

International investment law claims—going up in smoke?

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Arbitration analysis: Steven Nelson, partner, and Michael Robbins, associate, at Dorsey & Whitney LLP, examine in detail the judgment in *Philip Morris v Uruguay* concerning an investor-state claim challenging Uruguay's restrictions on cigarette packaging, and assess the practical implications of the decision, which essentially reinforce previous case law regarding the state's power to protect public health.

Original news

ICSID tribunal dismisses Philip Morris tobacco regulation claim, LNB News 11/07/2016 115

In an award dated 8 July 2016, the tribunal in the International Centre for Settlement of Investment Disputes (ICSID) arbitration between Philip Morris Brands SarL (and others) and Uruguay (Case No ARB/10/7) dismissed the claimants' claim that the respondent, through tobacco-control measures regulating the tobacco industry, violated the agreement between the Swiss Confederation and the Oriental Republic of Uruguay on the Reciprocal Promotion and Protection of Investments dated 7 October 1988 (the bilateral investment treaty (BIT)) in its treatment of trademarks associated with cigarette brands in which the claimants had invested

What are the practical implications of the decision?

The decision reinforces earlier (non-binding) precedents establishing that the investment protections provided by BITs do not preclude the exercise by states of their police power for the bona fide purpose of protecting public health, safety, welfare, the environment and the public interest generally, without incurring liability to compensate foreign investors—provided that the measures taken are not arbitrary, grossly unfair, unjust, discriminatory or disproportionate to the ends sought to be achieved. Those conclusions are consistent with existing principles of customary international law. At the same time, as the tribunal found, the obligations of states to foreign investors under existing customary international law are constantly evolving, and the decisions of tribunals, such as this one, established in respect of claims under BITs are having an impact on that evolution, incrementally strengthening the protections afforded against unlawful expropriation or arbitrary state action.

As a practical matter, though, the decision stands as a reminder to foreign investors that they generally are subject to the same regulatory risks as domestic enterprises, subject only to the protections against abuses of power that international law has always afforded as a matter of state responsibility for injury to aliens, as those protections are being elaborated in the context of a globalising economy.

What is the background to the award?

The claim originated from Uruguay's decision to introduce measures regulating the sale of tobacco products in that country. These measures included the government's adoption of a single presentation requirement precluding tobacco manufacturers from marketing more than one variant of cigarette per brand family (the single presentation requirement (SPR)) and an increase in the size of graphic health warnings required to be included on cigarette packages to 80% of the relevant surfaces (the 80/80 Regulation). The two are jointly referred to herein as the 'challenged measures'.

Philip Morris Brand Sàrl (Switzerland) (PMB), Philip Morris Products SA (Switzerland) (PMP) and Abal Hermanos SA (Abal) (Philip Morris or the claimants) submitted a claim against the Oriental Republic of Uruguay (the respondent) to the International Centre for Settlement of Investment Disputes (ICSID) under BIT, art 10 and article 36 of the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID Convention). BIT allows Swiss investors to assert direct claims in arbitration against the Uruguayan Government for breaches of the investment protections in BIT.

The tribunal had rejected the respondent's objections to its jurisdiction in a partial award dated 2 July 2013. That decision opened the way for consideration of some of the important issues of substantive law that had been raised, but not

decided, in another case initiated by other subsidiaries of the same multinational in *Philip Morris Asia Ltd (Hong Kong) v The Commonwealth of Australia* (PCA Case No 2012-12), which was an arbitration before a tribunal appointed under the aegis of the Permanent Court of Arbitration pursuant to a 1993 BIT between Hong Kong and Australia. That arbitration concerned Australia's enactment of legislation that required tobacco companies marketing cigarettes in that country to sell them only in logo-free, drab dark brown packaging and prohibited them from using their logos or marketing content, apart from the brand name in standard font.

Regrettably, the tribunal in that case had been compelled on the facts to hold that it lacked jurisdiction, so it never reached the merits. Nonetheless, the case resulted in a stunningly misguided political uproar over the fact that it had even been possible for a foreign multinational to assert a claim against a sovereign government, particularly one based on that government's exercise of regulatory measures designed to curb the use of tobacco products in the interest of public health. The decision on the merits in *Phillip Products v Uruguay* should dispel a good deal of the unwanted hysteria on the subject and rebalance the discussion toward acceptance of the rule of law. However inconvenient, it may occasionally be to governments to be called upon to defend their actions against claims that they violate international legal standards, which incidentally they occasionally do.

On what grounds did Philip Morris assert that there had been a violation of BIT?

The claimants asserted that they were entitled to compensation and damages under BIT, and under customary international law, on the basis that the challenged measures constituted breaches of the respondent's obligations under the following provisions of BIT:

- article 3(1)—impairment of use and enjoyment of investments
- article 3(2)—failure to accord fair and equitable treatment (FET), and denial of justice
- article 5—expropriation, and
- article 11—observance of commitments

In short, the claimants took a 'shotgun' approach, which appears to have become somewhat standard, of trying to shoehorn the same facts into a violation of every conceivable provision of BIT. At its core, however, the dispute involved allegations by the claimants that, through the enactment of the challenged measures, the Government of Uruguay, arbitrarily and in derogation of its commitments, had deprived claimants of the value of their brand assets, including their intellectual property (IP) in registered trademarks as well as goodwill, associated with each of their cigarette brands, numbering 13 in all. In addition to being arbitrary, in the view of the claimants, the measures undermined the claimants' legitimate expectations and destroyed the legal stability that Uruguay pledged in BIT.

The relatively unique aspect of this case is the denial of justice claim. Denial of justice is actually a separate category of breach of state responsibility for injury to aliens under customary international law, but the only BIT provision within which it arguably fits is the FET provision. Claimants' commencement of arbitration under BIT followed on the heels of Abal's challenge of both of the challenged measures in Uruguay's courts, on separate grounds. Under the Uruguayan judicial system, Abal was required to litigate its claims in two separate courts the Tribunal de lo Contencioso Administrativo (TCA) which has jurisdiction to assess the legality of administrative acts such as decrees and the Supreme Court of Justice (SCJ), which has jurisdiction to assess the constitutionality of laws. However, the two courts had based their decisions regarding the 80/80 Regulation on contradictory interpretations of the scope of the authorising legislation which could not be reconciled, resulting in denying Abal any relief from that measure. Less interestingly, the TCA had rejected the challenge to the SPR in a decision that cited facts relevant to a similar challenge raised by a competitor rather than those pertaining to Abal's own case.

What did Uruguay contend in response?

Uruguay submitted that the challenged measures were adopted in compliance with Uruguay's international obligations, including BIT, for the single purpose of protecting public health. According to Uruguay, both regulations were applied in a non-discriminatory manner to all tobacco companies, and they amounted to a reasonable, good faith exercise of Uruguay's sovereign prerogatives. The SPR was adopted to mitigate the ongoing adverse effects of tobacco promotion, including the claimants' false marketing that certain brand variants are safer than others, even after misleading descriptors such as 'light,' 'mild,' 'ultra-light' were banned. The 80/80 Regulation was adopted to increase consumer awareness of the

health risks of tobacco consumption and to encourage people, including younger people, to quit or not to take up smoking, while still leaving room on packages for brand names and logos.

With reference to the claimants' position that the grant of registration of its trademarks in Uruguay was tantamount to a right to use them rather than simply to prevent third parties from doing so, Uruguay denied that the grant of such registration had the effect of creating an unconditional right to carry on the business to which the trademarks related or of insulating that business from general regulations such as the challenged measures.

What did the tribunal decide?

The claimants' different claims of breach of the BIT were substantially rejected. The tribunal's decision under each head of claim is briefly described below.

Expropriation under BIT, art 5

The tribunal held that in order to be considered an indirect expropriation of property, a state's measures should amount to a 'substantial deprivation' of its value, use or enjoyment. In applying that standard, the tribunal held that the measures were not expropriatory because the effects of the SPR were far from depriving Abal of the value of its business or even causing a 'substantial deprivation' of the value, use or enjoyment of the claimants' investments. (It was undisputed that after the introduction of the SPR, Abal eliminated seven of its 13 variants of cigarettes. The eliminated variants accounted for roughly 20% of Abal's domestic sales.) In so deciding, the tribunal rejected the claimants' argument that such deprivation must be assessed in respect of each of its brands, holding instead that in this case the standard must be applied against the claimants' business as a whole. Accordingly, the claimants' claim regarding the expropriation of their investment was rejected.

The tribunal's analysis might have ended there, but in light of the extensive debate between the parties at the hearing, the tribunal also considered the application of the police power's doctrine to the expropriation claim. The tribunal concluded that the challenged measures were a valid exercise by Uruguay of its police powers for the protection of public health. The tribunal held that in order for a state's action in exercise of regulatory powers not to constitute indirect expropriation, the action must be taken bona fide for the purpose of protecting the public welfare. Protecting public health has long since been recognised as an essential manifestation of the state's police power, as indicated also by BIT, art 2(1), which permits contracting states to refuse to admit investments for reasons of public security and order, public health and morality and must be non-discriminatory and proportionate to the objective they were meant to achieve. In the tribunal's view, the challenged measures met those requirements. The tribunal held that BIT, art 5(1) must be interpreted in accordance with article 31(3)(c) of the Vienna Convention on the Law of Treaties requiring that treaty provisions be interpreted in the light of any relevant rules of international law applicable to the relations between the parties—a reference which includes customary international law.

Denial of FET under BIT, art 3(2)

Claims based on denial of FET have probably given tribunals in BIT arbitrations more difficulty than any of the others due to the relative uncertainty of the legal standard. Among other things, there has been a recurring issue as to whether the FET provisions simply embody existing principles of customary international law or set out autonomous treaty standards. The tribunal finessed this issue very nicely, noting that while, as noted above, treaty provisions are to be interpreted in the light of any relevant principles of international law, of which customary international law is a recognised source, the impact of BITs on the evolution of customary international law in turn cannot be ignored. Rejecting for that reason the relatively narrow standard of older case law, the tribunal said the current standard is broader although its precise content is far from being settled.

The tribunal went on to state that whether a particular treatment is fair and equitable depends on the circumstances of the particular case but that factors typically taken into account are:

- transparency
- protection of the investor's legitimate expectations
- freedom from coercion and harassment
- procedural propriety and due process
- good faith, and

- that the relevant standard has been held to be breached by state conduct that is arbitrary, grossly unfair, unjust or idiosyncratic

In response to the claimants' assertion that the challenged measures were arbitrary, the tribunal referred to the definition of arbitrariness set out in an International Court of Justice decision (*Eletronica Sicula SpA (ELSI) (United States of America v Italy)*, judgment of 20 July 1989 at para [130]) as a 'wilful disregard of due process of law, an act which shocks, or at least surprises, a sense of juridical propriety'. It held that the challenged measures were not 'arbitrary' because they were implemented by the state for the purpose of protecting public health based on objective factors and evidence available at the international level, as confirmed by the World Health Organisation and the Pan American Health Organisation amicus briefs, which contain a thorough analysis of the history of tobacco control and the measures adopted to that effect. In the tribunal's view, there was no requirement for Uruguay to perform additional studies or to gather further evidence in support of the challenged measures. It further held that the judgments of regulatory authorities are entitled to considerable deference or a 'margin of appreciation', at least in matters of protection of public health, so long as they are rational and arrived at in good faith.

Turning to the claimants' other claim as to breach of the FET standard, the tribunal held that the requirements of legitimate expectations and legal stability do not affect the state's rights to exercise its sovereign authority to legislate and to adapt its legal system to changing circumstances. On this basis, it held that changes to general legislation (at least in the absence of a stabilisation clause, in which a sovereign contracting party agrees to certain limitations on its freedom to make changes in its law and/or regulations affecting the investment) are not prevented by the FET standard if they do not exceed the exercise of the host state's normal regulatory power in the pursuance of a public interest and do not modify the regulatory framework relied upon by the investor at the time of its investment 'outside of the acceptable margin of change.

In this case, moreover, given the widely-accepted articulations of international concern for the harmful effect of tobacco, the claimants' expectation could only have been of progressively more stringent regulation of the sale and use of tobacco products. Nor is it a valid objection to a regulation that it breaks new ground. Provisions such as BIT, art 3(2) do not preclude governments from enacting novel rules, even if these are in advance of international practice, provided these have some rational basis and are not discriminatory.

Accordingly, the claimants' claims of breach of the FET standard of BIT, art 3(2) was dismissed by a majority vote, arbitrator, Gary Born dissenting.

Impairment of use and enjoyment of the claimants' investments under BIT, art 3(1)

The claimants claimed to have lost the 'use', 'enjoyment' and 'extension' of their investment by reason of measures that they considered unreasonable. In their view, the term 'unreasonable' was interchangeable with 'arbitrary,' so that the same facts demonstrating the respondent's violation of the FET obligation on ground of 'arbitrariness' were sufficient to establish an 'unreasonable' impairment of their investment under BIT, art 3(1). For the same reasons that were given for dismissing the claim for breach of BIT, art 3(2), the tribunal concluded that there was no breach of BIT, art 3(1), dismissing the claimants' claim also in this regard.

Failure to observe commitments as to the use of trademarks under BIT, art 11

Responding to the claimants' argument that a trade mark is a commitment that arises when a submitted registration application is granted under Uruguayan law, the tribunal held that a trademark is not a unique commitment made in order to encourage or permit a specific investment. The tribunal reasoned that unlike the case of an authorisation or a contract, where the host state may undertake some specific obligations to the investor, Uruguay entered into no commitment 'with respect to the investment' by granting a trademark. It did not actively agree to be bound by any obligation or course of conduct, it simply allowed the investor to access the same domestic IP system available to anyone eligible to register a trade mark. A trademark gives rise to rights, but their extent, being subject to the applicable law, is liable to changes which may not be excluded by an umbrella clause—if investors want stabilisation they have to contract for it. The tribunal concluded that trademarks are not 'commitments' falling within the intended scope of BIT, art 11. Accordingly, the claimants' claim of breach by the respondent of BIT, art 11 by the adoption of the challenged measures was rejected.

Denial of justice

The claimants alleged that the respondent, through its judicial system, committed two denials of justice in breach of the FET standard set out in BIT, art 3(2). First, in that the final decision of the SCJ on the constitutionality of Law 18,256 and the TCA's decision on the legality and validity of the 80/80 Regulation were based on interpretations of the law that were directly contradictory with one another and second, in that, when rendering its judgment, the TCA failed to address Abal's arguments and evidence and instead considered the challenge against the same regulation brought by one of its competitors, British American Tobacco. Law 18,256 reaffirmed and reinforced measures adopted under previous decrees, including:

- the prohibitions of smoking in public or private enclosed places (article 3)
- the limitation of retail advertising to point-of sale and the prohibition of all other forms of advertising, promotion and sponsorship of tobacco products including at sporting events (article 7), and
- the prohibition of the free distribution of tobacco products (article 11)

The parties were in agreement that the relevant legal standard for a denial of justice in this context was breached if and when the judiciary conducted fundamentally unfair legal proceedings or rendered outrageously wrong final and binding decisions. The tribunal noted that an allegation of denial of justice is subject to an elevated standard of proof as it condemns the state's judicial system as such, hence there must be clear evidence of an outrageous failure of the judicial system.

Addressing the apparently contradictory ratio decidendi in the two judgments on the 80/80 regulation, the tribunal noted that it is common in civil law systems for there to be administrative tribunals separate from the general court system and not part of a common judicial hierarchy. In the tribunal's view, it was unusual that the Uruguayan judicial system did not provide any mechanism for resolving conflicts of reasoning, which the tribunal described as a 'quirk' in the Uruguayan legal system. However, while it said the failure of the TCA to follow the SCJ's interpretation of the law might appear unusual, even surprising, it was not shocking or serious enough to constitute a denial of justice. For these reasons the tribunal by majority held that the procedural improprieties were not sufficient to rise to the standard of a denial of justice, arbitrator Born again dissenting. As to the decision of the TCA on the SPR, the tribunal held that Abal's arguments had all been taken into account and that any procedural improprieties did not meet the high threshold required to constitute a denial of justice.

On what grounds did arbitrator Born dissent?

Arbitrator Born was unable to agree with the majority that Uruguay's failure to provide the claimants any means of judicial recourse following contradictory decisions by the SJC and TCA did not constitute a denial of justice or that the SPR for tobacco products did not constitute a denial of FET.

Mr Born concluded that the operation of the Uruguayan judicial system in this case constituted a denial of justice. Specifically, he was of the view that Uruguay denied Abal justice when its courts rendered directly contradictory decisions interpreting article 9 of Law 18,256 in proceedings involving Abal but did not thereafter provide Abal access to a judicial forum in which to present a presumptively serious constitutional challenge to article 9 of Law 18,256 as that provision had been authoritatively interpreted and applied to it. In his view, this amounted to 'heads, I win, tails, you lose' treatment, without affording Abal the possibility of subsequent judicial recourse, which is contrary to BIT, art 3(2) and the guarantee of FET and the rule of law.

With regard to the SPR, Mr Born took the view that, as no other country in the world had adopted such a regulatory approach, and on basis of the factual background and the evidentiary record, the SPR was manifestly arbitrary and disproportionate, in further violation of BIT, art 3(2).

Interviewed by Susan Ghaiwal.

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