Eastern Europe. Governments were now concerned about the continuance of oil and gas supplies from the former Soviet territory, the successor states were concerned about the flow of money from the export of oil and gas and they wanted to attract western capital to modernize and expand their production. So, a treaty, called Energy Charter Treaty (ECT), was concluded in 1994, came into force in 1998 and has been ratified meanwhile by 51 countries, mainly European, and by the European Union. Russia has signed the treaty, but has not ratified it, and has meanwhile formally declared to be no longer willing to ratify.

Because of its aim to foster capital export to energy producing countries, the treaty has also an investment protection chapter. It is modelled after the many other investment treaties, that is, it obliges the treaty states to fair and equitable treatment of investors from other treaty states and it prohibits unjustified expropriation. Violation of these provisions entitles the investor to seek compensation, enforceable against the guilty treaty state by arbitration.

This investment protection was sought against Russia by three shareholders of Yukos, that is, two holding companies in the Republic of Cyprus and one on the Isle of Man. Together they were holding about 70% of the Yukos shares, and each was under the control of Chodorkowsky and his associates through a sophisticated chain of holdings and trusts leading to Gibraltar and the Channel Islands. They claimed that all the legal measures of the Federation of Russia against Yukos were not simply measures of tax assessment and judicial enforcement, but were all part of an overarching strategy of the Russian government to destroy Yukos, to get back into the hands of the state its extensive oil and gas facilities, and to get rid of Mikhail Chodorkowsky – he was allegedly suspected to become a dangerous political opponent to President Putin.

A giant arbitration proceeding developed before a panel of arbitrators formed with the services of the Permanent International Court of Arbitration in the Hague. The three arbitrators were a retired judge from the United States, an *Avocat* from Geneva and a Professor and practitioner from Canada, the chairman. They called themselves the “Arbitration Tribunal”.

The tribunal had first to decide on its jurisdiction, after Russia has not ratified the treaty. In 2009, in an interim judgment of 200 pages, they decided against Russia, on the basis of Russia having signed the treaty without objecting to its provisional application which the treaty expressly declares to follow from such signature. After a busy further five years, the tribunal gave its final judgment on 14 July 2015. The judgment holds the Federation of Russia liable for a violation of the Energy Charter Treaty and orders it to pay the claimants a compensation of 50 billion US-Dollars. The judgment is an impressive document of more than 600 pages. It is available at the website of the Permanent Court of Arbitration.

For our subject of today, I need not go into details, but two aspects are remarkable for our context:

The tribunal did not deny the measures taken by the Russian authorities to have been permissible under Russian law, and it did not dispute the compatibility of the laws applied with the treaty. It emphasized, instead, the harsh and rash procedures against Chodorkowsky personally and against Yukos and it concluded from this overall picture and all the circumstances that the claimants had proven their allegation, that is that the Russian government under President Putin had conceived a plan to destroy Yukos and to appropriate its assets to the state in the first place, and that it exploited the tax evasion scheme as a

welcome trigger for the execution of that plan. In the tribunal's view, the insolvency proceeding was only the concluding part of an ongoing, carefully orchestrated expropriation, lasting from the tax audits in 2003 to the elimination of Yukos from the company register in 2007.

The other remarkable aspect is how the tribunal arrived at the amount of 50 billion dollars of compensation. It had assessed the losses suffered by the claimants at about 70 billion dollars. It then held the claimants and their shareholders liable for contributory fault because of their extensively practised tax evasion system that had made them, in the view of the tribunal, "vulnerable" and had opened the way to the eventual destruction of Yukos. The tribunal claimed wide discretion in weighing the parts played by both sides and in attributing the shares to be taken, and it came to the conclusion that 25% of the loss should be borne by the claimants themselves, which makes for about 50 billion dollars left for their compensation.

IV. The lesson

It would be useless here to comment on the judgment. We must rather take it, and the other illustration cases, as an indication of the potential of judicial review of insolvency proceedings the investment treaties hold in store. What do investment treaties like TTIP and CETA mean to insolvency law? In my view, the potential is enormous. The treaties allow judicial imposition of state liability to individual investors caught in insolvencies on the basis of circumstances far back in time and high up in politics, brought together under a guiding idea, and they allow the arbitrators wide discretion in comparing and evaluating the behaviour of the participants involved. As to the range of circumstances possibly to be considered, the treaties are 'comprehensive' in the widest possible sense. No such reaching out into the factual and legal surroundings would be allowed, let alone be possible, in a normal national insolvency court. This discrepancy of what an insolvency court and what the investment protector is allowed and able to consider, is the primary source of the potential conflict between the fields. In every country bound by an investment protection treaty, the insolvency statute automatically carries a reservation saying: "This law is subject to investment protection under an applicable investment treaty." The reservation can be invoked in every case where the investment concerned is worth the costs of the arbitration under the treaty. That is the lesson.

V. Legal and policy assessment

The proponents of investment protection in the business world, in governments and in the EU-Commission praise their project with the well-known arguments for free trade, that is, all in all, to enhance further economic growth. It is obvious, however, that they are demanding a price.

The constitutional price is increasingly debated in Europe – it is the impairment of democracy, the loss in governmental sovereignty, the interference with the power of Parliament over the budget. There is also a price in terms of international law – the sovereign states are to accept private investors as competitors, equipped with enforceable compensation claims, in the structuring and management of international relations.

We are here to focus on the contribution demanded of insolvency law. It is to yield on three central issues. The first issue is firmness of means and results. Insolvency proceedings are there to sort out with the strong hand of the state a troubled economic situation and thereby to put investors – debtors and creditors – on a new and firm legal footing, by liquidation, restructuring or both. The results of an insolvency proceeding must be final, but they are not when they can be later challenged, if indirectly, by any unhappy investor with a claim for compensation.

The second issue is equality. Insolvency must respect ranks but it must not make a difference within ranks, equality insofar is one of its hallmarks. The investment treaties allow inequality, they benefit only the investors of the other treaty state, not domestic investors and not the foreign investors of other than treaty states. To be sure, the compensation to protect investors is available only after the conclusion of the insolvency proceeding, but the hope for, or apprehension of, such compensation can of course influence the participants and courts before.

Thirdly, international insolvency law can be disturbed. The ideal attitude in this field is to give international recognition and assistance to an insolvency proceeding that has been conducted in an appropriate forum in an appropriate manner. This liberal attitude is a concern of many international instruments, for instance of the UNCITRAL model law. Where recognition, however, threatens to bring the recognition state into a conflict with its obligations under an investment protection treaty, we can no longer safely expect it to follow the internationally accepted ideal.

And then, we have a special problem here on the European level. The Insolvency Regulation requires the member states to give legal effect to insolvency proceedings opened and conducted wherever in the Union. So, if the Union would make an investment treaty like TTIP and CETA, all the member states, not only the one with the proceeding, but all the others where its effects are realized, may become liable to Canadian or American investors under the respective treaty. Was the Union really empowered to make an insolvency regulation with member state liability to American investors automatically attached? Or, to put it reversely, would a member state be entitled to deny recognition under the Insolvency Regulation if such recognition might trigger such a liability? We can see here, that investment treaties like TTIP and CETA can raise even in insolvency law European constitutional questions. Such questions to my knowledge have not been addressed by the negotiating teams of the EU-Commission.

VI. Embrace or oppose?

All in all, the contribution asked of insolvency law for the envisaged investment protection treaties is substantial. The insolvency law community ought to consider whether to oppose the projects or to subscribe to them. To be sure, investment protection under such treaties offers an immense fee potential – but not for everybody. The arbitrations are so demanding in manpower and time that only big law firms can confidently manage them. Apart from that fee potential, the price, in my view, is very high; representatives of the insolvency profession would do well in their homelands to approach their governments with the problem, make them aware of the built in threat to their insolvency procedures and ask them how they are going to sustain them. And my recommendation to INSOL Europe is to give the problem close attention and place questions to the European Commission. I do not see that they have really seen the full dimension of their treaty projects.