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## INTERNATIONAL INVESTMENT PROTECTION LAW: REVISITING THE “UMBRELLA CLAUSE”

### I. Introduction

International investment protection law plays a vital role in encouraging foreign investment by safeguarding investors against host state actions that could have a negative impact on their investments. While the states attempt to 'restore' regulatory powers, investor protections are under scrutiny in the new tide of international investment treaties. Its concept having been evolved over the years both in terms of legal interpretation and its significance in investment arbitration, umbrella clause is being reconsidered as a form of investor protection. However, the question here lies is - does the documented advancement of standards in international investment law, enabled by emerging jurisprudence constante, authentically represent a shift from the fifty-year-old historical application of the umbrella clause? For this paper, doctrinal research is employed focusing on legal analysis of the umbrella clause, interpretations and shedding light on its significance and evolving jurisprudence.

### II. Conceptual meaning of 'Umbrella Clause'

Contractual obligations are essentially governed by the contractual dispute resolution mechanism, while those deriving from the Bilateral Investment Treaty (BIT) would be governed by the BIT's dispute resolution mechanism. An outcome of the umbrella clause is that it may blur out the demarcation between this contract and the BIT. The said clause, also referred to as an obligation observance clause ('pacta sunt servanda' clause), is a clause in an international

investment agreement (IIA) through which the host state assures the observance certain investment-related obligations. The clause name derives from the ubiquitous notion it places contracts and other obligations under an umbrella of one unit. Although the precise wording of umbrella clauses could vary discreetly, it is usually worded along these lines : “*Each Contracting Party shall observe any obligation it may have entered into with regard to investments of nationals of the other Contracting Party.*”<sup>1</sup> According to this clause, an infringement of the state contract may constitute a breach of the BIT.<sup>2</sup> These clauses are mainly shaped to augment the contractual and additional responsibilities of host states under the protective aegis of an investment treaty.<sup>3</sup> It calls to extend treaty protections to investment contract breaches and facilitates international award enforcement, reassuring foreign investors that their contracts will be upheld at the international level. Some examples of an umbrella clause are incorporated in Article 2 of the UK Model BIT<sup>4</sup>, Article 8 of the 1991 German Model BIT<sup>5</sup> and Article 10 of the Switzerland model BIT.<sup>6</sup>

### III. Origin and History of Umbrella Clause

Having its origins in the 20th century, the first hint of the umbrella clause can be linked to the United Kingdom and Peru's 1921 Agreement<sup>7</sup> in relation to a tribunal having been set up for a mineral concession. Proceeding further, in the early 1950s, the negotiation discussions between the Anglo-Iranian Oil Company (AIOC) and the Iranian Government gained prominence, following the nationalization of AIOC's operations in Iran. The primary concern during these negotiations was ensuring the enforcement of contractual agreements between foreign investors and host states. Lauterpacht, as AIOC's expert, pitched a dual strategy, which reflected having the effect of umbrella clause to provide contract harmony by setting a mechanism for executing the contractual arrangements between the investor and the host State:

<sup>1</sup> Shchavelev Alexander, ‘Umbrella Clauses: A balanced approach to interpretation’, Munich GRIN Verlag (2012) <https://www.grin.com/document/262674>

<sup>2</sup>United Nations conference on trade and development, UNCTAD Series on International Investment Policies for Development, ‘The Role of Investment agreements in attracting foreign direct investments to developing countries’ (2009) (p.54) [https://unctad.org/system/files/official-document/diaeia20095\\_en.pdf](https://unctad.org/system/files/official-document/diaeia20095_en.pdf)

<sup>3</sup> Tilbe Birengel, ‘Umbrella Clauses in Investment Arbitration’, Erdem & Erdem (July 2017) <https://www.erdem-erdem.av.tr/en/insights/umbrella-clauses-in-investment-arbitration>

<sup>4</sup> UK Model BIT 2008 Art. 2

<sup>5</sup> German Model BIT 1991 Art.8

<sup>6</sup> Switzerland model BIT 1995 Art. 10

<sup>7</sup> Agreement Between the United Kingdom and Peru Respecting the Mineral Property “La Brea Y Parinas.” (1922). The American Journal of International Law, 16(3), 137–141. <https://doi.org/10.2307/2213239>

first, incorporating such a clause that would ensure the contract violations would come under the ambit of international investment protection violation and second, the implementation of a treaty between them that would be parallel to the settlement agreement between the investor and the State. Lauterpacht's investor-state contract protection strategy was incorporated into proposed conventions for the protection of foreign investment. The "umbrella" clause appeared as a novel investment protection mechanism in a formal (but non-binding) document in 1958, in Article IV, Section 4, of the Abs-Doelle Draft<sup>8</sup>. In addition, the 1959 Abs-Shawcross Draft Convention on Investments entails a rule similar to an umbrella clause. During the late 1950s and 1960s, similar umbrella clauses influenced by the Abs-Shawcross Draft were incorporated into various draft conventions and bilateral investment treaties (BITs). Notably, the clause was a fundamental basis for the 1967 OECD draft Convention on the Protection of Foreign Property.<sup>9</sup> After its initial formal recognition in the German-Pakistan Bilateral Investment Treaties (BITs) and its incorporation into the widely adopted OECD models, the umbrella clause became a prevalent component in the majority of BITs, paving the way in the BIT models of nations such as the USA, the UK, Switzerland, and the Netherlands. However, minority treaties of Australia, and Japan's BITs contain umbrella clauses<sup>10</sup>. The historical evolution of the umbrella clause implies that it arose as a consequence of the lack of adequate protections for investor-state contracts and quasi-contractual arrangements within both national and international legal frameworks. Its primary objective was to fill in the lack of effective mechanisms for resolving disputes in investor-state relationships.

#### IV. Scope of the Umbrella Clause

The goal of an umbrella clause is to broaden investment protection<sup>11</sup> and the scope of umbrella clauses in international investment treaties and agreements can vary based on the precise

<sup>8</sup> Thomas Walde, 'The "Umbrella" Clause in Investment Arbitration: A Comment on Original Intentions and Recent Cases', TDM 4 (2004), [www.transnational-dispute-management.com](http://www.transnational-dispute-management.com)

URL: [www.transnational-dispute-management.com/article.asp?key=286](http://www.transnational-dispute-management.com/article.asp?key=286)

<sup>9</sup> Yannaca-Small, K, 'Interpretation of the Umbrella Clause in Investment Agreements', OECD Working Papers on International Investment, (March 2006), OECD <http://dx.doi.org/10.1787/415453814578>

<sup>10</sup> *Id.* at 8

<sup>11</sup> Mihir C. Naniwadekar, 'The Scope and Effect of Umbrella Clauses: The Need for a Theory of Deference?' 2(1) TRADE L. & DEV. 169 (2010) <http://docs.manupatra.in/newslines/articles/Upload/4E016C4F-3051-47B2-AF60-AD8AA7D39715.pdf>

language used. However, umbrella clauses typically include certain essential elements and obligations. Firstly, umbrella clauses often include commitments made by the host country in the BIT or free trade agreement (FTA) itself. This includes protection standards such as reasonable and equitable treatment, expropriation protection and so on. Secondly, numerous umbrella clauses extend their coverage to include obligations deriving from specific investment contracts between the foreign investor and the government or relevant authorities of the host country. This means that if a host country breaches an investment-related contract, the investor can invoke the umbrella clause to seek compensation or resolution through arbitration. In some instances, the scope of umbrella clauses may encompass obligations deriving from other agreements directly related to the investment. Among these agreements may be licenses, permits, and concessions.

A question thus arises of whether umbrella clause covers every contractual obligation between the foreign investor and the host state? The answer is no. Rather, the contract between the parties must fundamentally count as an investment as per the applicable laws and treaty as non-investment related contracts are excluded.<sup>12</sup> Although unilateral modifications or terminations of such contracts may be detrimental to other investors, the umbrella clause does not cover claims for breaches of such contracts. This limitation is the result of the umbrella clause's exclusion of non-investment-related contracts from its coverage, as opposed to its one-sided focus on sovereign breaches. As long as the host State's administrative or legislative promises resulted in an investment and were intended to encourage such investments, they should be considered contractual-like commitments eligible for umbrella clause protection.<sup>13</sup> The majority of arbitral jurisprudence also supports a broad interpretation of the types of obligations that the clause encompasses. Typically, the debate can be traced back to two distinct investment treaty arbitrations of SGS Société Générale de Surveillance S.A.: *SGS v. Pakistan* (2003) and *SGS v. Philippines* (2004).<sup>14</sup>

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<sup>12</sup> Stephan W Schill, 'Enabling Private Ordering: Function, Scope and Effect of Umbrella Clauses in International Investment Treaties', *Minnesota Journal of International Law* (2009) 143.

<https://scholarship.law.umn.edu/mjil/143>

<sup>13</sup> *Id.*

<sup>14</sup> Samanth J Rowe & Svetlana Portman, 'Current trends in Umbrella Clause arising from breach of contractual obligations', *International Bar Association* (3 June 2021) <https://www.ibanet.org/current-trends-umbrella-clause-claims>

*SGS v Pakistan and SGS v Philippines:*

In the cases of *SGS v Pakistan* and *SGS v Philippines*, At issue was whether SGS, the claimant, had the authority to use the umbrella clause within the Switzerland-Pakistan BIT and the Switzerland-Philippines BIT to submit a claim for a breach of contract before an investment treaty tribunal<sup>15</sup>. In the case of *SGS v. Pakistan*, the tribunal took a highly restrictive view of the umbrella clause. It argued that allowing an investor to bring an umbrella clause claim based on a contract breach would have profound and far-reaching consequences on a contracting party, and thus, there must be undisputed and substantial proof that this was the contracting parties' joint intention<sup>16</sup>. Failing such evidence, the tribunal dismissed the umbrella clause claim. It distinguished between BIT claims and contract claims, viewing the BIT as establishing an independent standard for judging the parties' conduct. On the other hand, in *SGS v Philippines*, the tribunal adopted a more permissive interpretation of the umbrella clause, elevating the claim for breach of contract to a claim for breach of the BIT. However, it held that the umbrella clause could not supersede the parties' contractual dispute resolution clause, which designated Philippine courts as the exclusive jurisdiction for contract breach claims.<sup>17</sup> Consequently, the tribunal stayed the proceedings until the Philippine courts had addressed the dispute.<sup>18</sup> In *Supervision v Costa Rica*, the tribunal adopted yet another approach, emphasizing the quality of the breach required to trigger the umbrella clause.<sup>19</sup> It asserted that not every contractual breach could be alleged as a direct violation of the BIT, introducing a degree of selectivity.<sup>20</sup> Overall, the outcomes of these awards have raised concerns. The *SGS v Pakistan* tribunal unduly narrowed the scope of the umbrella clause, while the *SGS v Philippines* award reintroduced the principle of exhaustion of domestic remedies for contract disputes involving foreign investors and governments. The central argument is that if a dispute primarily pertains to contractual matters and does not implicate governmental powers or prerogatives, it should be subject to the

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<sup>15</sup> *SGS Société Générale de Surveillance S.A. v. Islamic Republic of Pakistan*, ICSID Case No. ARB/01/13

<sup>16</sup> *Id.*

<sup>17</sup> *SGS Société Générale de Surveillance S.A. v. Republic of the Philippines*, ICSID Case No. ARB/02/6

<sup>18</sup> *Id.*

<sup>19</sup> *Supervision Control S.A. v. Republic of Costa Rica*, ICSID Case No. ARB/12/4.

<sup>20</sup> *Id.*

jurisdiction specified in the contract itself. Only when state courts violate the BIT in the process, might the BIT's principles, such as "denial of justice" and "due process," come into play.<sup>21</sup>

### **V. Functional Interpretation of the umbrella clause**

All treaty provisions, umbrella clauses included, should be interpreted in a fair manner, taking into account their usual meaning within their context and considering the treaty's objectives and intentions<sup>22</sup>. The general rule of interpretation entailed in Article 31 of the Vienna Convention, neither promoting too narrow nor too liberal interpretation, requires the umbrella clause to be perceived not simply by textual distinctions between "obligations" and "commitments", but should take into account the context in which the umbrella clause operates in light of the context, object and purpose of the clause.<sup>23</sup> A state acting in its sovereign power being under the realm of international law should not act in way which might jeopardise the contract agreed upon by it or its agencies with the private entities<sup>24</sup>. Consequently, it is upon state to assume responsibility for failing to honour obligations under these contracts, regardless of whether such failure stems from the executive, legislative, or judicial branches. This interpretation aligns with the functional purpose of the umbrella clause, which is to safeguard contractual agreements from unwarranted sovereign interference.

### **VI. Effect of the Umbrella Clause**

Umbrella clauses have been a subject of an ongoing debate since years as it is through this clause the foreign investors have a gap to elevate investment contract violations to the claims of international investment treaty violations.

A) Awards giving effect to the clause: In *Noble Ventures v. Romania*<sup>25</sup>, the tribunal examined the scope of the umbrella clause within the United States and Romania BIT which stated that each party must adhere to obligations related to investments. The claimant argued that Romania's failure to renegotiate debts owed by a state-owned company, as per a contractual obligation, constituted a breach of the umbrella clause.<sup>26</sup>

<sup>21</sup> Supra note. 8

<sup>22</sup> Vienna Convention on the Law of Treaties, Art.31(1)

<sup>23</sup> Supra Note. 8

<sup>24</sup> *Id.*

<sup>25</sup> *Noble Ventures, Inc. v. Romania*, ICSID Case No. ARB/01/11

<sup>26</sup> *Noble Ventures, Inc. v. Romania*, ICSID Case No. ARB/01/11

The Tribunal agreed with the assertion that a breach of a domestic contract could constitute a violation of an international investment treaty, holding the host state responsible.<sup>27</sup> This interpretation aligned with the decision in *SGS v. Philippines* case. The tribunal in the case of *CMS v. Argentina* held that certain provisions in an investment license, characterized as "stabilization clauses," created commitments that were public in nature.<sup>28</sup> Argentina's failure to uphold these commitments was considered a breach of the umbrella clause in the Netherlands-Argentina BIT<sup>29</sup> and similar decision was held in the case of *Eureko v. Poland*.<sup>30</sup>

B) Awards reducing the effect of the Clause : The tribunal's decision in the case of *SGS v. Pakistan*, as discussed above, was widely criticized holding that the umbrella clause did not apply to breaches of contract between the parties. The rationale was that although some BITs could convert all state contract breaches into BIT breaches, there was insufficient evidence to prove this was the intent of both states when including the umbrella clause in the BIT. Similar arguments arose in cases like *El Paso v. Argentina*<sup>31</sup>, *Pan America v. Argentina*<sup>32</sup>, and *Sempra v. Argentina*<sup>33</sup>, where tribunals made distinctions between the sovereign and commercial roles of states. These decisions offers clarity regarding umbrella clauses in investment arbitration, emphasizing that they should fundamentally encompass disputes related to investment agreements where states are acting in a sovereign capacity rather than a commercial one. This effectively narrows the scope of obligations governed by such clauses unless the state's actions align with its sovereign role.

## VII. Significance of the clause and Potential Challenges

The umbrella clause showcases as a much-debated aspect for protecting the rights of foreign investors and promoting foreign direct investment (FDI) by providing a mechanism to address

<sup>27</sup> *Id.*

<sup>28</sup> *CMS Gas Transmission Company v. The Republic of Argentina*, ICSID Case No. ARB/01/8

<sup>29</sup> *Id.*

<sup>30</sup> *Eureko B.V. v. Republic of Poland* 2005

<sup>31</sup> *El Paso Energy International Company v. The Argentine Republic*, ICSID Case No. ARB/03/15

<sup>32</sup> *Pan American Energy LLC and BP Argentina Exploration Company v. The Argentine Republic*, ICSID Case No. ARB/03/13

<sup>33</sup> *Sempra Energy International v. The Argentine Republic*, ICSID Case No. ARB/02/16.

breaches of investment-related commitments made by host countries. Firstly, the clause elevates contractual commitments and other obligations made by host countries to foreign investors to the status of international law. This enhances investor protection by providing a mechanism for investors to directly enforce these commitments through international arbitration, bypassing potentially biased domestic courts. Secondly, the presence of the umbrella clause in bilateral investment treaties (BITs) and free trade agreements (FTAs) provides foreign investors with confidence that their rights and contractual agreements will be protected. This, in turn, encourages FDI by reducing the perceived risks associated with investing in foreign jurisdictions. Thirdly, the clause offers a clear legal framework for enforcing commitments, creating a stable environment for investors and potentially reducing investment disputes. Lastly, host countries are held accountable for their obligations, whether they are treaty-based or contract-based. This encourages host countries to adhere to their commitments and act in a manner consistent with international law, promoting responsible governance.

However, the function of the umbrella will continue to pose challenges in terms of interpretation. Some contend that the umbrella clause violates a state's regulatory rights, resulting in its omission from modern treaties.<sup>34</sup> I assert that the problem should be resolved by selecting from various methodologies, recognizing that not all obligations can be encompassed within the scope of an umbrella clause, while still ensuring the clause maintains its meaningfulness. A lot depends on the wording and interpretation of an umbrella clause and it should not be excessively broad, covering all conceivable obligations, but it should also not be rendered devoid of significance. The question then becomes locating a mechanism – a legal measure – to determine which obligations are and are not covered by the umbrella clause. A test based on the definition of "investment", rather than the tribunal's approach of "sovereignty" test appears to be the most robust alternative.

## VIII. Conclusion

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<sup>34</sup> Lee Carroll, 'What Place Does an Umbrella Clause Have in the New Generation of Bilateral Investment Treaties?', (2023), 40, *Journal of International Arbitration*, Issue 2, pp. 125-154, <https://kluwerlawonline.com/journalarticle/Journal+of+International+Arbitration/40.2/JOIA2023007>



The umbrella clause plays a significant role in the new generation of international investment treaties, but it must be drafted with care. The diverse formulations of the umbrella clause in investment agreements have led arbitral tribunals to interpret the clause differently. Therefore, the correct interpretation of an umbrella clause depends on factors such as its precise wording, usual meaning, context, treaty objectives, and the negotiating parties' intention<sup>35</sup>. It remains a vital instrument for investor protection, but its future efficacy will depend on the careful formulation of treaties, taking into consideration the delicate balance between protecting investors and respecting a state's regulatory sovereignty.

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<sup>35</sup> Mallick, Arpit Kumar, 'Interpretation of the Umbrella Clause in Bilateral Investment treaties' (12 Aug 2010) [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3859323](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3859323)