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Can an Investor Claim Lost Profits for Breach of Pre-contractual Relations?

An abundant number of agreements have been and will be concluded between states and investors operating under the bilateral investment regime and even a larger number of negotiations will fail before reaching the final stage of signature. An investor may spend large sums of money with the aim of concluding an agreement with the state. If the final agreement is not signed, these investments may be lost. Is the bilateral investment regime able to assist investors where investors spend large sums of money and where the negotiations are terminated by the state? Would the investor only be able to recover its costs or could the state also be liable for the investor's lost profits?

The recent award of the arbitral tribunal composed of Daniel Price, Professor Brigitte Stern and presiding arbitrator Hon. Marc Lalonde in the investment arbitration case Luigiterzo Bosca v the Republic of Lithuania revisited the issue of protection of pre-contractual rights under the investment treaties. The award explored the issues of pre-contractual rights and the definition of investment under the BITs. It also addressed the extent of a state's liability in cases of breaches of pre-contractual relations between an investor and a state.

[1] The authors of this article acted as counsels to the state in the arbitral proceedings *Luigiterzo Bosca v Lithuania*. The purpose of this article is not to assess, but to provide a brief overview of the findings and the reasoning of the arbitral tribunal's award. Hence, any statements provided in this article are without prejudice to the position of the counsel or the state itself in the arbitral proceedings against Luigiterzo Bosca. In this article Luigiterzo Bosca is also mentioned as "the investor", however the state disputed the claimed investments of Mr. Bosca in terms of Lithuania-Italy BIT. Hence, this cannot be used as an admission of Mr. Bosca's status as an investor possessing "investment" under Lithuania-Italy BIT.

Earlier case law and Luigiterzo Bosca v Lithuania award

Earlier case law

Awards preceding the arbitral tribunal's decision in *Luigiterzo Bosca v the Republic of Lithuania* have predominantly rejected the investors' claims arising out of pre-contractual relations. The arbitral tribunals invariably concluded that pre-contractual expenditures or pre-contractual rights were not an investment under the applicable BIT. Therefore, the claims were dismissed because of the lack of tribunals' jurisdiction over the dispute, which does not arise out of an investment. However, a brief overview of the tribunals reasoning below does not suggest a firm rejection of pre-contractual claims under the bilateral investment regime.

Probably the first and the most-cited decision of an arbitral tribunal on the issue of protection of pre-contractual rights under investment treaty regime is ***Mihaly v Sri Lanka***. In *Mihaly* the American investor claimed from the state its wasted costs resulting from the state's decision to withdraw from the negotiations which were based on a letter of intent establishing general framework for the negotiations. The arbitral tribunal found that it had no jurisdiction over the dispute, since the pre-contractual expenditures did not constitute an "investment". Hence, the dispute did not arise out of an investment as required under Article 25 of the ICSID Convention.[2] It was emphasized that the negotiations never matured into a legally binding contract. However, the tribunal left the door open for the investment claims outside the ICSID Convention. The tribunal made two observations in this respect: first, by stating that "*in other circumstances, similar expenditure may perhaps be described as an investment*"[3]; and, second, by concluding that the investor's remedy may not arise because an investment had been made, "*but rather because the requirements of proper conduct in relation to negotiation for an investment may have been breached.*"[4] Arguably, the tribunal's findings meant the following:

(i) Pre-contractual expenditures may constitute an investment in the circumstances where the tribunal is not restricted by the definition of investment under Article 25 of the ICSID Convention, *i.e.* when the investor's claim is heard in the arbitral institutions, such as ICC, SCC, LCIA, etc. or in *ad hoc* arbitration under the UNCITRAL arbitration rules. In such circumstances the only restrictions on the tribunal's jurisdiction with respect to the definition of "investment" may be set in the bilateral investment treaty which may include the definition of investment as broad as to include the pre-contractual expenditures or pre-contractual rights;

(ii) The investor may claim the pre-investment expenditures from the state in cases where the BIT protects the investors at the stage of admission or establishment of investments (*e.g.* USA,[5] Canadian,[6] and Japanese[7] BITs), *i.e.* before investment is established in the host state.

The investor's claim arising out of pre-contractual relations was also rejected by the ICSID tribunal in ***Zhinvali v Georgia***. As opposed to *Mihaly*, in this case the tribunal's analysis shifted from the definition of "investment" under the ICSID Convention to the Georgian Law on Investment[8] which also provided for the state's consent to arbitration under the ICSID Convention. Though the investor and the state had signed several agreements on the exclusivity period of negotiations, the tribunal found that pre-contractual expenditures were not an "investment" under the Georgian law.

The next case which was perhaps the closest to what the *Mihaly* tribunal described as "*other circumstances*" when the investor's pre-contractual

[2] Article 25 of the ICSID Convention provides that "*[t]he jurisdiction of the Centre shall extend to nay legal dispute arising directly out of an investment*…" The ICSID tribunals interpreting this provision as

[3] Mihaly v Sri Lanka, para. 48.

[4] Mihaly v Sri Lanka, para. 51.

[5] See *e.g.* Article II.1 of the USA – Czech Republic BIT.

[6] See *e.g.* Article II.3 of the Canada – Venezuela BIT.

[7] See *e.g.* Article II.1 of the Japan – Vietnam BIT.

[8] Art. 1.1 of Georgia Investment Law provided that "*[i]nvestment is any kind of property or intellectual value or right to be contributed and used in the entrepreneurial activity*…"

expenditures may be claimed from the state was ***Nagel v Czech Republic***. UK national William Nagel had cooperation agreement with the state's agency with the view to receive operational license in the Czech Republic. After the state refused to award the license, the investor filed a claim with the Arbitration Court of the SCC. The claimant argued that his rights arising out of cooperation agreement was an investment under UK-Czech Republic BIT in the form of "*claims to money or to any performance under contract having financial value*".[9] Though the arbitral tribunal's jurisdiction was not restricted by the definition of investment under Article 25 of the ICSID Convention, it nevertheless concluded that the investor made no investment in the host state. The tribunal explained that an "investment" is an "asset" which has a financial value. It concluded that in particular case the investor's rights did not have financial value because it did not create legitimate expectations to the investor. The legitimate expectations did not exist because the parties were only obliged to work together without any guarantee that the licence would be obtained.

F-W Oil Interests v Trinidad & Tobago was again an ICSID case where the investor was a winner of a public tender, negotiated with the state's agency over the agreement for exploitation and extraction of oil offshore of Trinidad & Tobago, but the state decided to withdraw from the negotiations with the investor. The arbitral tribunal's jurisdiction was subject to the rules of the ICSID Convention, however, it started its analysis from the definition of "investment" under USA-Trinidad & Tobago BIT. As a starting point, the arbitral tribunal stated that "*the investor must show the existence of some form of legally enforceable right, or its equivalent*"[10]. It further added that only "*proprietary or contractual rights*" may fall under the definition of investment under the BIT.[11] The arbitral tribunal concluded that it lacked jurisdiction over the case because the investor made no investment in the host state. Firstly, the tribunal recognized that it was illogical to claim the investor's locally enforceable right to recover wasted costs was an investment. An investment must predate the breach of it; hence, failure to conclude the agreement cannot be investment and the breach of it at the same time.[12] Secondly, the tribunal found that both parties insisted that they would not be legally bound before the execution of a formal contract.[13]

Luigiterzo Bosca v Lithuania award

The stage of pre-contractual relations between the investor and the state, however, did not bar the arbitral tribunal from exercising the jurisdiction in *Luigiterzo Bosca v the Republic of Lithuania*. Even though the arbitral tribunal went one step further as opposed to earlier decisions rejecting the claims on the grounds of lack of investment in the host state, the *Bosca* award shows that in similar circumstances the investor may not expect more than the recovery of wasted costs.

"Bosca" branded production of sparkling wines is probably the second best known brand of sparkling wines in Lithuania after the national brand "Alita". The state-owned producer of sparkling wines "Alita" was privatized in 2003 and the Italian national Luigiterzo Bosca was among 4 bidders who participated in the public tender for the acquisition of Alita. Mr Bosca's bid was the highest and he was declared the winner of the public tender. Mr Bosca and the privatization agency of Lithuania entered into negotiations over the share purchase agreement.

The negotiations went smoothly and only several issues were left to be agreed upon between the parties. However, the privatization agency held to its guns and was not willing to reduce the requested size of contractual fines. The privatization agency declared "take it or leave it" and set the deadline for agreement on the final version of the text. After Mr Bosca had failed to initial the text of the agreement within the set time frame, it withdrew from the negotiations with the Italian sparkling wine producer.

Luigiterzo Bosca then sued the privatization agency for its failure to observe the tender regulations, the Lithuanian Civil Code provisions prescribing the duty to act in good faith in pre-contractual relations and requested the state to compensate his out-of-pocket

[9] Article I(iii) of the UK – Czech Republic BIT.
[10] F-W Oil Interests v Trinidad & Tobago, para. 124.
[11] F-W Oil Interests v Trinidad & Tobago, para. 125.
[12] F-W Oil Interests v Trinidad & Tobago, para. 142.
[13] F-W Oil Interests v Trinidad & Tobago, para. 162.

expenses incurred in the process of negotiations with the state. The case went through all the three instances and the Supreme Court of Lithuania recognized that Mr Bosca was mistreated in the tender process and awarded him the direct damages. The judgment of the court was executed and Mr Bosca was compensated his direct damages.

The Italian national felt that the justice was still not done – a few years later Mr Bosca initiated the *ad hoc* arbitration proceedings under the UNICTRAL rules of arbitration and submitted a claim against the state under Italy-Lithuania BIT. Mr Bosca alleged the state's failure to accord just and fair treatment, national treatment, most-favoured-nation treatment and guarantees of legal expropriation. The investor claimed that "but for" the state's conduct Mr Bosca would have earned around EUR 207 million from operating Alita.

The state requested to dismiss the Mr Bosca's claim on various grounds, including the absence of investment in the state, failure to prove the breaches of the state's international obligations and the fact that the Italian national was already compensated by the local courts.

The arbitral tribunal concluded that it had jurisdiction over the dispute because Mr Bosca's involvement in the alcohol market of Lithuania by way of providing services to the company producing "Bosca" production constituted "know-how" under Article 1(1)(d) of the Italy-Lithuania BIT. Accordingly, the service agreement had the necessary elements of contribution, risk and duration typically considered the basic characteristics of an investment. Something not often seen in investment arbitration – the arbitral tribunal recognized that Mr Bosca's participation in Alita tender was an "associated activity" in the form of "making of contract" under the Protocol of the BIT.

The Protocol to the Italy-Lithuania BIT extends the treaty protection to various activities associated to investment, *e.g.* "the dissemination of commercial information", "the acquisition of property" and, as referred to by the tribunal, "the making of contract". The extension of treaty protection not only to investment, but also to activities associated to investment, is an unusual, but not unseen, construction of bilateral investment treaties. Arguably, the Italy-Lithuania BIT was influenced by the same generation of the USA BITs which also grant treaty protection to "associated activities" similar to the ones listed in the Protocol of the Italy-Lithuania BIT (see, *e.g.,* Article I.1(e) of the USA-Lithuania BIT or Article I.1(e) of the USA-Latvia BIT).

Having concluded that Mr Bosca's participation in Alita tender constituted the "making of contract" under the Protocol of the BIT, the arbitral tribunal noted that the issue was not about the state's interference with Mr Bosca's investment – the service agreement. The service agreement which was concluded by the Italian investor with the producer of "Bosca" production in Lithuania could not have been affected by the state's decisions to withdraw from the negotiations with Mr Bosca. However, Mr Bosca's participation in the tender was "associated activity" to Mr Bosca's prior investment in Lithuania. Particularly the "associated activity" in the form of "making of contract" was the object of the alleged interference by the state.

On the merits, the arbitral tribunal found the state liable for its failure to accord a just and fair treatment to Mr Bosca's "making of contract" in Lithuania. The arbitral tribunal decided not to examine any further alleged breaches of the treaty by noting that in any event any other breaches would not lead to awarding any additional damages to Mr Bosca.

On the quantum phase of the case, the arbitral tribunal completely rejected Mr Bosca's claim for EUR 207 million in damages. The grounds for dismissing the claim on damages were primarily facts-specific*, e.g.,* the tribunal stated that it was not clear if the parties would have eventually agreed on all issues before concluding the contract. However, the tribunal's reasoning shows its inclination to accept the principal position that in pre-contractual relations the putative investor should not expect more than recovery of out-of-pocket expenses. The arbitral tribunal stressed that the parties were still in pre-contractual relations and, relying on arbitral and doctrinal support, concluded that damages based on assumption of the concluded contract were too remote and speculative. As a result, Mr Bosca was only entitled to the recovery of direct damages. Since the direct damages were already compensated to Mr Bosca, the claimant's entire request for damages was entirely dismissed.

Luigiterzo Bosca v the Republic of Lithuania may be one of rare awards where an investor's treaty claim arising out of pre-contractual relations managed to overcome the jurisdictional hurdle of "investment". This was determined by the following two factors: *first,* the investor's prior involvement in the state which was an "investment" and a platform for further expansion by way of negotiations over the transaction; and, *second*, favourable treaty provisions not only granting protection to investment, but also extending the scope of protection to "associated activities", such as "making of contract".

However, *Luigiterzo Bosca v the Republic of Lithuania* award suggests that the arbitral tribunals may be reluctant to award more than direct damages either in all cases where the parties are still in pre-contractual relations or the threshold may be very high, *i.e.* the conclusion of a contract must be a certainty in order to award the lost profits to the investor.

Conclusions

The arbitral tribunals before *Luigiterzo Bosca v the Republic of Lithuania* invariably dismissed the investors' claims arising out of pre-contractual relations. Generally, the mere pre-contractual relations are insufficient to prove the existence of investment under the BIT. However, there may be some consensus as to how the investor should act and what the investor must show in order to prevail with its claim:

(i) The investor should pursue its claim in forums not restricted by the definition of investment under Article 25 of the ICSID Convention;

(ii) The investor's claim should be based on a broad-based definition of investment under the bilateral investment treaty encompassing any assets, such as "any rights or claims to money" or "any rights conferred by law or contract";

(iii) Ideally, the investors claim arising out of pre-contractual relations should be based on existing investment which was sought to be expanded via the anticipated agreement with the state. The putative bilateral investment treaty should expand treaty protection to "associated activities" to investment, such as "making of contract" or "acquisition of property";

(iv) The mere claim to money arising out of breach of general duty of good faith prescribed by the national law without a self-standing investment in the host state may not be sufficient – the claim to money cannot be an investment and the breach of it at the same time;

(v) The best-effort obligations established in the letters of intent, cooperation agreement may not be enough to constitute legitimate expectations and, thus, a right having a financial value (an asset), and, in turn, an investment protected by the bilateral investment treaty;

However, even if the investor persuades the arbitral tribunal that during the pre-contractual negotiations the investor possessed investment and this investment was not treated in accordance with the treaty provisions; the investor may only recover direct damages unless the investor proves that but for state's conduct the contract would have been concluded for certain.