Freezing government policy: Stabilization clauses in investment contracts by Robert Howse

The problem of moral hazard and its implications for the protection of ‘legitimate expectations’ under the fair and equitable treatment standard by Jonathan Bonnitcha

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Critics of investment law have argued that investment treaties are unduly biased towards the interests of investors, and that, particularly through interpretation by pro-investor arbitrators, the expropriation and fair and equitable treatment provisions of these treaties have resulted in the requirement to compensate investors even for publically-interested regulatory change, including environmental and social regulations. Those who defend the arrangements in question argue that, in fact, in most instances where investors have received compensation, governments have acted out of regulatory opportunism, luring the investor into the country with promises of a stable and favorable regulatory framework, only to alter that framework to the investor’s disadvantage, or threaten to do so in order force renegotiation of the terms and conditions of the investment, after the investment is established.

As an alternative, or in addition, to an investment treaty, investors and host states can bargain contractually over the allocation of regulatory risk. In particular, they can include stabilization clauses in host government contracts, which commit governments to not alter regulatory frameworks in a way that undermines the economic viability of the investment. Moreover, they can make such contracts enforceable through international arbitration, thus avoiding dependence on the domestic court system in the host country.

Despite the enormous amount of controversy over BITs and their effects on regulatory autonomy, there has been very little attention to stabilization clauses. Yet such clauses are used extensively, particularly in the case of investments in extractive industries, infrastructure and the energy sector.

Stabilization clauses and regulatory chill
The most sustained examination of stabilization clauses is in a 2008 study spearheaded by John Ruggie and the International Financial Corporation (IFC) of the World Bank.¹

The Ruggie/IFC report mostly understands the problem of stabilization clauses as a tradeoff between the need of developing countries for capital, which leads to a willingness to make such commitments to investors, and the policy autonomy that such governments would prefer in order to implement the social and environmental and other regulatory measures that respond to the needs of their citizens over time. The study surmises that, with strengthened negotiating skill and capacity, a better informed citizenry and pressure on multinational corporations to behave with social and environmental responsibility, developing country governments will be able to achieve “fairer” or more balanced stabilization clauses, which protect essential policy space, while addressing the key concerns of investors with respect to stability. The Ruggie/IFC report points to the much more balanced and nuanced nature of stabilization clauses in investment contracts to which OECD member countries are parties, suggesting that governments with sophisticated negotiating capacity are able to come to terms with investors while avoiding blanket “freezing” or “full equilibrium” clauses, which constrain policy space over a broad, or unlimited, range of regulatory fields. However, the variance between OECD countries and developing countries, particularly in sub-Saharan Africa, could be explained by the greater political and regulatory uncertainty in these countries;

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investors feel they are much less able to predict what kind of future regulatory and political changes may occur that may affect the value of the initial bargain with the state.

Generally speaking, it is not efficient to compensate private actors for regulatory change, a point extensively argued in Louis Kaplow’s classic article “Legal Analysis of Economic Transitions.”2 In this study, Kaplow examines most of the rationales for compensation that relate to market and government failure and concludes that there is little likelihood, on balance, that government will do better than the market in efficiently allocating the risk of regulatory change.

If we begin from the default position that compensation for regulatory change is not efficient, then our preliminary conceptualization of a stabilization clause will be that it confers a benefit or rent on the firm. Either this rent reflects capture or it has a legitimate public policy rationale in that it affects the behavior of the firm in a manner that accomplishes a legitimate goal of the government. This goal is generally understood, for example in pro-stabilization documents of the World Bank, as the attraction of foreign capital that has a positive role in the country’s development strategy. That begs the question of why stabilization is desirable over larger subsidies to the investor, for example. A tentative answer is that investors show an inclination for desirable over larger subsidies to the investor, for example. Shareholders do not typically directly bargain with states when investment contracts are negotiated. Instead, managers and lawyers bargain with bureaucrats or the legal counsel they hire, who represent the political principals. The standard advice is that a stabilization clause should be demanded as a condition of an investment contract. The IFC/Ruggie study, which interviewed a wide range of managers and lawyers involved in investment contract negotiations, confirmed that demanding such clauses is assumed to be in the interests of shareholders. Evaluation of regulatory risk in the host country by managers and lawyers is often difficult and expensive. Writing into contracts more refined allocations of regulatory risk (environment, labor laws, health, zoning, taxation etc.) between the investor and the host state, as is suggested by the IFC/Ruggie study, may simply be regarded by the managers and lawyers as too costly. This is especially the case in a state where there are multiple levels of regulatory authority that can affect the operations and revenues of the investment.

“Obsolescing bargain” theory holds that, over time, the bargaining power of the government increases relative to that of the investor. This is because of the hostage effect: having substantial sunk costs, the investor cannot easily walk away from the project if the state seeks to renegotiate the contract to its advantage, for example demanding a higher share of the returns from the project. In the case of a private contractual party, this kind of threat is mitigated by the fact that if the investor refuses to renegotiate it can always seek to enforce the terms of the contract in the courts, or in international arbitration. However, the state has an option not available to a private party, namely that it can unilaterally extract a greater share of returns through regulatory action. The most obvious case, often discussed in the literature, and observed in practice, is changing the fiscal regime so as to impose a higher tax on the returns of the investor.

The IFC/Ruggie report makes the point that this kind of concern with regulatory opportunism, as opposed to mere regulatory uncertainty, could be addressed by very limited stabilization clauses, of the kind that trigger regulatory compensation only for discriminatory or arbitrary regulatory actions; these would appear to overlap substantially with obligation respect to national treatment and fair and equitable treatment, both of which embody non-discrimination norms. While it may seem implausible that a state would change generally applicable regulation in order to single out a particular investment and extract rents from it, the situation becomes complicated when there is only one investor in the sector, or all investors are foreign investors with comparable contracts. It may be further exacerbated where there is weakly developed rule of law and administrative procedure, such that targeted discriminatory action can be hard to distinguish from generally applicable legislative or regulatory action.

If, in the absence of a stabilization clause, the government can adjust the bargain export or force renegotiation ex post, then it has a means to address information asymmetries. In general, anything that constrains the possibility of correcting for information asymmetries through renegotiation exacerbates transaction costs. The firm has less incentive to withhold relevant information at the time of the bargain, or misrepresent its capacities, knowing that, if it does so, the government has the unilateral option to react by changing the regulatory framework or forcing renegotiation through threatening to do so. In this sense, the transaction costs of contracting could be considered to be higher in the presence of a stabilization clause.
Stabilization clauses also create moral hazard on the part of the firm. Knowing it is insulated against regulatory changes the firm may decide not to take precautions against the occurrence of events that, because of their social costs, may predictably trigger regulatory responses that are costly to the firm (for example, certain environmental harms).

However, the political benefits that flow from investment contracts often accrue up front; there is the immediate promise of jobs and local economic development, while it may well be a subsequent government that pays the political price in terms of loss of policy space. In contrast, front loading of compensation to the firm, a rational response to regulatory opportunism enabled by the “obsolescing bargain”, entails immediate political costs, to the extent that the regime is left with fewer resources with which to win political support.

Policy implications and agenda for future research
A recent manifesto by a group of progressive academics was highly critical of the manner in which investment treaties interfere with regulatory autonomy, while stating a preference for investment contracts over treaty obligations on the apparent assumption that states can insure that commitments with respect to regulatory stability are more narrowly tailored and more clearly defined in contracts. However, just the reverse may be true. Obligations such as the requirement of compensation for expropriation and of fair and equitable treatment have, admittedly, been read by some tribunals as providing some sort of guarantee against regulatory changes that are harmful to the investor. Nevertheless, these readings are the exception rather than the rule. The norms on expropriation and fair and equitable treatment do address concerns about regulatory opportunism that are often cited as rationales for stabilization clauses, but because of the considerable uncertainty as to whether a tribunal will order compensation for regulatory change in the absence either of a formal taking or evidence of arbitrary and/or discriminatory behavior of the regulator, investment treaties do not facilitate regulatory capture by the firm in the way that stabilization clauses do (of course depending on how they are drafted).

The negotiation of stabilization clauses in secret contributes substantially to the danger of regulatory capture.

The negotiation of stabilization clauses in secret contributes substantially to the danger of regulatory capture. Both may be significant issues for investors. But they may require different kinds of contractual or other devices to manage.

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Notes
Economists have been criticised for focusing exclusively on maximising efficiency, to the neglect of other values. These criticisms are important and well-made, yet they do not undermine the view that efficiency should be one of the criteria by which legal rules are evaluated. A rigorous examination of efficiency is especially important in the context of IIT interpretation, because a common justification for IITs is that they provide economic benefits. The concept of efficiency

The concept of efficiency is central to economic analysis of public policy, including the economic analysis of legal rules. Efficiency concerns the maximising of net economic benefits; a policy improves efficiency if its economic benefits exceed its economic costs. Economists have been criticised for focusing exclusively on maximising efficiency, to the neglect of other values. These criticisms are important and well-made, yet they do not undermine the view that efficiency should be one of the criteria by which legal rules are evaluated. A rigorous examination of efficiency is especially important in the context of IIT interpretation, because a common justification for IITs is that they provide economic benefits.

How IITs affect efficiency

The primary means by which IITs affect economic efficiency is by influencing the investment decisions of foreign investors. A more efficient investment decision creates greater net economic benefits, regardless of to whom those benefits accrue. The profitability of an investment project is a first approximation of the efficiency gain of undertaking the project, because profit represents the excess of economic benefits of production over economic costs. This is the foundation of the basic economic argument for IITs—that they give prospective investors confidence that their property and contractual rights will be protected abroad, encouraging them to reallocate their capital from less profitable projects in their home markets to more profitable projects available elsewhere.

But this argument relies on a highly simplified model of economic activity. A more sophisticated model would acknowledge that there are often external costs and benefits of production that do not accrue to the investor. As discussed below, these externalities mean that the (un)profitability of a project does not necessarily imply its (in)efficiency.

The problem of moral hazard and why it reduces efficiency

Moral hazard refers to a situation where economic actors make profit-maximising but inefficient decisions because they are able to avoid costs associated with their conduct. The problem of moral hazard is often associated with insurance—when someone takes out insurance against a given type of harm, they no longer have an incentive to take prudent (efficient) steps to reduce the risk of that harm occurring. In practice, the protections contained in IITs operate as a form of insurance for investors against harm caused by future government conduct. This raises the risk of moral hazard—that investors might undertake projects without adequately assessing the externalities created by their projects, and the associated risk that future governments might redress such externalities when they begin to crystallise.

This problem has been explored in considerable detail in economic literature. The key insight that emerges from this literature is that protecting investors from having to bear the cost of new, efficiency-improving government measures is likely to result in inefficient investment decisions. As such, investors should not be protected from efficient regulatory change, even if it results in the investment becoming unviable. Such legal protections would insure investors against changes in government policy, allowing them to ignore the risk posed to contemplated investments by efficiency-improving policy change.

This scenario is easier to illustrate with an example. It would be inefficient for an investor to sink capital into building a factory which would operate at a profit of one thousand dollars a year by dumping pollutants in a river that cause two thousand dollars a year worth of damage to a downstream oyster industry. The most efficient investment decision would be for the investor not to undertake the investment in the first place and to allocate its capital to some other project. An investor that knew that future governments were free to prohibit dumping without compensating the investor would be less likely to commence such a project. On the other hand, an investor that knew that future governments would be required to pay compensation if it prohibited dumping would be far more likely to undertake the project.

In the example above, a prohibition on dumping pollutants is efficiency-improving because the benefits of the ban exceed the costs. In cases that come before arbitral tribunals there may be considerable evidentiary difficulties in determining whether given government measures are efficiency-improving. I do not suggest that tribunals should attempt to make such determinations on a case-by-case basis. Rather my argument is that the more expansive strands of current ‘legitimate expectations’ jurisprudence are highly likely to result in investors being compensated for losses caused by efficiency-improving government conduct. As such, these broader understandings of the doctrine of legitimate expectations induce moral hazard on the part of investors.
Existing jurisprudence on the protection of ‘legitimate expectations’ under the fair and equitable treatment standard

It is now widely accepted that fair and equitable treatment (FET) provisions, which are found in the vast majority of IITs, protect foreign investors’ legitimate expectations. Despite this apparent consensus, arbitral tribunals have taken markedly different views of the range of expectations that might potentially qualify as ‘legitimate’ expectations. I identify four distinct views about the scope of the doctrine in contemporary arbitral decisions. The narrowest interpretation seems to require that an expectation be based on specific legal entitlements vested in a foreign investor under the law of the host state in order for such an expectation to be legitimate. For example, in LG&E v Argentina the tribunal held that an expectation would have to ‘exist and be enforceable by law’ to merit protection. According to this view, the doctrine functions as an additional, international layer of protection for existing rights, rather than as a source of new rights. A second view is that a legitimate expectation need not be based on the legal rights of the investor, so long as it is based on specific, unilateral representations made by a government official. This also seems to be the dominant view in academic commentary. This set of decisions also embodies the limitation that expectations must be reasonable in light of the political and economic circumstances of the host state to be protected by the FET standard.

A third strand of decisions suggests that an investor may legitimately expect the regulatory regime in place at the time of the investment to remain in force, even if the government has not promised to retain the regulatory regime and the investor has no legal right under domestic law to its continuance. In these decisions the emphasis is on the protection of expectations that are ‘basic’ to the decision to invest; there is far less emphasis on assessment of whether the basic expectation in question was reasonable in the circumstances. At the far end of the jurisprudential spectrum are a fourth group of cases in which investors have succeeded in claims for breach of legitimate expectations, despite the identified expectation having no base in the legal rights of the claimant under domestic law, nor in representations made by the host state or the regulatory arrangements in force at the time the investment was made. One such decision is Bau v Thailand. Here the tribunal accepted that the investor had an expectation of a ‘reasonable rate of return’, where the expectation was based solely on the investor’s business plans at the time of making the investment.

What the problem of moral hazard means for the doctrine of legitimate expectations

Extending legal protection to the basic expectations that underpin an investor’s business plan—as was done in Bau—is highly likely to induce moral hazard. A state’s liability under this interpretation of the doctrine of legitimate expectations does not turn on an examination of whether the state’s conduct was efficiency improving (either explicitly or de facto). Rather it provides investors with a degree of insurance against government actions that undermine the profitability of their investments, regardless of whether the government action is efficient. This is precisely the sort of legal rule that is likely to discourage investors from internalising the risk to their business plans posed by future, efficiency-improving government conduct.

Protecting general expectations of regulatory stability is also likely to cause serious problems of moral hazard. Arbitral decisions that have applied this understanding of the doctrine of legitimate expectations have determined liability by assessing whether the altered regulation was ‘basic’ to the investor’s decision to invest. This approach eschews economy-wide judgement of whether the regulatory change was efficiency-improving, in favour of an assessment of whether the change has seriously affected the investor’s interests. Such expansive legal protection is unjustifiable from an economic perspective. An investor should be required to bear the risk of efficient regulatory change, because that risk plays an important role in discouraging investors from initiating socially undesirable investment. This holds true even in cases where regulatory change is ruinous an an investment.

Conclusion

This article argues that two of the broader interpretations of the doctrine of legitimate expectations are likely to reduce economic efficiency on account of inducing moral hazard on the part of foreign investors. This is because broader interpretations of the doctrine provide foreign investors with too much protection from regulatory and policy change. Economic theory shows why leaving foreign investors exposed to the risk of certain types of policy change plays a crucial role both in dissuading foreign investors from undertaking projects that are not in the public interest, and in encouraging foreign investors to structure the projects they do undertake in a way that minimises external costs. This is an important conclusion because it illustrates that stronger legal protections of this type for foreign investment are not necessarily desirable on economic grounds; indeed, sometimes they are profoundly undesirable.

There may be a number of other grounds on which one could criticise (or defend) broad protection of an investor’s expectations. This piece has not attempted to assess these arguments. By putting environmental and human rights arguments to one side, I do not intend to suggest that they are less important than economic arguments, nor to suggest that dumping pollution in a river is only objectionable if it inhibits potentially more lucrative investment downstream. Rather, I hope to show that debate about IITs does not necessarily reduce to an argument about the importance of economic development vs. the importance of environmental protection and realisation of human rights. My own view is that narrower interpretation of key IIT provisions would be preferable on economic, human rights, environmental and rule of law grounds.

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14 Biwater Gauft v United Republic of Tanzania ICSID Case No ARB/05/22, Award, 24 July 2008, [601]; Saluka Investment BV v Czech Republic Partial Award, 17 March 2006, [305]; Continental Casualty v The Argentine Republic ICSID Case No ARB/03/39, Award, 5 September 2008, [261]

15 CME v Czech Republic Partial Award, 13 September 2001, [611]; Occidental Exploration and Production Company v the Republic of Ecuador LCIA Case No UN3467, Final Award, 1 July 2004, [184]; Enron Corporation v Argentine Republic ICSID Case No ARB/01/3, Award, 22 May 2007, [267]

16 Técnicas Medioambientales Tecmex v United Mexican States ICSID Case No ARB(AF)/00/02, Award, 29 May 2003, [154]

17 According to this interpretation, the doctrine of legitimate expectations operates somewhat akin to a stabilization clause, in that it protects foreign investors from change to the legal regime governing an investment. However, the legal effect of this interpretation differs from a broadly drafted stabilization clause in that only changes to regulations that were ‘basic’ to the decision to invest would constitute a breach of legitimate expectations.

18 Bau v The Kingdom of Thailand Award, 1 July 2009, [123]. Similarly, Bogdanov v Republic of Moldova Arbitral Award, 22 September 2005, 17; MTD v Chile ICSID Case No ARB/01/17, Award, 21 May 2004, [163]

19 The tribunal held that: In spite of the fact that there was no guarantee by the Respondent of an explicit rate of return, the Tribunal considers that a reasonable rate of return – reasonable in all the circumstances, including the signing of MoA2 – was part of the Claimant’s legitimate expectations and the failure to fulfil such a reasonable expectation was a breach of the Respondent’s obligations.

20 I develop this argument at length in my doctoral dissertation, J Bonnitcha ‘A normative framework for evaluating interpretations of investment protection treaties’ (University of Oxford, forthcoming April 2011)
During crises in that decade, capital controls in the 1990s were used to avoid the worst of the damages that form part of the TPP negotiations, successfully used by Indonesia, South Korea, Taiwan and Thailand to help their nations escape some of the damage caused by the global financial crisis.

Under these circumstances, capital controls can help smooth the inflows and outflows of capital and protect developing economies. Most controls target highly short-term capital flows, usually conducted for speculative purposes.

For example, Colombia’s 2007 capital controls required foreign investors to park a percentage of their investment in the central bank, which helped that nation escape some of the damage from the global financial crisis. Chile and Malaysia, two nations that form part of the TPP negotiations, successfully used capital controls in the 1990s to avoid the worst of the damages during crises in that decade.

In the wake of the financial crisis, nations such as Brazil, Indonesia, South Korea, Taiwan and Thailand have all used capital controls to stem the massive inflows of speculative investment entering their economies and wreaking havoc on their exchange rates and asset markets. South Korea, where the won has appreciated by 30% since 2008, has direct limits on foreign exchange speculation, for example, and has also levied an outflows tax on capital gains of foreign purchases of government bonds.

A pathbreaking IMF study finds that capital controls like these have helped developing nations stem currency appreciation and asset bubbles in the past. Moreover, the IMF study found that capital controls helped buffer some of the worst effects of the financial crisis in some developing countries. In lieu of these findings, the IMF now endorses the use of capital controls as a part of the macroeconomic policy toolkit. The IMF permitted capital controls on outflows in Iceland, Ukraine and Latvia as the crisis hit, and has recently recommended that nations such as Brazil, Colombia, and India use controls on inflows to tame the mass influx of capital that herded to emerging markets in 2009-2010. In 2010 the IMF took a step further and recommended that a system of global coordination be put in place for capital controls, an initiative that the G-20 will take up in 2011.

Capital controls and U.S. treaties

In contrast with the treaties of many other industrialized nations, the template for United States trade and investment treaties does not leave adequate flexibility for nations to use capital controls to prevent and mitigate financial crises. At their core, U.S. treaties see restrictions on the movement of speculative capital as a violation of their terms. The safeguards in U.S. treaties were not intended to cover capital controls.

This shortcoming in U.S. treaties has recently been the subject of significant controversy. In January of 2011, 250 economists from the United States and across the globe, including a Nobel Laureate, former IMF officials, two former ministers of finance, and members of pro-trade think tanks such as the Peterson Institute for International Economics sent a letter to the U.S. government calling on the U.S. to address this imbalance in U.S. trade treaties. That letter was followed by a rebuttal letter signed by many of the major corporate lobby organizations in the United States and has since become elevated as an important issue in pending treaties and negotiations.

U.S. trade and investment treaties explicitly deem capital controls as actionable measures that can trigger investor-state claims. The Transfers provisions in the investment chapters of trade treaties, or in stand alone BITS, require that capital be allowed to flow between trading partners “freely and without delay”. This is reinforced in trade treaties’ chapters on financial services that often state that nations are not permitted to pose “limitations on the total value of transactions or assets in the form of numerical quotas” across borders.

In the financial services chapters of U.S. trade treaties, and in U.S. BITS, there is usually a section on “exceptions.” One exception, informally referred to as the “prudential exception,” usually has language similar to the following from the US-Peru trade treaty:

Reforming United States trade and investment treaties for financial stability: The case of capital controls

Kevin P. Gallagher

This short essay discusses new evidence in the economics profession showing that capital controls are important macro-prudential measures that nations should have in their toolkit to prevent and mitigate financial crises. More importantly for this publication, it will be shown that United States trade and investment treaties do not reflect the emerging consensus on capital controls. There is a unique opportunity to rectify this problem as the United States finalizes its new model bilateral investment treaty (BIT) and moves forward on negotiations for a Trans-Pacific Partnership Agreement (TPP) with numerous Pacific Rim nations. Moreover, an opportunity for reform lies in the pending Congressional votes on Bush-era trade deals such as those with South Korea, Colombia, and Panama.

New research on capital controls and financial stability

Capital flows—cross-border non-foreign direct investments—can help developing countries grow. Indeed, many developing countries may lack the savings or financial institutions that can help finance business activity. Capital from abroad can fill that gap. Therefore, under normal circumstances, the more capital flowing into a developing country, the more the country benefits. However, cross-border capital flows tend to be “procyclical”: too much money comes in when times are good, and too much money evaporates during a downturn.

A key characteristic of the global financial crisis has been the mass swings of capital flows across the globe. Indeed, international investment positions now surpass global output. Developing and emerging markets are no strangers to these flows. When the crisis hit, capital rapidly left the developing world in a flight to the “safety” of the United States market. A key characteristic of the global financial crisis has been that nations such as Brazil, Colombia, and India use controls on inflows to tame the mass influx of capital that herded to emerging markets in 2009-2010. In 2010 the IMF took a step further and recommended that a system of global coordination be put in place for capital controls, an initiative that the G-20 will take up in 2011.

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Financial Services chapter: Article 12.10: Exceptions

1. Notwithstanding any other provision of this Chapter or Chapter Ten (Investment), Fourteen (Telecommunications), or Fifteen (Electronic Commerce), including specifically Articles 14.16 (Relationship to Other Chapters) and 11.1 (Scope and Coverage) with respect to the supply of financial services in the territory of a Party by a covered investment, a Party shall not be prevented from adopting or maintaining measures for prudential reasons, including for the protection of investors, depositors, policy holders, or persons to whom a fiduciary duty is owed by a financial institution or cross-border financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of this Agreement referred
to in this paragraph, they shall not be used as a means of avoiding the Party's commitments or obligations under such provisions.

Capital controls are not seen as permissible under this exception. This has been communicated by the United States Trade Representative and in 2003 testimony by the Under Secretary of Treasury for International Affairs to the U.S. Congress. In general this is because the term “prudential reasons” usually interpreted in a much narrower fashion, pertaining to individual financial institutions. Concern has also been expressed that the last sentence is “self-canceling,” making many measures not permissible.

The prudential exception in services chapters or BITs is usually followed by an exception for monetary policy that often reads like (again to use the US-Peru Trade treaty):

2. Nothing in this Chapter or Chapter Ten (Investment), Fourteen (Telecommunications), or Fifteen (Electronic-Commerce), including specifically Articles 14.16 (Relationship to Other Chapters) and 11.1 (Scope and Coverage) with respect to the supply of financial services in the territory of a Party by a covered investment, applies to nondiscriminatory measures of general application taken by any public entity in pursuit of monetary and related credit or exchange rate policies. This paragraph shall not affect a Party's obligations under Article 10.9 (Performance Requirements) with respect to measures covered by Chapter Ten (Investment) or under Article 10.6 (Transfers) or 11.10 (Transfers and Payments).

This second exception could be seen as granting nations the flexibility to pursue necessary monetary and exchange rate policy (of which capital controls are a part). Yet the last sentence in that paragraph specifically excludes transfers.

These provisions were very controversial with the US-Chile and US-Singapore trade treaties in the early 2000s. U.S. trading partners repeatedly asked for a safeguard that would include capital controls but the United States has denied that request. In a few instances, U.S. negotiators granted special annexes that allowed U.S. trading partners to receive an extended grace period before investor-state claims can be filed with respect to capital controls, as well as limits on damages related to certain types of controls. These annexes are still inadequate in the wake of the financial crisis for at least four reasons. First, the annexes still allow for investor-state claims related to capital controls—they just require investors to delay the claims for compensation. An investor has to wait one year to file a claim related to capital controls to prevent and mitigate crises, but that claim can be for a measure taken during the cooling off year. The prospect of such investor-state cases could discourage the use of controls that may be beneficial to financial stability. Second, many other nations' treaties allow for capital controls. Indeed, the Canada-Chile FTA, the EU-Korea FTA, the Japan-Peru BIT, and the Japan-Korea BIT (just to name a few) all grant greater flexibility for capital controls. This gives incentives for nations to apply controls in a discriminatory manner (applying controls on EU investors but not on US investors). Third, the IMF has expressed concerns that restrictions on capital controls in U.S. agreements, even those with the special annexes, may conflict with the IMF’s authority to recommend capital controls in certain country programs, as they have done in Iceland and several other countries. Finally, the special dispute settlement procedure included in the US-Chile and Singapore FTAs did not become a standard feature of U.S. agreements. It is not in CAFTA, any U.S. BIT, or the pending US-Korea FTA.

Reforming U.S. treaties for financial stability

This problem should be rectified. It is in the interests of the U.S. and its trading partners to have adequate policy space to prevent and mitigate financial crises. A number of (non-exclusive) options are possible. First, some IMF officials have gone so far as to recommend that speculative capitals in the form of derivatives and other financial “innovations” be omitted from the definition of investment in treaties. Such an option was also recommended in the International Institute for Sustainable Development’s Model Investment Treaty. Another option, more recently advocated by the IMF, is to come up with a uniform safeguard language that can be used by all nations. Finally, and more specific to U.S. treaties, the “exceptions” language in U.S. treaties could be broadened to explicitly allow for the flexibility to deploy controls and other measures now recognized as prudential to prevent or mitigate a crisis.

The “prudential exception paragraph” could have a footnote with an explicitly non-exhaustive list that clarifies that prudential measures include capital controls, among other measures. The last sentence in that paragraph could be deleted (as it is in the North American Free Trade Agreement), as could the omission of “transfers” from last sentence in the “monetary policy” exception also quoted above.

This issue should be rectified in the pending trade deals with South Korea, Colombia, and Panama. Moreover, it should be corrected in the soon to be completed review of US model BIT and taken forward in negotiations for a TPP, and elsewhere.

The global financial crisis has made it all to obvious that granting our trading partners the flexibility to use legitimate policies to prevent and mitigate financial crises is also good for the United States. When its trading partners fall into financial crisis, the United States loses export markets and subsequently jobs in the export sector. Capital controls can help stabilize exchange rates, which is good for long-term investors and for exporters and importers from the United States. When countries abroad cannot control financial bubbles that drive up currency values, American consumers may be hurt by rising prices on imported goods. As we have learned all too well, financial instability in a globalized world can be contagious, and quickly come back to the United States.

Author

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Notes

When international rules interact: International investment law and the law of armed conflict

Freya Baetens

The last two decades have witnessed an exponential increase in arbitral disputes between investors and States under international investment treaties. UNCTAD reports 357 known registered cases by the end of 2009; of these, 202 cases—or 57 percent—were initiated after 2004. Independent investment tribunals now regularly render binding decisions as to whether States have violated investment protection standards guaranteed under various bilateral and multilateral investment treaties—a phenomenon that has turned international investment law into one of the most dynamic fields of public international law.

However, while attention is increasingly focused on the investment protection standards enshrined in international investment treaties, relatively little discussion has been lent to the interaction between international investment law and other subfields of international law. But rather than operating in a vacuum, international investment law has important implications for, and is impacted by, other rules of international law, including human rights law, international trade law, and sources of regional law, such as the law of the European Union.

This brief essay zooms in on one interactive relationship that is particularly timely given the present unrest in parts of the Middle East and North Africa: foreign investment law and the law applied to armed conflict. No definitive conclusions will be put forward; rather, this article is rather intended to set out areas for further discussion.

The ‘full protection and security’ standard

There is no obvious or express link between international investment law and the law which applies in situations of armed conflict or hostilities. However, rules on protection of foreign investors are not automatically suspended as soon as an armed conflict erupts; on the contrary, bilateral investment treaties (BITs) often contain clauses which address precisely such situations—often termed ‘full protection and security’ or ‘constant protection and security’ clauses. These clauses have been applied and interpreted by arbitral tribunals. In Amco Asia v. the Republic of Indonesia, the investor’s local contracting partner (PT Wisma) took over the investment project (a hotel) by force with the help of the Indonesian armed forces. The tribunal decided that although the forcible takeover was not attributable to Indonesia, it was still in breach of its international obligations because it failed to protect the investor against such a takeover by Indonesian citizens. Also in AMT v. Zaire, the tribunal held that Zaire breached its obligations by not preventing the looting of the investment by the armed forces.

Notably, the interpretation of full protection and security clauses has been extended beyond physical security to guarantee a certain degree of legal security. Examples include the CME v Czech Republic and Lauder v The Czech Republic cases, where both panels assessed the same facts (termination of a contract), reached a different conclusion but agreed that the full protection and security standard encompasses the protection of legal rights including access to a judicial system. However, this standard merely prescribes due diligence and does not impose absolute liability. Moreover, during armed conflict, foreign investors could be also protected under other investment treaty obligations, for example expropriation or national treatment—depending on the formulation of the BIT in question.

Conflict of norms: Does investor protection or the law of armed conflict prevail?

International investment law contains a tension between its existence as a primarily treaty-based lex specialis and its claim to being a projection of principles of general international law. It is indeed consistent with the inner logic of international investment law that only those rules of investment protection which must yield to the law of armed conflict should be expected to yield. Yet, in an international legal order where even certain fundamental human rights become subject to derogation in situations of armed conflict, certain questions inevitably must be raised. It is true that international investment law transcends its origins as a primarily self-contained regime; and indeed, there are areas in which investment law has borrowed extensively by analogy from international humanitarian law, such as the protection of aliens. However, the effects of armed conflict on general international law (and, in particular, the law of treaties) remain substantial, and there is extensive practice outside the realm of investment law which explains the effect of humanitarian law on general international law. Thus, any claim of the continued application of investment law in situations where international humanitarian law supersedes general international law must be scrutinized with a certain dose of skepticism.

Rules on protection of foreign investors are not automatically suspended as soon as an armed conflict erupts.

Exceptional circumstances: Necessity and force majeure

Under the international rules on State responsibility, States can justify ‘internationally wrongful conduct’ via reliance on circumstances which preclude such wrongfulness, most notably ‘necessity’ and force majeure. These general international law justifications also apply in the context of international investment law. In AAPL v. Sri Lanka, military necessity in particular was assessed by the tribunal when
examining acts of the Sri Lankan security forces executing a counter-insurgency operation during which the investment (a prawn farm) was destroyed. Nevertheless, the tribunal held that the force deployed by the armed forces had been excessive and found Sri Lanka responsible.

Necessity has also been invoked in cases involving economic crises such as CMS v. Argentina, Enron v. Argentina, LG&E v. Argentina and Sempra v. Argentina. However, tribunals have been very reluctant to accept such justification—with the exception of the LG&E tribunal (annulment procedure still pending). Finally, even if a tribunal accepts the justification of ‘necessity’ or force majeure, this does not necessarily release the respondent State from payment of compensation for material loss or preclude wrongfulness for breach of peremptory norms of general international law, whether the conduct is carried out by the outgoing government or by the insurgent movement which forms the new government, in accordance with the principle of continuity of the State.

No rights without obligations: When investors are involved in armed conflict

Focusing on investor protection during armed conflict highlights only part of the picture; critically, the interests of the civil communities affected by armed conflict must also be protected. These communities need protection not only from the immediate effects of the armed conflict, but also from the persons or entities pulling the strings, as the vast majority of modern armed conflicts, if not based on, at least are closely connected with economic interests of the belligerent parties. Business corporations which maintain trade relations with partner groups or entities that are at the same time engaged in (internal) armed conflicts may become indirectly involved in the commission of serious crimes. Through the provision of financial resources to regional armed groups for example, the exploitation of natural resources in conflict zones, international business actors may even incur criminal liability if they know that their resources are also used to provide these armed groups with weapons subsequently used against civilians. The crimes committed may amount to international crimes such as war crimes, crimes against humanity or even genocide. In such (extreme) cases, corporate actors may even come under scrutiny by the International Criminal Court for their participatory role in such crimes, if the individual criminal liability of the person(s) in control of such financial transactions on behalf of a corporate actor can be established.

Conclusion

However unlikely it may seem prima facie—the rules of international investment law and the law of armed conflict do interact in practice. This has recently become painfully clear for foreign investors in Libya and elsewhere in North Africa and the Middle East, where people and property (particularly of foreign origin) are facing violence and destruction. That raises the question: could foreign investors in Libya challenge the Libyan government (the present or the future one) for loss of profits or property due to a violation of ‘full protection and security’? Libya currently has only 13 BITs in force (6 of which are with EU members) but other countries going through a period of unrest (to say the least) may have many more—Egypt for example is a party to a more than 20 BITs. The good news for the investor perspective, of course, is that these treaties remain valid in spite of radical changes of government. So international obligations continue and the insurrectional government which subsequently becomes the legitimate government can be held responsible for violations that occurred during the insurrection. The practical implications of this, however, are unclear.

This article has highlighted one example of how developments in ‘other fields of international law’ influence the development of international investment law, but also vice versa, developments in investment law impact the evolution of other fields of international law. That raises the need for scrutiny of how concepts, principles and rules developed in the context of other sub-fields could (or should) inform the content of investment law. Moreover, certain solutions conceived for resolving problems in these other settings may provide examples for addressing current problems in the field of investment law. This can subsequently serve as an aid to determine whether international investment law is open to developments in other sub-fields of international law, or whether it is evolving into the direction of a self-contained regime.*

Notes

3 Amcor Asia Corporation and Others v The Republic of Indonesia, Award, 20 November 1984. 1 ISID Rep 413; see also Rumel v Kazakhstan, Award, 29 July 2008. Seuka Investments BV (The Netherlands) v The Czech Republic, Partial Award, 17 March 2006; Eastern Sugar v Czech Republic, Partial Award, 27 March 2007.
4 AMT v Zaire, Award, 21 February 1997, 5 ISID Rep 11.
6 AAPL v Sri Lanka, Award, 21 June 1990, 4 ISID Rep 246.
7 CMS Gas Transmission Company v Argentina, Award, 12 May 2005; Enron Corporation and Ponderosa Assets, LP v Argentina, Award, 22 May 2007; LG&E Energy Corp and ors v Argentina, Decision on Liability, 3 October 2006; Sampo v Argentina, Award, 28 September 2007.

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Dr. Freya Baetsens is Assistant Professor of Public International Law, Leiden University. This article includes topics that have been suggested by the members of the panel on ‘International Investment and Armed Conflict’ (Ms. Meg Kinnaar, Dr. Gladis Hernandez, Judge (Ret.) Koorosh Ameli and Dr. Philipp Ambach) at the conference on ‘The Interaction of International Investment Law with Other Fields of Public International Law’ (Leiden, 8-9 April 2011). For more information about the conference, see below.

Those who are interested in further discussing these issues, are invited to participate in the conference on “The Interaction of International Investment Law with Other Fields of Public International Law” which will take place on 8 and 9 April 2011 at Leiden University, The Netherlands. The conference will bring together experts from the field of international investment law and renowned scholars and practitioners from other sub-fields of international law. For the draft programme and online registration, please visit http://www.law.leiden.edu/research/news/conference-iil.html.

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Research Notes


Disputes arising under future treaties, the divide fell between on the issue of the application of rules on transparency to specifically defined, prompted objections to its inclusion. The exception might be interpreted more broadly, if not more concerns that the potential “integrity of the arbitral process” s described as allowing the tribunal to protect the physical safety and prevent intimidation of witnesses. However, that exception was interpreted more broadly, if not more specifically defined, prompted objections to its inclusion.

On the issue of the application of rules on transparency to disputes arising under future treaties, the divide fell between those in the “opt-in” and “opt-out” camps. The former took the position that if and when new rules on transparency are concluded, they should be a separate or stand-alone instrument that will only apply if and when states take the specific step of “opting in” to the transparency rules in their future treaties. A reference to UNCITRAL Arbitration Rules in a treaty would not include the new transparency components. The default UNCITRAL rules in this scenario would be the generic, “non-transparent” rules.

The other group’s position was that the provisions on transparency should be adopted in relation to the general UNCITRAL Arbitration Rules; and that references to those general arbitration rules in future treaties will thereby automatically incorporate the rules on transparency, unless countries specify otherwise (or “opt out” of the transparency rules) in their treaties. In this option, the treaty parties still retain the power not to submit to the new rules, but they need to explicitly say it.

Perhaps the most contentious issue centered on the application of the new rules to disputes arising under existing treaties. It was pointed out that if new provisions on transparency are integrated within the general UNCITRAL Arbitration Rules, references in existing treaties to those rules (as opposed to, for example, more specific references to the “1976 UNCITRAL Arbitration Rules”), could be interpreted to incorporate any amendments to the UNCITRAL Arbitration Rules, including new transparency provisions.

Incremental progress, but chasms remains

The February 2011 meeting saw progress on some of the issues preliminarily surveyed the previous fall. On the issue of form, for instance, support seemed to crystallize for the idea that the working group should proceed by drafting clear rules on transparency as opposed to more nebulous guidelines or principles.

With respect to the content of those rules, many delegations also advocated increased transparency in various stages of investor-state disputes. In particular, proposals that the public must be notified of at least the existence of investor-state disputes, that amicus curiae should be allowed to submit briefs in certain circumstances, and that awards should be made public received fairly strong backing.

Delegations expressed more divergent positions on other topics, such as whether and what documents submitted to tribunals (such as briefs, witness statements, and exhibits) must be disclosed.

Other key areas of debate related to the scope and availability of exceptions to new rules on transparency, and the applicability of any new rules on transparency to disputes arising under existing and future treaties.

There was apparent unanimity that an exception to prevent disclosure of confidential, privileged and other information protected from disclosure under applicable law was necessary. There was also general agreement that an exception to protect the “manageability of the arbitral proceedings” would be too broad, and could swallow the general rule providing for public disclosure. Nevertheless, some delegations supported giving the tribunal discretion to deviate from rules on transparency in order to “protect the integrity of the arbitral process.” That exception was described as allowing the tribunal to protect the physical safety and prevent intimidation of witnesses. However, concerns that the potential “integrity of the arbitral process” exception might be interpreted more broadly, if not more specifically defined, prompted objections to its inclusion.

On the issue of the application of rules on transparency to disputes arising under future treaties, the divide fell between

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requested the Secretariat to draft possible rules reflecting the proposals made on content. Those texts will be considered by the working group during its next meeting, which is scheduled to be held in October 2011 in Vienna, Austria.

Civil society groups file amicus request in Pac Rim v. El Salvador

The Center for International Environmental Law, on behalf of La Mesa Nacional Frente a la Minería Metálica de El Salvador, (El Salvador National Roundtable on Mining) has filed a request with the ICSID Secretariat to proceed as amici curae in a dispute between a U.S. mining company and the government of El Salvador.

The prospective amici member organizations comprise a coalition of community organizations, research institutes, and environmental, human rights, and faith-based non-profit organizations with a shared concern over El Salvador’s mining industry.

The amici request comes in response to a USD$77 million investment arbitration case against El Salvador, Pac Rim v. Republic of El Salvador. Pac Rim Cayman LLC, a U.S. subsidiary of Canada’s Pacific Rim Mining Corp, alleges that El Salvador wrongfully denied permits that were needed to explore and develop gold mining opportunities, including a site for its proposed El Dorado mine. The dispute is being brought under the Central America Free Trade Agreement (CAFTA).

In 2002 El Salvador’s Ministries of the Economy and the Environment issued exploration permits to Pacific Rim to determine the potential for gold mining in the country. Not long after the company began exploration, community members became concerned over water and soil contamination associated with cyanide-laced water used in the gold-mining process. La Mesa actively worked to raise awareness of mining’s potential to devastate El Salvador’s environment.

Pacific Rim claims that it invested USD$77 million to acquire, perfect, and maintain exploration and exploitation rights. However, the government of El Salvador stopped providing exploration permits while a mining environmental impact assessment was performed.

Pac Rim’s proposed mining areas are all within the basin of Rio Lempa, El Salvador’s largest and most important river and the source of drinking water for approximately half of El Salvador’s 6 million people.

In addition, the amici contend that although Pac Rim claims it is bringing its case against the Republic of El Salvador, the real locus of the dispute is between Pac Rim and the independently organized communities that would be affected by its proposed mine. Pac Rim is using the ICSID process to gain an “illegitimate advantage” over its opposition in the domestic Salvadoran policy dispute over mining.

North America’s largest lead producer files notice of intent to arbitrate against Peru

The lead producer Renco Group took steps to arbitrate against Peru in December 2010. Renco, on behalf of itself and its subsidiary Doe Run Peru (DRP), claims that Peru’s conduct improperly exposed it to liability for environmental remediation, environmental harms, and personal injuries, causing it to shut down its smelting and refining operations.
Renco alleges that Peru’s conduct violates various contractual agreements and the U.S.-Peru Trade Promotion Agreement (PTPA).

As relief, Renco is claiming at least US$800 million in damages. Additionally, Renco is seeking an award that declares Peru exclusively liable for various civil claims against Renco and DRP by residents living near DRP’s facilities in Peru.

The dispute concerns La Oroya, a town high in the Andes with a population of roughly 30,000, which emerged in conjunction with the 1922 installation of metal smelting and refining facilities in the area. Years of operations and toxic industry byproducts from the smelting and refining operations have left high levels of pollutants in the region’s air, water, and soil. 1 According to Renco, when DRP purchased the business in 1997, the Peruvian government agreed to clean up “much of” that pre-existing contamination in and around La Oroya. 2

Later, DRP asked the Peruvian government for several extensions of the deadline for the environmental management and clean-up work. According to Renco, this was due to the Peruvian government’s original underestimation of the work entailed, expansion of the obligations imposed on DRP, and financial difficulties relating to metals market. 3

However, in July 2010, after DRP missed the extension deadline to prove that it had the necessary financing to restart operations and to complete the environmental cleanup, its operations permit was cancelled.

This situation has caught the attention of the Interamerican Commission on Human Rights (IACHR), which released a petition in 2009. It alleges that when the Peruvian government granted DRP extensions to complete its environmental remediation efforts, it improperly allowed the company to postpone crucial environmental cleanup. 4 The petitioners, which are the La Oraya residents, complain that the state allowed business activities to trump public health concerns.

Notes


2 Notice of Intent to Arbitrate, para. 3.

3 Notice of Intent to Arbitrate, paras. 30-31.

4 2006 Earthjustice Petition to the IACHR, p.67, see footnote 1

Years of operations and toxic industry byproducts from the smelting and refining operations have left high levels of pollutants in the region’s air, water, and soil.

Canadian organizations petition European Parliament over investment provisions in trade pact

A coalition of Canadian organizations is concerned about the investor-protection mechanisms under negotiation in the Canada-E.U. Comprehensive Economic and Trade Agreement (CETA). The CETA intends to liberalize trade and investment between Canada and Europe, enhancing their economic relationship; however, opponents charge that CETA will result in a sizeable Canadian deficit, a loss of employment, and a disregard for public welfare.

A NAFTA Chapter 11-style framework inspired CETA’s standards to protect investors. Previous European trade agreements excluded these substantial investor protections and arbitration methods.

Supporters advocate for CETA’s promise of a mutually beneficial economic arrangement. The Canadian and E.U. governments point to the agreement’s potential to improve investment, labour mobility, and regulatory cooperation.

But in a letter directed to the European Parliament, Canadian opponents take aim at the Act’s sweeping investor-protection clauses. They argue that the measures will undermine states’ abilities to self-regulate, fearing that the NAFTA-like provisions place investors’ economic interests ahead of public welfare.

The NAFTA investor provisions were originally intended to prevent investors from being victimized by inadequate legal systems. However, CETA need not approach investor protection in the same manner – Canada and the E.U. both have adequate judicial channels to support investor claims, argue the Canadian organizations, which include labour unions and think-tanks.

CETA’s opponents point to the $CAD 157 million in damages that Canada has already lost in NAFTA claims. They assert that CETA will result in further financial loss and will hinder progressive social policies because investor protection will usurp citizens’ best interests.
Lise Johnson

In an award dated 12 September 2010, the tribunal in RosInvestCo v. Russian Federation issued an award in which it found that the Russian Federation had unlawfully expropriated RosInvestCo's property, but muted the claimant's victory by awarding it only US$3.5 million of its US$232.7 million claim.

The award is particularly notable for its treatment of the most-favored nation (MFN) provision, and specifically the degree to which that provision allows investors to "cherry-pick" favorable clauses from bilateral investment treaties (BITs) while disregarding provisions that might narrow the rights granted in those clauses.

The issue of the scope of the MFN provision first arose in the tribunal's October 2007 decision on jurisdiction. In that decision the tribunal determined that the governing UK-Soviet BIT alone did not grant it the power to hear the dispute. However, the tribunal concluded that RosInvestCo could use the MFN provision in the UK-Soviet treaty to incorporate a broader dispute settlement provision found in the BIT between Denmark and Russia.

In the 2010 award, the tribunal again addressed RosInvestCo's ability to rely on the broader dispute resolution provision in the Denmark-Russia BIT. This time, the tribunal considered whether it would also have to take into account limitations of the Denmark-Russia BIT's dispute settlement provisions; specifically the carve-out for disputes related to taxation.

Despite saying that it did not need to definitively resolve the issue, in its award the tribunal effectively disregarded those limitations.

As RosInvestCo's shares plummeted in value, RosInvestCo, an English corporation, purchased a total of seven million shares in the company in late 2004, allegedly on the basis that the market had overestimated the risks to Yukos.

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However, Russia proceeded with its efforts to collect the taxes and associated penalties, which by the middle of December 2004 had grown to an amount of roughly US$20 billion. Russia began by auctioning a key part of Yukos' business on 19 December 2004. Yukos' remaining assets were then liquidated in a series of auctions, with the final auction held on 15 August 2007.

RosInvestCo submitted a request for arbitration in October 2005, asserting that the tax assessments, penalties, and enforcement actions expropriated RosInvestCo's property in violation of the governing UK-Soviet BIT.

On the merits, Russia defended the claim on various grounds, including that the measures were not expropriatory because they were legitimate exercises of its police and taxation powers; and that the government's actions had not caused the investor any substantial or permanent losses, nor interfered with any legitimate expectations.

The tribunal found that "some of Respondent's explanations and arguments [justifying its tax assessments and enforcement actions] seemed plausible," that the 19 December 2004 auction appeared "to have been conducted within the limits of discretion awarded by Russian law," and that the subsequent bankruptcy auctions seemed consistent with Russian law and even "the higher standards to be applied under the IPPA."

Ultimately, the tribunal concluded that the "Respondent's measures, seen in their cumulative effect towards Yukos" did not pass the test of being bona fide, non-discriminatory, and non-confiscatory, and therefore constituted an expropriation.

However, the tribunal declined to determine whether any of the challenged measures, taken alone, would constitute a breach of the BIT.

With respect to the Russia's arguments regarding RosInvestCo's legitimate expectations and its purported losses (or, more accurately, the lack of either), the tribunal determined that such issues related to the amount of damages that would be awarded, not whether there had in fact been an expropriation. That the tribunal found Russia's arguments on those points persuasive is reflected in its decision to award RosInvestCo just a fraction of its claimed sum.

The lengthy award's analysis of the merits is notable for its treatment of such issues as the bounds of legitimate government regulatory freedom, the elements of an expropriation claim, and determinations of damages. Yet the award is particularly remarkable for its treatment of jurisdiction and, within that broad issue, the specific matter of whether and how a clause excepting "taxation" from the scope of the Denmark-Russia BIT might affect the tribunal's ability to rely on that agreement's dispute resolution provisions (in conjunction with the UK-Soviet BIT's MFN article) to hear RosInvestCo's claims.

The tribunal determined in its 2007 jurisdictional decision that the governing UK-Soviet BIT, standing alone, did not grant it the authority to determine whether there had been an expropriation. The tribunal found, however, that it could exercise jurisdiction over the dispute by using an MFN provision in the UK-Soviet BIT to incorporate a broader dispute resolution provision contained in the BIT between Denmark and Russia.

After the decision on jurisdiction was issued, Russia asserted that although the Denmark-Russia BIT contained broader investor-state dispute resolution provisions, those provisions were limited by an exception in Article 11(3) that carved out "taxation" from the scope of the agreement. Thus, according to Russia, because (1) the Denmark-Russia BIT, upon which the tribunal based its jurisdiction, would not allow investor-state arbitration of disputes relating to "taxation," and (2) RosInvestCo's claims were all based on Russian taxation, the tribunal did not have jurisdiction over the dispute.

In response, RosInvestCo attempted to frame its claims so as to remove the tax assessments from the crux of the dispute. It argued that the tax assessments were pretexts for the expropriation, but did not themselves expropriate its property. According to the claimant, its property was expropriated...
through the auctions held to collect the tax assessments. RosInvestCo also cited the decision in Renta 4 S.V.S.A. v. The Russian Federation for support. In that case, Russia had asserted essentially the same argument regarding the impact of the Article 11 “taxation” exception as it was asserting in RosInvestCo. However, the Renta tribunal rejected it in no uncertain terms, declaring that “[t]hink that ten words appearing in a miscellany of incidental provisions near the end of the Danish BIT would provide a loophole to escape the central undertakings of investor protection would be absurd.”

The RosInvestCo tribunal acknowledged that although it had already determined it had jurisdiction based on Article 8 of the Denmark-Russia BIT, “it could be argued that … [t]he Tribunal is bound to import Article 8 in its context, i.e., subject to Article 11.” Yet instead of accepting or rejecting such an argument, the tribunal opted to leave the issue unresolved with the declaration that its resolution was “irrelevant.” The tribunal explained that, when assessing liability, it would not consider whether there was “an expropriation by way of taxation,” but instead whether the “cumulative combination” of the taxation measures and the consequential auctions expropriated RosInvestCo’s property. According to the tribunal, such a “totality of the circumstances” approach that subsumed the taxation measures within a broader group of challenged conduct obviated the need for it to determine what impact, if any, the Article 11 taxation exception had on its jurisdiction.

The RosInvestCo and Renta cases fuel the debate over the appropriate scope of the MFN clause. In effect, both decisions allow an investor covered under the “basic” UK-Soviet BIT to use that treaty’s MFN provision to enjoy the protections of a non-existent “super treaty”—a treaty composed only of the favorable protections from other available agreements, and not the limitations countries insert in those agreements to balance the rights given to investors with their rights and obligations as governments. Significantly, by allowing a UK investor to enjoy the more favorable dispute resolution provisions of the Denmark-Russia BIT unhinged from that agreement’s taxation or other exceptions, the UK investor would then enjoy more favorable treatment than a Danish investor covered by the Denmark-Russia BIT. That begs the question: if a Danish investor was to bring a claim under the Denmark-Russia BIT, would the Danish investor be able to cite the treatment actually accorded to UK investors as a basis for bypassing the Article 11 taxation exception?

Arguably, the approach effectively allowed in RosInvestCo (and explicitly sanctioned in Renta) converts the MFN provision from a tool to prevent discrimination between foreign investors from different countries, to one that ratchets up treaty protections in favor of investors with their rights and obligations as governments.

Notes

1 Paras. 97, 520, 524, 557, 567, 612.
2 Para. 522.
3 Para. 535.
4 Para. 633 (emphasis added); see also paras. 498, 525, 557, 575.
6 Para. 270(a).
7 Para. 271.
8 Para. 271.

Panama cleared of claims by US investors over a power plant dispute Nations Energy Inc., et al. v. Republic of Panama, ICSID Case No. ARB/06/19

Jennifer Donofrio

A group of American investors have been ordered to pay US$4.6 million to Panama as a partial recovery for the costs and expenses Panama sustained in an ICSID dispute.

In its 24 November 2010 award, drafted in Spanish, a majority of the three-member tribunal rejected all claims by Nations Energy Inc., Jaime Jurado, and Electric Machinery Enterprises, Inc—a consortium of US investors in a Panamanian power plant.

The claimants had a stake in COPESA, a Panamanian energy corporation under agreement to construct and operate a power plant. Construction of the COPESA plant began in 1998, when a Panamanian tax law was in effect that was particularly favorable to foreign investors. However, Panama repealed the law in 1999.

Several years later, the investors sought to sell their shares and secure the transfer of the tax credits as well. According to claimants, correspondence from the DGI (The General Directorate of Intelligence, Panama’s Internal Revenue Service) seemed to indicate—hypothetically—that transferring the tax credits would be permissible. This approval came in response to the claimants’ inquiry regarding tax credits connected to loans issued by a bank. The claimants’ query did not mention indirect investments or the possibility of COPESA issuing the shares and the associated tax credits.

The claimants’ specific request involving COPESA and tax credit transferability was denied in 2005 in accordance with current Panamanian law. Since transferring tax credits was forbidden, according to claimants, selling shares and bonds became nearly impossible, and contributed to COPESA’s financial ruin.

Under the U.S-Panama BIT, the claimants cited unfair and inequitable treatment and indirect expropriation in relation to the refusal to allow the transfer of tax credits to third parties. They sought a US$62 million damages award against Panama in addition to reparations for costs, attorneys’ fees, and interests.

In rejecting the claim of unfair and inequitable treatment, the tribunal noted that the BIT permits claims over “matters of taxation” in just a few narrow circumstances, such as alleged expropriation. Tax policies, the tribunal determined, fell outside the parameters of a fair and equitable treatment claim.

Next, the tribunal discussed whether Panama’s refusal to allow the claimants to transfer tax credits to a third party qualified as an expropriation under the BIT. The tribunal ruled that a “hypothetical right” to transfer tax credits was not a “true attribute” of property ownership that justifies an expropriation claim. The tribunal therefore rejected the claim of expropriation.

In a dissenting opinion, José María Chillón Medina, the arbitrator appointed by the claimants, expressed his disagreement on some decisions of his colleague arbitrators Claus von Wobeser (Panama appointee) and Alexis Mourre (President). He diverged from the majority’s ruling on fair and equitable treatment, the tax credits, and the arbitration costs.

Medina considered the BIT’s provision on fair and equitable treatment as a requirement for a specific standard of fairness, even in areas involving taxation. Otherwise, he argued, a large purpose of a treaty—to protect investments—could easily be rendered meaningless.
Furthermore, Medina emphasized that the tax credits were in effect when the claimants initiated their investments. He acknowledged the importance of State sovereignty over financial policy, but argued that a State can change a law while preserving rights that were granted by a previous regulation.

In addition, Medina reasoned that the claimants held a reasonable expectation of a stable legal framework that would protect against the investment’s loss of value. In his opinion, the tribunal’s decision hindered the investment environment and infringed upon international responsibility.

Finally, Medina disagreed to claimants bearing the full cost of the arbitration. He pointed out that the defendants also brought claims that the tribunal rejected. Therefore, the claimants should not have been burdened for all of the arbitration costs as both parties raised claims that the tribunal ultimately denied.

**Dutch claimants clear jurisdictional hurdle in claim against Venezuela Cemex v. Venezuela ICSID Case No. ARB/08/15 Jennifer Donofrio**

A tribunal of the International Centre for Settlement of Investment Disputes (ICSID) has ruled that Venezuela’s 1999 investment law does not indicate consent to ICSID arbitration. Nonetheless, the tribunal found it does have jurisdiction to hear a claim by Dutch investors under the Netherlands-Venezuela BIT.

Cemex Caracas and Cemex Caracas II complain that their indirectly-owned cement plant was expropriated without compensation.

The first claimant, Cemex Caracas Investments BV, and its wholly owned subsidiary, Cemex Caracas II Investments BV, were both incorporated in the Netherlands.

Cemex Caracas II owned 100% of the shares in a Cayman Islands company, Vencement Investments, which in turn owned 75.7% of the shares in Cemex Venezuela (CemVen), a cement company incorporated and operating in Venezuela. (Claimants are hereinafter referred to as “Cemex”).

Cemex claimed that an ICSID tribunal had jurisdiction to hear the case under Venezuelan investment law and under the Netherlands-Venezuela BIT. In particular, the claimants pointed to Article 22 of Venezuela’s investment law, arguing it provided advance consent to international arbitration with foreign investors. Both of these claims were contested by Venezuela.

Venezuela argued that the BIT required that the investment be “of” the claimants. However, the investment in dispute was held through the intermediary Cayman Islands company; therefore, according to Venezuela, the investment in CemVen did not meet this criterion.

The tribunal sought clarification by examining state intent at the time of the investment’s enactment. At the time of the law’s adoption, Venezuela had already ratified 17 BITs. The previous BITs, in plain language, offered either unconditional consent to ICSID arbitration or consent to ICSID upon the concerned national’s request.

The tribunal concluded that if Venezuela intended to give advance consent to ICSID arbitration, the drafters of Article 22 would have made it explicit. Thus, it deemed that Venezuela’s investment law does not consent to ICSID jurisdiction.

However, the tribunal reasoned that the BIT covers indirect investments. It cited similar BIT interpretations in preceding cases dealing with indirect ownership, such as Siemens v. Argentina, in determining its jurisdiction over the proceeding.

The tribunal ruled that the BIT entitled Cemex to assert claims for alleged treaty violations of their indirect investments.

This is the second ICSID tribunal to determine that Article 22 does not open the door to ICSID arbitration. A similar conclusion was drawn in a 10 June 2010 jurisdictional decision involving subsidiaries of Exxon-Mobil and Venezuela.9

The tribunal deferred determination of the proceeding’s costs to a later stage of the arbitration.

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**Notes**

9 Mobil v. Bolivarian Republic of Venezuela, ICSID Case No. ARB/07/27


A Stockholm Chamber of Commerce tribunal has rejected an Austrian investor’s claims in a dispute with Tajikistan over energy-exploration licenses, despite finding that the Tajik government had breached the Energy Charter Treaty (ECT).

The investor, Mohammad Ammar Al-Bahloul, entered into gas and oil exploration discussions with the Tajikistan government in 1998. Although the permits were not secured, energy exploration commenced.

Mr. Bahloul claimed he frequently requested, and the Tajik government frequently promised, the necessary licenses and permits. In the wake of mounting technical and management issues, the claimant ceased operations. The claimant also discovered that other organizations secured access to exploratory areas that had been offered exclusively to him.

A partial award in September 2009—only recently made public—affirmed that the Tajik government violated the ECT when the energy exploration licenses it promised never emerged. That decision was affirmed in an 8 June 2010 final award.

Yet while the claimant had asked the tribunal to order Tajikistan to issue the licenses for exploration, that request was considered unfeasible given Tajikistan’s lack of availability and cooperation in the proceedings, the time that had lapsed since claimant’s initial license requests, and the presence of other companies in the territories linked to the licenses.

In lieu of specific performance, the claimant requested damages of approximately US$230 million and nearly US$240 million in interest. But the tribunal ruled that the claimant based the figures on hypothetical predictions of profit and it declined the damage request.

However, the tribunal ordered Tajikistan to pay a portion of the claimant’s legal and arbitration costs. It also left open a possibility for the claimant to bring allegations for costs he may sustain “in future circumstances” given Tajikistan’s “ongoing breach” of ECT obligations.
“Scope and Definition”
UNCTAD, March 2011

A new UNCTAD study titled “Scope and Definition” reviews how the concepts of “investment” and “investor” have been defined in international investment agreements (IIAs), and how different definitions have affected countries hosting foreign direct investment (FDI). The study notes that there is a trend in recent IIAs of narrowing the definition scope for the two terms, possibly in reaction to interpretations by arbitration tribunals in the past. The paper concludes with a section on policy options for IIA negotiators. It argues that adding a development policy dimension to the technical definition of investment would help bring developmental concerns to the centre of the agreements’ objectives, and to the forefront of tribunals’ considerations (i.e. even before going into the substantive assessment of contested host country measures). Adoption of such practice would be an important step towards making IIAs contribute to economic sustainability, according to UNCTAD. The study is available at: http://www.unctad.org/Template/Page.asp?intItemID=5865&lang=1

“Most-favoured Nation Treatment”
UNCTAD, January 2011

This UNCTAD paper takes stock of the evolution of most-favoured-nation (MFN) treatment clauses in IIAs and explains the MFN treatment and some of the key issues that arise in its negotiation, particularly the scope and application of MFN treatment to the liberalization and protection of foreign investors in recent treaty practice. Subsequently, the paper analyses whether and under what conditions the application of the MFN treatment clauses contained in IIAs can be used by arbitral tribunals to modify the substantive protection and conditions of the rights granted to investors under IIAs to enter and operate in a host State. The paper also provides policy options as regards the traditional application of MFN treatment and identifies reactions by States to the unexpected broad use of MFN treatment, and provides several drafting options, such as specifying or narrowing down the scope of application of MFN treatment to certain types of activities, clarifying the nature of “treatment” under the IIA, clarifying the comparison that an arbitral tribunal needs to undertake as well as a qualification of the comparison “in like circumstances” or excluding its use in investor-State cases. The study is available at: http://www.unctad.org/Template/webflyer.asp?docid=14358&intItemID=5821&lang=1

“Land deals in Africa: What is in the contracts?”
Lorenzo Cotula, IIED, February 2011

This paper by Lorenzo Cotula of the International Institute for Environment and Development (IIED) analyses twelve land deals from different parts of Africa and their wider legal frameworks. It discusses the contractual issues for which public scrutiny is most needed, and aims to promote informed public debate about them. Key issues identified in the paper relate to the contracting process, to economic fairness between investor and host country, to the distribution of risks, costs and benefits within the host country, to the degree of integration of social and environmental concerns, and to the extent to which the balance between economic, social and environmental considerations can evolve over often long contract durations. This research aims to provide an empirical basis for these processes and contribute going that direction. The report is available at: http://pubs.iied.org/12568IIEED.html?a=Cotula

“Foreign Direct Investment in Times of Crisis”

This paper compares the current foreign direct investment (FDI) recession with FDI responses to past economic crises. It states that although developed country outflows have taken an equally big hit as major developed countries have after past crises, outflows seem to be bouncing back more slowly this time. By contrast with the overall decline in recent years, inflows to emerging markets often remained stable during their past economic crises. Both patterns indicate that the global scale of the current crisis has led to a greater FDI response than after individual country crises in the past. Compared with global economic downturns since the 1970s, the current FDI recession has also been greater in magnitude. The exception is the FDI plunge in the early 2000s, despite the much smaller economic crisis at the time. The study recommends that policymakers not just further liberalize FDI regimes–as they find was the typical pattern during earlier crises–but rather use the downturn to rethink their FDI policies with an enhanced focus on “sustainable FDI” promotion. The study is available at: http://ideas.repec.org/p/iie/wpaper/wp11-3.html

Events 2011

April 8-9

May 5
EMBEDDING HUMAN RIGHTS INTO INVESTMENT TREATIES, Council Chamber, King’s College London, London, United Kingdom, contact federico.ortino@kcl.ac.uk

May 3-5
MINING & MINERALS: WHAT ROLE IN A SUSTAINABLE FUTURE, CEPMLP, University of Dundee, http://www.buyat.dundee.ac.uk/browse/extra_info.asp?compid=2&prodid=89&modid=2

May 6

May 20

June 9-10
CONFERENCE ON TEN YEARS OF ENERGY CHARTER TREATY ARBITRATION ORGANIZED BY SCC, ICSID AND THE ENERGY CHARTER SECRETARIAT, Stockholm, http://www.chamber.se/?id=33813

June 14-15

October 26-27
SIXTH COLUMBIA INTERNATIONAL INVESTMENT CONFERENCE: “THE RESOURCE BOOM AND FDI IN AFRICA,” Faculty House, Columbia University, New York
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