New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM
An ALM Publication
VOLUME 255—NO. 11
TUESDAY, JANUARY 19, 2016

OUTSIDE COUNSEL

Expert Analysis

Rare Investor-State Arbitration Finding On Hungary Bankruptcy Court Decision

By **Joseph J. LoBue**

And **Helene Gogadze**

International investment treaties typically protect foreign investors' right to "fair" and "equitable" treatment. This fair and equitable treatment (FET) guarantee has been understood to protect foreign investors' legitimate, reasonable and justifiable expectations in relation to their investments. International arbitration tribunals have found that the FET guarantee encompasses the concept of due process. Thus, tribunals have held that the FET guarantee precludes treaty states from administering justice in local proceedings in a manner that deprives foreign investors of due process rights. Such claims have come to be known as "denial-of-justice" claims.

International tribunals have articulated various definitions of denial of justice, including: "manifest injustice in the sense of a lack of due process leading to an outcome which offends a sense of judicial propriety,"[1] "administering justice in a seriously inadequate way,"[2] a "clearly improper and discreditable" decision,[3] "a willful disregard of due process of law, an act which shocks, or at least surprises, a sense of judicial propriety."[4] Nevertheless, in all cases, the threshold for finding that a national court's decision amounts to a denial of justice is high, and the circumstances satisfying that threshold are rarely met.

To amount to a denial of justice, the treaty state must have failed to provide a minimally adequate system of justice. International arbitration tribunals will not serve as appellate bodies correcting errors of domestic procedural or substantive law made by national courts. But, in certain circumstances, clear or malicious misapplication of local law or procedure may support a foreign investor's treaty claim based on a denial of justice.[5]

Such a rare denial of justice finding was made in a recently published award in an investor-state arbitration conducted under the Arbitration Rules of the International Centre for Settlement of Investment Disputes (ICSID). In *Dan Cake S.A. v. Hungary*, the ICSID tribunal held that a Hungarian national court decision "shock[ed] a sense of juridical propriety" and "perfectly fit" the various definitions of a "denial of justice" articulated by other tribunals. ICSID Case No. ARB/12/9, Decision on Jurisdiction and Liability (Aug. 24, 2015), ¶146. The court decision that was the subject of the award had effectively denied the investor its statutory right to a "composition hearing" in connection with bankruptcy liquidation proceedings, which was the only means available to the investor to avoid the sale of its assets. The ICSID tribunal concluded that the national court's decision constituted a denial of justice, and thus a violation by the Hungarian State of its obligations under the Portugal-Hungary Bilateral Investment Treaty to treat the Portuguese investor in a fair and equitable manner. Id. at ¶145.

> To amount to a denial of justice, the treaty state must have failed to provide a minimally adequate system of justice.

The ICSID tribunal has yet to determine the question of damages. The investor is seeking €47.9 million, plus interest.

'Dan Cake S.A. v. Hungary'

The claimant, Dan Cake, is a Portuguese company that in 1996 acquired a majority of the shares in a Hungarian company, later named Danesita. Danesita was in the business of supplying biscuits and cookies to Eastern European, Southern European and Scandinavian countries. However, the markets did not turn out to be as promising for Danesita as Dan Cake had envisioned. In 2006, Danesita's creditors pursued the company for unpaid debts. The Metropolitan Court of Budapest, sitting as a bankruptcy court, declared Danesita insolvent and appointed a liquidator to sell Danesita's assets. ¶¶2, 30-32.

As found in the ICSID tribunal's award, under Hungarian bankruptcy law, the liquidator was required to proceed with the public sale of the debtor's assets within 120 days from the date of the court's liquidation order. Once liquidation was ordered, the only way Danesita could have avoided the sale of its assets under Hungarian law was to enter into a restructuring agreement with its creditors. For this purpose, the Hungarian Bankruptcy Act allows the debtor company to request that the bankruptcy court convene a "composition hearing" at which the creditors have an opportunity to vote on and approve an agreement prepared by and negotiated with the debtor. If the agreement is approved, the sale of the assets is avoided. ¶¶45-47.

Danesita, with Dan Cake's help, reached agreements with various creditors to settle certain debts, and was in the process of negotiating agreements with other creditors. Accordingly, Danesita submitted a request to the court seeking to convene a composition hearing. Danesita's request was accompanied by the three required documents specified in the Bankruptcy Act:

JOSEPH J. LOBUE *is a partner at Fried, Frank, Harris, Shriver & Jacobson.* HELENE GOGADZE *is an associate at the firm.*

a proposed agreement, a list of creditors drawn up by the liquidator, and an appropriate program for the restoration of solvency. ¶¶46, 49.

Notwithstanding Danesita's right under the statute, the court refused to convene a composition hearing. Instead, the court ordered Danesita to supplement its request with numerous additional documents within 10 days. In addition, in its decision, the court specifically noted the liquidator's obligation to proceed with the sale of the assets within 120 days from the publication of the liquidation proceedings, and served a copy of the order on the liquidator. Danesita was unable to comply with the additional conditions imposed by the court, and there was no opportunity available to appeal the court's decision. ¶¶54-55. The liquidation resulted in the sale of Danesita's factory, and Dan Cake lost its investment. ¶¶57-59.

Dan Cake initiated investor-state arbitration against Hungary under the Portugal-Hungary Bilateral Investment Treaty, claiming that Hungary violated, among other things, Dan Cake's right to fair and equitable treatment. ¶¶60-65.

'Denial-of-Justice' Finding

The ICSID tribunal found that, under the circumstances of the case, the court's refusal to convene a composition hearing resulted in a denial of justice, giving rise to a treaty claim. The tribunal stressed that convening a prompt composition hearing was the only way for Danesita and Dan Cake to prevent the sale of Danesita's assets and the loss of Dan Cake's investment in Hungary. ¶¶92-93. Under Hungarian bankruptcy law, if the court convened a composition hearing, the liquidator would have had to stop the process of selling the assets. At the composition hearing, the creditors could have voted against the sale of assets. In the absence of the hearing and the vote of the creditors, the liquidator was under an obligation to start the public sale of the assets within 120 days of the date of publication of the liquidation proceedings. It would have been pointless to hold a composition hearing after the sale. ¶94.

The tribunal acknowledged that it was impossible to determine whether a composition hearing would in fact have resulted in a vote by the creditors in favor of restructuring and preventing the liquidation of assets. However, according to the tribunal, one thing was certain: whatever chance Danesita had of avoiding liquidation of its assets was destroyed by the court's refusal to convene a composition hearing. ¶142.

The tribunal further found that the court's decision refusing to convene a composition hearing was surprising, puzzling, and rendered in flagrant violation of the Bankruptcy Act. ¶142. The tribunal noted that the debtor's right to a composition hearing was specifically provided for by law in mandatory terms. In particular, the Bankruptcy Act provides that, upon the debtor's request, the bankruptcy court "shall" convene a composition hearing within 60 days following the receipt of the petition and the three documents specified in the act. ¶94. The parties did not dispute that Danesita submitted the documents required by the Bankruptcy Act. Nevertheless, the court ruled that the request was not suitable to be served on the creditors and refused to convene a composition hearing. ¶98.

Instead, the court imposed seven additional conditions on Danesita that included the submission of voluminous supplemental documentation.

In 'Dan Cake S.A. v. Hungary,' the ICSID tribunal found that the court's decision refusing to convene a composition hearing was surprising, puzzling, and rendered in flagrant violation of the Bankruptcy Act.

Importantly, the tribunal accepted the proposition that the court had inherent power to require the submission of additional documents or information, not specifically mentioned in the statute, that the court deemed necessary to administer the case. ¶113. The tribunal also acknowledged that it was not an arbitration tribunal's role to review a court's reasoned judgment as to whether particular supplemental information or material is indeed "necessary" in a given case. In the tribunal's opinion, mere disagreement with a court along such lines would not establish that the court's decision was unfair or inequitable.

However, according to the tribunal, it could find the court's decision unfair or inequitable if it found that some of the requirements imposed by the court were obviously unnecessary or impossible to satisfy, or in breach of the investor's fundamental rights. ¶117. And that is exactly what the tribunal found. The tribunal reviewed the seven additional conditions imposed by the court and found five of the conditions obviously unnecessary in relation to convening a composition hearing. In this regard, the tribunal distinguished (and found that the court did not properly distinguish) documents and information that might be necessary at the hearing from documents and information that were necessary to convene a future hearing.

The tribunal noted that the law did not require, and it would have been absurd to require, that all the information and documents demanded by the court be in place on the day of the order convening the hearing. ¶115.[6] The tribunal concluded that two of the other conditions imposed by the court violated Dan Cake's statutory rights (as a creditor of Danesita), and that the remaining condition was impossible to satisfy within a reasonable time. ¶¶118-141.

Based on the totality of the circumstances, the tribunal determined "that the Court simply did not *want*, for whatever reason, to do what was mandatory." (emphasis in original). ¶142. Accordingly, the tribunal found a denial of justice in the court's "shocking…refusal, in violation of Hungarian law, to convene a composition hearing which was the only way to prevent the sale of the factory." ¶160.

1. *Lowen v. United States*, ICSID Case No. ARB(AF)/98/3, Award (June 26, 2003), ¶132.

2. *Azinian v. Mexico*, ICSID Case No. ARB(AF)/97/2, Award (Nov. 1, 1999), ¶102.

3. *Mondev Intenrational Ltd. v. USA,* ICSID Case No. ARB/01/7, Award (Oct. 11, 2002), ¶¶127-128);

4. *Elettronica Sicula, USA v. Italy*, 1989 ICJ 15, ¶15.

5. *Chevron v. Ecuador*, UNCITRAL Final Award (Aug. 31, 2011), ¶35 ("The courts' undue delays and refusals are in clear violation of Ecuador's own laws governing judicial proceedings…the breaches of Ecuadorian law evidence a breach of the minimum standard of treatment under customary international law."); *Azinian v. Mexico*, Award (Nov. 1, 1999), ¶¶102-103 (a wrong and inadequate finding may suggest a due process violation when the decision is so evidently improper that it amounts to "a clear and malicious misapplication of law" and raises "justified concerns as to the judicial propriety of the outcome" of the case) *Mr. Franck Charles Arif v. Republic of Moldova*, ICSID Case No. ARB/11/23, Award (April 8, 2013), ¶537 (noting that the judiciary may breach the standard by "fundamentally unfair proceedings and outrageously wrong, final and binding decisions"); *Rumeli Telekom v. Republic of Kazakhstan*, ICSID Case No. ARB/05/16, Award (July 29, 2008), ¶¶651-653, 657 (the substance of the decision may be relevant if it is "so patently arbitrary, unjust or idiosyncratic that it demonstrates bad faith"); *RosinvestCo UK Ltd. v. Russia*, SCC Case No. V079/2005, Final Award (Sept. 12, 2010), ¶279 ("The substantive outcome of a case can be relevant as an indication of lack of due process and thus can be considered as an element to prove denial of justice.").

6. By way of example, one of the conditions required Danesita to submit evidence, such as a letter of intent from the debtor and the creditors to enter into a composition agreement, in order for the court to be able to assess whether the composition hearing was likely to result in a positive vote by the necessary number of creditors. The tribunal determined that the court did not have any valid basis to demand such evidence at the time the composition hearing was requested. According to the tribunal, if the Hungarian legislators meant to include a likelihood-of-success requirement as a prerequisite to a hearing, they would have expressly included such a requirement in the statute. ¶¶126-127.

Reprinted with permission from the January 19, 2016 edition of the NEW YORK LAW JOURNAL © 2015 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. For information, contact 877-257-3382 or reprints@alm.com. # 070-01-16-27