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Investors’ Obligations and Host State Policy Space

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The Department of Investment has been in charge of promoting foreign investment in Morocco since 1996. Beyond its mandate to provide information on the country’s potential, the Department creates and implements investment promotion strategies targeting specific sectors to promote the realization of projects. Its plan of action revolves around four main axes:

- Identifying different categories of investors and countries initiating foreign investment;
- Promoting priority sectors such as tourism, NTIC, electronic and automobile components, textiles, aeronautics and the agro-alimentary industry;
- Coordinating between national institutions and international organizations in the field of investment; and
- Locating projects according to the opportunities offered in the different regions of Morocco, in collaboration with the Regional Investment Centres.

In order to further the government’s investment policy, while carrying out its mission, the Department of Investment is organized along two main poles, namely cross-sectional and sector-oriented:

- Two divisions cover investment promotion, communication and cooperation, research and regulations;
- Two other divisions are dedicated to activities in priority sectors, agriculture and industry on one hand, tourism and services on the other.

To maximize efficiency, these structures benefit from the support of offices in charge of human resources and general affairs. The Department of Investment, along with its initial mandate, also steers the Inter-Ministerial Investment Commission, an appeal and arbitration body presided by the Prime Minister. The Department of Investment plans to establish an independent agency dealing specifically with promotion in early 2009.
INVESTORS’ OBLIGATIONS AND HOST STATE POLICY SPACE
Vicente Yu and Fiona Marshall

This paper is in two parts. The first section looks at how investment treaties have approached the issues of investors’ obligations and host state policy space. The second section considers the treatment of the same issues by tribunals in investment treaty arbitrations.

I. DEVELOPMENTS IN INVESTMENT TREATIES

This section provides an overview of developments in investment treaty law. These developments are significant in terms of shaping the policy landscape and context for international investment policy-making at the national, regional and international levels that developing country governments will need to be aware of as they engage in bilateral, regional and international economic negotiations (e.g. on trade, investment, finance).

I. National FDI Legislation
Changes in terms of national legislation relating to foreign direct investment (FDI) in recent years continue to be focused by and large on effecting policy changes relating to investment promotion such as new or more general fiscal and financial incentives (e.g. lowering of corporate tax rates), establishment of special economic zones, and strengthening of national investment promotion agencies. However, in recent years, a growing number of such changes have been in the nature of increasing national regulatory restrictions or control over FDI (from 6% of such changes in 2000-2003, to 18% in 2004-2007, and around 25% in 2006-2007¹). Such regulatory policy changes have been particularly evident in the extractive industries sector, as many resource-exporting countries have introduced new sectoral or ownership restrictions or renationalized projects while other countries have also started introducing national security-related government review and approval requirements with respect to FDI in identified strategic sectors.² This may be the start of a trend in which countries, especially developing countries, seek to put in place FDI policies that are geared to and made more consistent with their national development goals.

II. Treaty Law on Investment
Treaty law relating to international investments – including the extent to which such investments would be subject to treaty rules on investor obligations to their host country or community and on the development policy space of the host country – is basically of two kinds:

² Id.
(i) Non-multilateral international investment agreements (IIAs) such as:
   a. bilateral investment treaties (BITs);
   b. regional treaty instruments that may contain investment-related provisions; and
   c. preferential trade and investment agreements (PTIAs); and

(ii) Multilateral treaty instruments.

A. IIAs

As of the end of 2006, 2,573 BITs have been concluded (of which 680 were South-South BITs), with an average annual increase of roughly 75 BITs for the period 2004-2006. Developing countries were involved in 60 of the 73 BITs concluded in 2006, with 23 of these BITs having been concluded between developing countries. The trend of more South-South BITs being concluded seems to be continuing.

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4 Id., p. 3.
5 Id., p. 4.
Based on UNCTAD data, there is a perceptible shift in terms of IIA-based treatymaking away from BITs towards other treaties with multiple States parties in which both trade and investment liberalization provisions are combined (such as free trade agreements (FTAs), the EU-ACP Economic Partnership Agreements (EPAs), and other PTIAs). There is also a trend towards the renegotiation of existing BITs and replacing them with broader PTIAs.⁶

In terms of content, most IIAs generally contain similar provisions with respect to key issues such as national treatment and most favoured nation (MFN) treatment for established investment, fair and equitable treatment, guarantees of compensation for expropriation and of free transfers, and consent to investor-State and State-State dispute resolution. However, there is variation in terms of how different IIAs treat non-discrimination with respect to the admission of foreign investors or prohibitions of certain performance requirements.⁷ More recent IIAs have shown some evolution in terms of further precision of IIA provisions with the objective of clarifying the meaning of certain investor rights and avoid “bad surprises” for host countries concerning their interpretation by arbitration tribunals.⁸

As a result of increased investor-State disputes in recent years, the issue of balancing investors’ rights with host countries’ policy space and regulatory flexibility has become a priority issue in terms of IIA formulation. To deal with this issue, three main approaches have emerged from the IIA negotiating practice of a small but growing number of countries:

“(a) Some countries have clarified individual IIA provisions, where there was concern that an expansive interpretation could diminish regulatory flexibility of host countries. This has happened with regard to provisions guaranteeing fair and equitable treatment of investment and the definition of an indirect expropriation.

“(b) Numerous recent IIAs include stronger emphasis on public policy concerns in order to ensure that investment protection is not pursued at the expense of other legitimate public interests. For example, they include exceptions for host country measures to maintain national security, preserve the public order or to protect public health, safety or the environment. Exceptions have been met with the concern that they may undermine the purpose of the IIA by providing the host country with a potentially broad justification for derogating from IIA obligations. In addition, such provisions have been the subject of few arbitral awards and thus their scope is not yet widely understood. Other IIAs include provisions calling upon host countries not to depart from labour or

⁶ See e.g. UNCTAD, World Investment Report 2008, p. 17.
⁷ See e.g. UNCTAD, Development implications of international investment agreements, IIA Monitor No. 2 (2007), p. 2.
⁸ Id., p. 3
environmental standards in attracting foreign investment, though often these provisions impose no binding obligation.

“(c) A few IIAs have strengthened the public’s role in investor-State dispute resolution by providing for greater transparency in proceedings, open hearings, publication of related legal documents, and allowing civil society representatives to submit amicus curiae briefs to tribunals.”

Currently, countries use reservations, exceptions, temporary derogations, transitional arrangements, and institutionalized monitoring and consultations mechanisms to indirectly address development and policy space concerns in their IIAs. This approach effectively creates a policy framework in which IIA provisions relating to investment liberalization and protection serve as the general rule to be interpreted and applied broadly while those provisions for policy and regulatory flexibility and development (such as reservations, exceptions, derogations) are exceptions which are interpreted and applied narrowly.

Another approach, although not yet clearly evident in IIAs, is to provide for investor and home country obligations directly in the IIAs as opposed to leaving it up to the host country to regulate under its domestic legislation. An example of this is the proposal submitted by China, Cuba, India, Kenya, Pakistan and Zimbabwe, in November 2002 to the WTO’s now-moribund Working Group on Trade and Investment (WGTI). In this proposal, these countries suggested that any discussion in the WTO on a multilateral framework on trade and investment should also look at “legally-binding measures aimed at ensuring corporate responsibility and accountability relating to foreign investors, including measures that clearly spell out investors' obligations and the obligations of their home governments.” These countries stressed “the right of host members to regulate foreign investors and the need for foreign investors to undertake obligations in line with host members’ interests, development policies and objectives” and that investors “should strictly abide by all domestic laws and regulations in each and every aspect of the economic and social life of the host members in their investment and operational activities. Further, in order to ensure that the foreign investor meets its obligations to the host member, the cooperation of the home member’s government is often necessary, as the latter can, and should, impose the necessary disciplines on the investors. The home member’s government should therefore also undertake obligations, including to ensure that the investor's behaviour and practices are in line with and contribute to the interests, development policies and objectives of the host member.”

A few examples of how investor obligations and other development goals (including policy space and flexibility) could be incorporated in IIAs are as follows:

9 Id., p. 6.
The 1998 Framework Agreement for the ASEAN Investment Area (AIA) which now covers all 10 ASEAN Member States has provisions (couched as general exceptions under Article 13 and some of which are standard in other IIAs) allowing Member States to undertake any measures necessary to protect national security; public morals; human, animal or plant life or health; the prevention of fraud or deceptive practices; the protection of privacy; or which are aimed at ensuring that investors comply with their tax obligations in the host jurisdiction. The AIA also has an emergency safeguard mechanism under Art. 14 that Member States can avail of to prevent or remedy serious injury that may be suffered or threatened as a result of the investment liberalization programme undertaken under the Agreement. Finally, the AIA in Art. 15 also allows Member States to take measures that may restrict investments or investment-related financial transfers in cases of serious balance of payments or external financial difficulties or threats thereof. ASEAN is currently in the process of negotiating the ASEAN Comprehensive Investment Agreement (ACIA) that would supersede the Framework Agreement. Among the guiding principles for the ACIA is the granting of flexibility for Member States as appropriate within the text of the treaty – although the extent to which this would actually be reflected remains to be seen.

The Investment Agreement for the COMESA Common Investment Area (CCIA) obliges Member States to “not waive or otherwise derogate from or offer to waive or otherwise derogate from measures concerning labour, public health, safety or the environment as an encouragement for the establishment, expansion or retention of investments” (Art. 5). This is a provision that is intended to prevent a “race to the bottom” in terms of investment liberalization and promotion among COMESA Member States. The CCIA in Art. 7.2(d) also mandates the CCIA Committee to make recommendations to Member States with respect to, inter alia, “the development of common minimum standards relating to investment in areas such as: (i) environmental impact and social impact assessments; (ii) labour standards; (iii) respect for human rights; (iv) conduct in conflict zones; (v) corruption; (vi) subsidies.” Art. 13 (labeled as “Investor Obligations”) of the CCIA states that “COMESA investors and their investments shall comply with all applicable domestic measures of the Member State in which their investment is made. Furthermore, the wording of the general exceptions in Art. 22 of the CCIA does away with the “necessity” test by allowing Member States to undertake measures that may be inconsistent with other CCIA provisions which are “designed and applied” (as opposed to necessary”) to protect national security; public morals; human, animal or plant life or health; or environment. The “design and application” test could conceivably be construed as being more flexible and broader than the “necessity” test.

The EU-CARIFORUM Economic Partnership Agreement (EPA) also contains provisions that allow the Parties to take measures to regulate or control investor behaviour. For example, Art. 72 (labeled as “Behaviour of investors”) explicitly allows Parties to cooperate and take measures, including domestic legislation, to prevent investors from engaging in bribery or other corrupt acts vis-à-vis public officials in
relation to a proposed or actual investment; to ensure that investors comply with core labour standards; to prevent investors from circumventing international environmental or labor agreements to which both Parties are party; and to require investors to establish local community liaison processes, where appropriate, especially in projects involving extensive natural resource-based activities. Additionally, Art. 73 requires both Parties to ensure that “foreign direct investment is not encouraged by lowering domestic environmental, labour or occupational health and safety legislation and standards or by relaxing core labour standards or laws aimed at protecting and promoting cultural diversity.”

B. Multilateral treaty instruments

1. The WTO Trade-Related Investment Measures Agreements (TRIMs Agreement)

Trade-related investment measures (TRIMs) cover a wide range of performance requirements and incentives that Governments can impose on foreign investors, and may be used to pursue various development policy objectives. These objectives could include export promotion, enhancing local content in goods produced by the foreign investor, promoting employment and other economic and social goals, and encouraging technology transfer to domestic industry. TRIMs have been used by many countries in the past to address trade imbalances due to trade-distorting practices of transnational corporations (TNCs) and promote economic development. The issue of “outlawing” TRIMs was pushed by developed countries over the opposition of developing countries for inclusion in the Uruguay Round’s negotiating agenda, and it eventually resulted in the TRIMs Agreement.

While the TRIMs Agreement does not cover measures that WTO Members may impose with respect to the regulation of investment as such (e.g. with respect to compliance with health, labour, or environmental regulations) or with the entry and establishment of foreign investors, it does impose treaty limitations on WTO Members’ policy space and flexibility with respect to regulating the trade-related aspects of established foreign investments’ operations in the host country.

With the entry into force of the TRIMs Agreement as part of the package of treaty instruments annexed to the WTO Agreement, WTO Members were committed to eventually eliminating “prohibited” TRIMs that are applied in relation to goods that may be internationally traded by enterprises (including investors) operating in the territory of the WTO Member. These “prohibited” TRIMs include the following investment measures: local content requirements, trade-balancing requirements, foreign exchange-balancing requirements, domestic sales requirements, and export restrictions. An important exclusion from the scope of prohibited TRIMs under the TRIMs Agreement is export performance requirements, which means that

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11 See TRIMS Agreement, Annex: Illustrative List of Prohibited TRIMS.
WTO Members remain free to impose export performance requirements on foreign investors operating in their territories.

Issues relating to the difficulties that developing countries face in implementing obligations under the TRIMs Agreement for the elimination of prohibited TRIMs have been placed on the agenda of the now-suspended Doha Round of WTO trade negotiations. Several developing countries have made proposals for amending the TRIMs Agreement, especially in the context of the Work Programme on Special and Differential Treatment and the Doha Ministerial Decision on Implementation-Related Issues. Such proposals, however, continue to be resisted by developed countries and no progress has been made.

2. The WTO General Agreement on Trade in Services (GATS)

The GATS requires WTO Members to allow, subject to any limitations or exceptions that a Member may indicate in its GATS Schedule of Specific Commitments, the services providers (e.g. corporations) of other WTO Members to supply services through “commercial presence” – i.e. the establishment of a branch, subsidiary or other entity in the other Member’s territory. In GATS parlance, this is “Mode 3” trade in services. This mode essentially commits WTO Members to allow the entry and establishment of foreign service suppliers from other WTO Members albeit subject to the host country’s specific schedule of GATS commitments and limitations to national treatment or MFN exceptions in relation to specific services sectors.

Foreign investments falling under GATS Mode 3 would be covered by the provisions of the GATS on, inter alia, most-favoured nation treatment (Art. II), national treatment (Art. XVII), and market access (Art. XVI). With respect to services sectors that are included in the WTO Member’s GATS schedule of specific commitments, and subject to any limitations or exceptions indicated therein, investments in WTO Member A of a service supplier under GATS Mode 3 from WTO Member B, for example, would be protected from being discriminated against vis-à-vis the investments of WTO Member C or from domestic competitors. WTO Members are also prohibited, under Art. XVI of the GATS, from imposing any of the following measures:

“(a) limitations on the number of service suppliers whether in the form of numerical quotas, monopolies, exclusive service suppliers or the requirements of an economic needs test;

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13 See GATS, Art. I.2(c), which states that: “For the purposes of this Agreement, trade in services is defined as the supply of a service: … (c) by a service supplier of one Member, through commercial presence in the territory of another Member.”
“(b) limitations on the total value of service transactions or assets in the form of numerical quotas or the requirement of an economic needs test;

“(c) limitations on the total number of service operations or on the total quantity of service output expressed in terms of designated numerical units in the form of quotas or the requirement of an economic needs test;

“(d) limitations on the total number of natural persons that may be employed in a particular service sector or that a service supplier may employ and who are necessary for, and directly related to, the supply of a specific service in the form of numerical quotas or the requirement of an economic needs test;

“(e) measures which restrict or require specific types of legal entity or joint venture through which a service supplier may supply a service; and

“(f) limitations on the participation of foreign capital in terms of maximum percentage limit on foreign shareholding or the total value of individual or aggregate foreign investment.”

The provisions above also essentially provide treaty-based limitations with respect to WTO Members’ ability to impose investor obligations and employ regulatory policy space and flexibility with respect to Mode 3-based foreign investments.

II. DEVELOPMENTS IN INVESTMENT ARBITRATION

The second section of the paper looks at how tribunals in investment treaty arbitrations have dealt with the issues of investors’ obligations and host state policy space. It should be noted at the outset that the lack of a doctrine of precedent in investment arbitration means that future tribunals are not bound to follow the cases discussed below. In general, however, tribunals do refer back to decisions of earlier tribunals, so the ensuing discussion will hopefully provide useful guidance.

A. Developments in investors’ obligations

On the basis of arbitral awards to date, investors can be considered to have three main obligations:

1. Not to engage in unconscionable conduct, including corruption
2. To make a reasonable risk assessment prior to investing in the host state
3. To manage and operate the investment reasonably

The effect of a breach of one of the above differs depending on the obligation. If the tribunal finds that the investor has engaged in unconscionable conduct, its claim may be vitiated. By contrast, breaches of the other two obligations may lead to a reduction of compensation in proportion to the degree of the investor’s loss that can be attributed to its own conduct as opposed to the host state’s treaty breaches.\(^{14}\)

Each of the three obligations has several component parts and these are discussed in more detail below.

1. The obligation not to engage in unconscionable conduct

If the investor has engaged in corruption, fraud, misrepresentation, undue influence or abuse of power, the host country may legitimately take measures against the investor, so long as the measures are lawful and proportionate. Even termination of the investment by the host state may be justifiable, provided that the termination is permitted under its national law and it is a proportional response to the unconscionable conduct.\(^ {15}\) This was demonstrated in the NAFTA case of Azinian v. Mexico.\(^ {16}\) The United States investors in that case held the concession to carry out the waste collection in a Mexican city. They had obtained the concession using a business plan that asserted that they had over 40 years experience in the waste disposal business and that made impressive statements about the amount of capital that would be invested. In fact, only one investor had experience in the industry, they had no resources of their own and were relying on capital coming from third parties. When a major third party withdrew from the project they failed to disclose this to the Mexican authorities. The tribunal held that this last non-disclosure was unconscionable and Mexico’s termination of the concession was justifiable in the circumstances.

In addition, the investor must act with transparency in its dealings with the host state. In Genin v. Estonia, the United States investor did not divulge that he was the ultimate shareholder of the foreign parent company that was investing in a branch of an Estonian bank.\(^ {17}\) Although the tribunal found that the Bank of Estonia’s banking supervision had acted in a manner that fell below generally accepted banking and regulatory practices in a number of respects, the investor’s failure to disclose his beneficial ownership entitled the Bank of Estonia to exercise its statutory discretion to revoke his operating licence.

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\(^{14}\) Muchlinski, Peter "Caveat Investor'? The Relevance of the Conduct of the Investor under the Fair and Equitable Treatment Standard.' International and Comparative Law Quarterly, 55 (3) 527 at page 530.

\(^{15}\) Ibid, page 536

\(^{16}\) Azinian v. Mexico, ICSID Case No ARB(AF)/97/2, Award 1 November 1999

\(^{17}\) Genin v. Estonia ICSID Case No ARB/99/2, Award 25 June 2001
A very similar example is the recent award in *Plama Consortium Limited v. Republic of Bulgaria*.\(^{18}\) The Plama claim concerned an important oil refinery in northern Bulgaria. Initially Plama represented a consortium of major companies, but when these withdrew, Plama continued in its own right, without disclosing that it was now only a corporate cover for a private individual with limited financial resources. The tribunal held that Bulgaria would not have given its consent to the investment had it known the true situation, and dismissed the claim, holding that the investment contract was void ab initio.

Recently, tribunals have taken a more proactive approach to allegations of corruption and fraud than in the past. To illustrate, in the 2000 award of *Metalclad v. Mexico*, despite strong allegations of corruption, the tribunal chose not to address the issue.\(^{19}\) In contrast, in the 2005 *Methanex v. United States* award, the tribunal considered that it had the capacity to examine allegations of corruption, even though the allegations had not been proven in the courts. It also laid out a methodology for doing so, using the analogy of “joining the dots”.\(^{20}\)

In the 2006 case of *Inceysa v. El Salvador*, the tribunal held that the investor had engaged in fraud and that the existence of the fraud vitiated its jurisdiction.\(^{21}\) In that case, the investor claimed that El Salvador had breached the terms of a contract entitling it to operate motor vehicle inspection facilities throughout the country. The tribunal found that Inceysa had provided false financial statements and forged documents to the authorities. In declining jurisdiction, the tribunal relied on the common BIT provision that the investment “must be made in accordance with the law of the host country”, holding that an investment made through fraudulent means could not be made in accordance with law.\(^{22}\)

The approach to corruption was taken a step further in a second case the same year, *World Duty Free v. Kenya*.\(^{23}\) In that case, the claimant freely admitted to paying a US$2 million bribe to the then-President of Kenya, but said that this was the only way to do business with Kenya. The tribunal rejected this argument, holding that as a matter of *ordre publique internationale* it could not hear a case in which the investment had been made through corruption. In doing so, the tribunal went further than the *Inceysa* tribunal, finding that an investment must be lawful even when there is no express provision requiring so in the BIT.

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18 *Plama Consortium Limited v. Republic of Bulgaria*, ICSID Case No. ARB/03/24
19 *Metalclad Corporation v. Mexico*, award 25 August 2000
21 *Inceysa Vallisoletane, SL v El Salvador*, ICSID Case No ARB/03/26, 2 August 2006
23 *World Duty Free Company Ltd v Kenya*, ICSID Case No ARB/00/7, 25 September 2006
2. The obligation to make a reasonable risk assessment before investing

This obligation was perhaps best summed up by the tribunal in *Maffezini v Spain*:

“bilateral investment treaties are not insurance policies against bad business judgments.”

Based on past awards, this obligation can be seen to have two parts, discussed below.

First, the investor must undertake a proper feasibility study. In *Waste Management v Mexico*, the investor claimed that the Mexican municipal authorities had wrongfully expropriated its waste disposal concession by failing to meet their financial obligations under the concession, causing the investment to fail. The tribunal held:

“In the Tribunal’s view it is not the function of the international law of expropriation…to eliminate the normal commercial risks of the foreign investor, or to place on Mexico the burden of compensating for the failure of a business plan which was, in the circumstances, founded on too narrow a client base and dependent for its success on unsustainable assumptions about customer uptake and contractual performance.”

In *Biwater Gauff Ltd v. Tanzania*, the investor claimed that Tanzania had wrongfully expropriated its contract to operate and manage various aspects of the Dar es Salaam drinking water supply. In its 2008 award, the tribunal noted that within eleven months from commencing the contract Biwater had sought an interim tariff review and that it applied for a full contract renegotiation just five months thereafter. The tribunal held that it was in no doubt that Biwater’s bid was “poorly prepared” and “it was manifest that serious problems were encountered in the performance of the contract from the very start.”

Second, the investor must bear the risks of choosing to invest in a high-risk high-return location. When investing in a country that has an unstable economic, social or political situation, the investor does so knowingly. As the tribunal in *Generation Ukraine v. Ukraine* noted:

“The Claimant was attracted to the Ukraine because of the possibility of earning a rate of return on its capital in significant excess to other investment opportunities in more developed countries. The Claimant thus invested in the Ukraine on notice of both prospects and potential pitfalls... the Claimant had undoubtedly experienced frustration and delay caused by bureaucratic incompetence and recalcitrance in various forms. But equally, the Claimant had managed to secure a 49-year leasehold over prime commercial property in the centre of Kyiv without having participated in a competitive tender and without having made any substantial payment to the Ukrainian authorities.

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24 *Maffezini v Spain*, ICSID Case No ARB/97/7, award 13 November 2000
25 *Biwater Gauff (Tanzania) Ltd v Tanzania*, ICSID Case No ARB/05/22, 18 July 2008, para 486.
26 *Generation Ukraine v. Ukraine*, ICSID Case No ARB/00/9, award 16 September 2003. The tribunal in *CMS v Argentina* ICSID Case No ARB/01/8, award 12 May 2005 and *Olguin v. Paraguay* ICSID Case No ARB/98/5, award 26 July 2001 took similar approaches.
To add a note of caution at this point, commentators have stressed that host states should not be able to use this argument to justify its own regulatory shortcomings, although the limits of each party’s obligations are unclear.27

3. **The obligation to manage the investment to a reasonable standard**

Loss suffered by the investor due to its bad management, rather than measures taken by the host state, should not be recoverable under the BIT.28 The obligation to manage the investment to a reasonable standard appears to have several elements.

The first element requires the investor to manage the investment in a way that will ensure the economic viability of the investment. In *Noble Ventures Inc v. Romania* the claimant had invested in the privatization of a major iron and steel works in Romania which subsequently got into serious financial difficulties. Noble claimed that the host state had undermined its investment by failing to restructure the steel works’ existing debts and through subsequent legal proceedings to reorganize the company. The tribunal held that the investor, by defaulting on loan repayments and refusing to invest any of its own funds in the restructuring, was much to blame for the company’s bad financial situation. The legal proceedings to reorganize the company were not carried out in an arbitrary or discriminatory manner, had not been done to undermine the investor’s privatization agreement and could be seen as the only short term solution to the social crisis that arose in the region as a result of the investor’s failure to pay its workforce. The investor’s claim was dismissed.29

In *Biwater Gauff Ltd. v. Tanzania*, the tribunal held that it was in no doubt that:

“As a result of the poor bid, coupled with numerous management and implementation difficulties, [Biwater and its subsidiary City Water] did not generate the income which had been foreseen, and accordingly the project quickly encountered substantial difficulties...The position was soon reached where it was clear that City Water simply could not continue without a fundamental renegotiation of the Lease Contract.”30

27 Muchlinski, page 546.
28 Muchlinski, page 547.
29*Noble Ventures Inc v Romania, Award*, ICSID Case No ARB/01/11; award 5 October 2005
30 *Biwater Gauff (Tanzania) Ltd v Tanzania*, ICSID Case No ARB/05/22, 18 July 2008, para 486.
Whilst the tribunal in *Biwater* held that certain aspects of Tanzania’s later conduct were in breach of its obligations under the BIT, it dismissed Biwater’s claim for damages in its entirety, holding that none of Tanzania’s conduct had caused Biwater no loss – its investment was by then already worthless.  

A second element of the obligation to manage the investment to a reasonable standard is a requirement to be aware of the regulatory environment in which it operates and to foresee regulatory changes that are likely as a result of the nature of the regulatory environment. This requirement is a counterpoint to the obligation on host states to act transparently and to respect any commitments to investors that existing regulations will not change.

This aspect is demonstrated in the case of *Methanex v. United States* in which a Canadian manufacturer of methanol claimed that Californian legislation which banned the production of fuel containing methanol-based additives was a breach of NAFTA.

The Tribunal dismissed the claim. It held that:

“*Methanex entered a political economy in which it was widely known, if not notorious, that governmental environmental and health protection institutions at the federal and state level, operating under the vigilant eyes of the media, interested corporations, non-governmental organizations and a politically active electorate, continuously monitored the use and impact of chemical compounds and commonly prohibited or restricted the use of some of those compounds for environmental and/or health reasons.*”

It was also considered significant that the host state had made no commitments to Methanex not to amend its regulatory framework. Thus it seems that unless the host state gives the investor a stabilization commitment prior to its investment, the investor will bear the risk of legally enacted changes in the host state’s regulation.

In the recent case of *Parkerings v. Lithuania*, the tribunal held:

“*The investor will have a right of protection of its legitimate expectations provided it exercised due diligence and that its legitimate expectations were reasonable in light of the circumstances. Consequently, an investor must anticipate that the circumstances could change, and thus structure its investment in order to adapt it to the potential changes of legal environment.*”

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31 *Biwater Gauff (Tanzania) Ltd v Tanzania*, ICSID Case No ARB/05/22, 18 July 2008, para 800-807.
33 *Parkerings-Compagniet AS v Lithuania*, Award on jurisdiction and merits, ICSID Case No ARB/05/8, award 14 August 2007, para 303.
A third aspect of the obligation to manage the investment requires the investor to comply with any applicable regulatory requirements. A failure to comply with the laws of the host state may even act to exclude the investment from protection under the BIT. In *Maffezini v. Spain*, the tribunal held that the Argentine investor’s failure to carry out an environmental impact assessment prior to the establishment of its Spanish chemicals plant as required by Spanish law meant that Spain did not breach the Argentina-Spain BIT when it stopped the project for failing to comply with its environmental regulations. 34 Although the investor was aware of the relevant regulations in this case, the tribunal added that ignorance of the law would be no excuse.

A fourth element is the requirement to take relevant professional advice. 35 In *Feldman v. Mexico*, the tribunal held that the investor, as a taxpayer, had to conform to the requirements of the host state’s tax law and it had an active duty, requiring positive steps, to obtain professional advice regarding its tax obligations. 36 If the investor does seek professional advice, but the advice is incorrect, in the absence of a misrepresentation by the host state, the investor must bear the results of any losses flowing from the bad advice. In the recent case of *Parkerings v. Lithuania*, the tribunal held that the host state’s failure to disclose a legal opinion, which advised that the investor would not be able to collect revenue from the parking fees from its planned multi-storey carparking facility near the old town of Vilnius as originally planned, was not a breach of the host state’s obligations. 37 The advice was provided by a private law firm and any other law firm could have provided the same advice. The fact that the investor did seek legal advice but the advice differed was not to be held against the host state. 38

**B. Developments in host state policy space**

“Policy space” is a term often used to denote the space left to states to govern and regulate as they see fit while still observing their obligations under international and national law. Investment treaties have the potential to restrict host states’ policy space because the investor may use the investor protections contained in these treaties to challenge a host state’s legally valid regulations and policies.

This part of the paper considers the level of deference that arbitration tribunals have paid to host states’ policy space. The paper looks first at cases where the investor alleges that it has been discriminated against

34 *Maffezini v Spain* ICSID Case No ARB/97/7, award 13 November 2000.
35 Muchlinski, page 553.
36 *Feldman v. Mexico*, ICSID Case No ARB(AF)/99/1, award 16 December 2002.
37 *Parkerings-Compagniet AS v Lithuania*, Award on jurisdiction and merits, ICSID Case No ARB/05/8, award 14 August 2007, paras 303-307.
38 Muchlinski, page 553.
or denied fair and equitable treatment by the host state. It then considers cases where the investor has claimed that the host state measures have effectively expropriated its investment.

1. Discrimination and fair and equitable treatment

As far back as 2000, the tribunal in the NAFTA case of SD Myers v. Canada\(^\text{39}\) held that when interpreting the “minimum international standard of treatment”\(^\text{40}\) under NAFTA, a tribunal:

“does not have an open-ended mandate to second-guess government decision-making. Governments have to make many potentially controversial choices. In doing so, they may appear to have made mistakes, to have misjudged the facts, proceeded on the basis of a misguided economic or sociological theory, placed too much emphasis on some social values over others and adopted solutions that are ultimately ineffective or counterproductive. The ordinary remedy, if there were one, for errors in modern governments is through internal political and legal processes, including elections.”\(^\text{41}\)

“The Tribunal considers that a breach of Article 1105 occurs only when it is shown that an investor has been treated in such an unjust or arbitrary manner that the treatment rises to the level that is unacceptable from the international perspective. That determination must be made in the light of the high measure of deference that international law generally extends to the right of domestic authorities to regulate matters within their own borders. The determination must also take into account any specific rules of international law that are applicable to the case.”\(^\text{42}\)

SD Myers was a U.S. company involved in the remediation of toxic waste. It challenged Canada’s decision to ban the transboundary shipment of toxic waste to the United States for processing. Notwithstanding the tribunal’s stated deference to government decision-making, it found Canada in breach of the national treatment standard and the minimum international standard of treatment.

Similarly, most subsequent tribunals, if they defer to host state policy space at all, do not appear to afford it much weight in their analysis of whether the BIT provisions were in fact breached.

In sharp contrast, the recent award in Parkerings v Lithuania expressly recognizes the importance of protecting the policy space of host states.\(^\text{43}\) The tribunal held:

\(^{39}\) SD Myers Inc v Canada, First Partial Award and Separate Opinion, Ad hoc—UNCITRAL Arbitration Rules, 13 November 2000

\(^{40}\) Article 1105(1) NAFTA: Each Party shall accord to investments of investors of another Party treatment in accordance with international law, including fair and equitable treatment and full protection and security. [emphasis added]

\(^{41}\) SD Myers, para 262.

\(^{42}\) SD Myers, para 263.

\(^{43}\) Parkerings-Compagniet AS v Lithuania, Award on jurisdiction and merits, ICSID Case No ARB/05/8, award 14 August 2007
“It is each State’s undeniable right and privilege to exercise its sovereign legislative power. A State has the right to enact, modify or cancel a law at its own discretion. Save for the existence of an agreement, in the form of a stabilisation clause or otherwise, there is nothing objectionable about the amendment brought to the regulatory framework existing at the time an investor made its investment. As a matter of fact, any businessman or investor knows that laws will evolve over time. What is prohibited however is for a State to act unfairly, unreasonably or inequitably in the exercise of its legislative power.”

An important aspect of the fair and equitable treatment standard is that the host state should respect the legitimate expectations held by the investor when deciding to invest. In the past some tribunals have interpreted the investor’s legitimate expectations very broadly, including that the investor is entitled to expect the host state to ensure the stability of the legal environment. Such an approach has the potential to restrict a host state’s ability to modify its laws if these might adversely affect an investor.

In contrast, the Parkerings tribunal, following on from its statement quoted above, confined an investor’s legitimate expectations with respect to host states’ policy space:

“The investor will have a right of protection of its legitimate expectations provided it exercised due diligence and that its legitimate expectations were reasonable in light of the circumstances. Consequently, an investor must anticipate that the circumstances could change, and thus structure its investment in order to adapt it to the potential changes of legal environment.”

The requirement not to take discriminatory measures is an important element of a number of common investment treaty protections including fair and equitable treatment, the minimum international standard of treatment, national treatment and most favoured nation treatment. It is also often included as a protection in its own right, e.g. an express obligation not to take arbitrary or discriminatory measures.

In deciding whether a host state has discriminated against an investor, the tribunal must compare the state’s treatment of the investor with its treatment of others in like circumstances. How the tribunal interprets “like circumstances” is crucial.

In the past, a number of tribunals, including the tribunal in SD Myers v. Canada quoted above, have looked to the law developed in the context of the World Trade Organization to understand when parties are in “like circumstances”. They have held that this varies depending on the circumstances and the context, but one important consideration is whether the enterprises are in competition with one another. The rationale behind

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44 Parkerings, para 332.
45 Parkerings, para 333.
this approach is that if a measure negatively affects an investor, but not its competitors, it will lose its place in the market to those competitors. Under this approach, such a measure would be discriminatory.\textsuperscript{46}

From a public welfare perspective, such an approach is problematic. For example, if the host state passed a law banning a polluting chemical, and the investor used that chemical whilst its competitors did not, the law could be considered a discriminatory measure.

In the 2001 award in \textit{Pope & Talbot Inc v. Canada}, the tribunal applied a refined approach:

\textit{“the Tribunal believes that, as a first step, the treatment accorded a foreign owned investment...should be compared with that accorded domestic investments in the same business or economic sector. However, that first step is not the last one. Differences in treatment will presumptively violate [NAFTA’s “no less favourable treatment” standard] unless they have a reasonable nexus to rational government policies that (1) do not distinguish, on their face or de facto, between foreign–owned and domestic companies, and (2) do not otherwise unduly undermine the investment liberalizing objectives of NAFTA.”}\textsuperscript{47}

Under the above approach, it was presumed that a host state measure that treated the investor and another company in the same sector differently was discriminatory unless the host state could justify otherwise.

The tribunal in \textit{Methanex Corporation v. United States} refined the approach further.\textsuperscript{48} Methanex, a Canadian company, claimed that a decision by the state of California to ban the fuel additive Methyl Tertiary Butyl Ether (MTBE) was in breach of the United States’ obligations under NAFTA. Methanex, a producer of methanol which is a component of MTBE, alleged that the decision was an attempt to protect United States’ ethanol producers and harm foreign methanol producers, rather than a legitimate environmental measure as claimed by the United States.

With respect to determining which enterprises should be determined in “like circumstances” for the purposes of assessing whether the United States had been discriminatory, the tribunal disagreed with Methanex’s argument (similar to that in \textit{SD Myers} above) that the test should be simply whether the enterprises are competitors. The \textit{Methanex} tribunal held:\textsuperscript{49}

\textit{“The key question is: who is the proper comparator? .... it would be as perverse to ignore identical comparators if they were available and to use comparators that were less “like”, as it would be perverse to refuse to find and to apply less “like” comparators when no identical comparators}

\textsuperscript{46} \textit{SD Myers v. Canada}, para 243-251.
\textsuperscript{47} \textit{Pope & Talbot Inc. v. Canada}, award on the merits of phase 2, 10 April 2001, para 78-79.
\textsuperscript{48} \textit{Methanex Corporation v United States}, Final award on jurisdiction and merits, 3 August 2005.
\textsuperscript{49} \textit{Methanex}, Part IV Chapter B, para 17.
The difficulty which Methanex encounters in this regard is that there are comparators which are identical to it.”

The tribunal held there had been no discrimination.

In another step forward, the 2007 award in Parkerings v. Lithuania made express recognition of the host state’s right to policy space in its analysis of “like circumstances”. In that case, Parkerings, a Norwegian company successfully tendered for a contract to construct a multi-storey carpark near the old town of Vilnius. It later became evident that parts of the contract contravened Lithuanian legislation. The project had also received objections from other government departments and community groups over the potential impact of the parking facility on the character of the old town, a UNESCO heritage site. The project stalled and eventually the city of Vilnius decided to terminate the contract.

Parkerings claimed that it had been discriminated against because another company, who had a contract to build a carpark in the same area, was allowed to proceed. The tribunal dismissed the allegation, stating:

“...the fact that [Parkerings’ project] extended significantly more into the Old Town as defined by the UNESCO, is decisive. Indeed, the record shows that the opposition raised against the [Parkerings project] were important and contributed to the Municipality decision to refuse such a controversial project. The historical and archaeological preservation and environmental protection could be and in this case were a justification for the refusal of the project. The potential negative impact of the [Parkerings project] in the Old Town was increased by its considerable size and its proximity with the culturally sensitive area of the Cathedral. Consequently, [Parkerings project] was not similar with the carpark constructed by [the other company].”

Notably, rather than considering public policy as a possible justification for discriminating against two companies in like circumstances, the Parkerings tribunal found that the public policy aspects meant that the two companies were not “in like circumstances” at all.

The awards discussed above demonstrate a growing recognition of the need to allow host states their policy space. These positive signs must be read warily however. Many tribunals continue to issue decisions without any reference to host state policy space. Moreover, the lack of a doctrine of precedent means that the more promising decisions may not be followed by tribunals in the future. In sum, the only way to ensure that a tribunal will take the need for policy space into account is by including express provisions in the investment treaty itself.

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50 Parkerings, para 392.
2. Expropriation

A survey of past arbitral awards reveals that when faced with a claim that host state measures are an expropriation, tribunals have approached the issue of host state policy space in three different ways. The first approach pays no heed to host states’ need for policy space. This approach places investment protection paramount and refuses to consider the policy reasons underlying the challenged measures taken by the host state. The second approach is willing to recognize the public policy aim of the challenged measure but requires that there be a reasonable relationship of proportionality between the burden the measure places on the investor and the public interest aim of the measure. The third approach does not see the public policy aim of the challenged measure as a criterion to be weighed against the burden on the investor, but rather a determining factor which prevents the measure being an expropriatory measure full stop. These three approaches are discussed in more detail below.

In its 2000 award the tribunal in *Metalclad v Mexico* took the view that the purpose of a measure depriving an investor of the benefit of its investment is irrelevant to whether or not the measure may amount to an expropriation. The measures at issue in *Metalclad* were a decision by the municipal authority not to grant a permit to operate a hazardous waste site and a subsequent government decree declaring the site part of a nature reserve for the protection of rare cactus. The *Metalclad* tribunal held:

“*The Tribunal need not decide or consider the motivation or intent of the adoption of the Ecological Decree. Indeed, a finding of expropriation on the basis of the Ecological Decree is not essential to the Tribunal’s finding of a violation of NAFTA Article 1110. However, the Tribunal considers that the implementation of the Ecological Decree would, in and of itself, constitute an act tantamount to expropriation.*”

The second approach is illustrated by the case of *Técnicas Medioambientales Tecmed S.A, v. Mexico* which also concerned a permit for a hazardous waste site in Mexico. In that case Tecmed commenced ICSID arbitration proceedings alleging that the Mexican government's failure to re-license its hazardous waste site was an expropriation in breach of the Spain-Mexico BIT. In its analysis the tribunal stated:

“*The principle that the State’s exercise of its sovereign power within the framework of its police power may cause economic damage to those subject to its powers as administrator without entitling them to any compensation whatsoever is undisputable.*”

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51 *Metalclad Corporation v. United Mexican States*, ICSID Case No. Arb(AF)/97/1, award 30 August 2000, para 111.
52 *Técnicas Medioambientales Tecmed S.A, v. The United Mexican Stat* states, ICSID Case No. ARB (AF)/00/2, award 29 May 2003.
53 Ibid, para 119.
However, in deciding whether or not Mexico’s conduct was an expropriation requiring the investor to be compensated, the tribunal drew on jurisprudence from the European Court of Human Rights, which has held that:\footnote{Ibid, para 122.}

“No only must a measure depriving a person of his property pursue, on the facts as well as in principle, a legitimate aim « in the public interest », but there must also be a reasonable relationship of proportionality between the means employed and the aim sought to be realised [...] The requisite balance will not be found if the person concerned has had to bear “an individual and excessive burden” [...] The Court considers that a measure must be both appropriate for achieving its aim and not disproportionate thereto.”\footnote{European Court of Human Rights, \textit{In the case of James and Others}, judgment of February 21, 1986, 50, pages 19-20, http://hudoc.echr.coe.int}

After a lengthy analysis, the Tecmed tribunal found that Mexico’s conduct did amount to an expropriation in that case.

The third approach is demonstrated in the 2005 award in \textit{Methanex Corporation v. United States}.\footnote{Methanex Corporation v United States, Final award on jurisdiction and merits, 3 August 2005.} The decision is important in a number of respects, but the most significant for present purposes is its approach to Methanex’s allegation that the state of California’s ban on MTBE was a measure tantamount to expropriation within Article 1110 of NAFTA. In dismissing Methanex’s claim, the tribunal held:

“In the Tribunal’s view, Methanex is correct that an intentionally discriminatory regulation against a foreign investor fulfils a key requirement for establishing expropriation. But as a matter of general international law, a non-discriminatory regulation for a public purpose, which is enacted in accordance with due process and, which affects, inter alios, a foreign investor or investment is not deemed expropriatory and compensable unless specific commitments had been given by the regulating government to the then putative foreign investor contemplating investment that the government would refrain from such regulation.”\footnote{Ibid, Part IV Chapter D, para 7.}

It held that the United States had made no such commitments to Methanex. The tribunal ultimately dismissed all of Methanex’s claims and ordered Methanex to pay the costs of the arbitration as well as the United States’ legal costs.

The approach taken by the \textit{Methanex} tribunal was affirmed and elaborated upon in the 2006 award in \textit{Saluka Investments BV v. Czech Republic}.\footnote{Saluka Investments BV v Czech Republic, Partial Award, PCA—UNCITRAL Arbitration Rules, 17 March 2006} In that case, Saluka, a Dutch-incorporated subsidiary of the Japanese financial group purchased a significant stake in a newly privatized Czech Bank, Investicni a Postovni Banka
(IPB), one of four Czech banks privatized at that time. The newly privatized banks all had a high ratio of non-performing loans. In 2000, facing insolvency after a series of bank runs, IPB was placed under forced administration and its ownership was transferred to a competitor. In 2001 Saluka commenced UNCITRAL arbitration proceedings against the Czech Republic under the Dutch-Czech BIT. Saluka claimed that financial assistance given to its competitors but not to it was a breach of the fair and equitable treatment standard under the BIT. Saluka also claimed that the placing of the bank in forced administration was a deprivation under article 5 of the BIT.

In its 2006 award, the tribunal agreed with Saluka that the government had breached the fair and equitable treatment standard with respect to its conduct prior to the forced administration. However, it held that the forced administration did not amount to a deprivation under article 5 of the BIT. 59 The tribunal noted that article 5 does not contain any explicit exception for the exercise of regulatory power. 60 It continued:

"However, in using the concept of deprivation, Article 5 imports into the Treaty the customary international law notion that a deprivation can be justified if it results from the exercise of regulatory actions aimed at the maintenance of public order. In interpreting a treaty, account has to be taken of "any relevant rules of international law applicable in the relations between the parties" — a requirement which the International Court of Justice ("ICJ") has held includes relevant rules of general customary international law. 61

It is now established in international law that States are not liable to pay compensation to a foreign investor when, in the normal exercise of their regulatory powers, they adopt in a non-discriminatory manner bona fide regulations that are aimed at the general welfare." 62

Although the tribunals in Methanex and Saluka clearly recognize host states’ right to policy space, as noted by the Saluka tribunal:

"international law has yet to identify in a comprehensive and definitive fashion precisely what regulations are considered “permissible” and “commonly accepted” as falling within the police or regulatory power of States and, thus, non-compensable. In other words, it has yet to draw a bright and easily distinguishable line between non-compensable regulations on the one hand and, on the other, measures that have the effect of depriving foreign investors of their investment and are thus unlawful and compensable in international law. 63

The Saluka tribunal held that:

59 The tribunal held that the term “deprivation” was equivalent to “expropriation” in other BITs.
60 Saluka, para 254
61 Saluka, para 254.
62 Saluka, para 255.
63 Saluka, para 263.
“It thus inevitably falls to the adjudicator to determine whether particular conduct by a state “crosses the line” that separates valid regulatory activity from expropriation. Faced with the question of when, how and at what point an otherwise valid regulation becomes, in fact and effect, an unlawful expropriation, international tribunals must consider the circumstances in which the question arises. The context within which an impugned measure is adopted and applied is critical to the determination of its validity.”

Unfortunately for host states, this means that even on the most progressive of approaches, there still remains a lack of clarity over the circumstances in which a public policy measure will be considered expropriatory. This reinforces the need for clearly-worded provisions addressing this point to be included in the treaties themselves.

CONCLUSION

In the context of investment treaties, the current global financial crisis adds even more urgency and importance to the need for developing countries to be fully aware of the challenges and opportunities that international investment agreements may pose to their development prospects. While much of investment-related treaty law remains focused on either investment promotion or protection, there are significant policy shifts taking place in terms of ensuring that domestic investment regulatory policy frameworks in developing countries that are molded in part by international investment agreements must provide for rules to govern investor obligations to the host country and to providing the host country with sufficient development policy space so as to obtain developmental benefits out of foreign investment.

With respect to arbitrations brought under investment treaties, there have been some notable developments regarding the approaches taken by tribunals to the issues of investor obligations and host state policy space. The current status of investor obligations in investment arbitration can be summarized as follows: If the investor has used corruption, fraud, misrepresentation, undue influence or abuse of power, the investor may be precluded from exercising its rights under an investment treaty, and a host country may legitimately take measures against the investor. Even termination of the investment by the host state may be justifiable, provided that the termination is permitted under its national law and it is a proportional response to the unconscionable conduct. The investor must act with transparency in its dealings with the host state. The investor must undertake a proper feasibility study before investing and the investor must bear the risks of choosing to invest in a high-risk high-return location. Once the investment has been made, the investor must manage the investment in a way that will ensure the economic viability of the investment. The investor must

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64 Saluka, para 264, emphasis in original.
be aware of the regulatory environment in which it operates. It should take relevant professional advice and ensure compliance with any applicable regulatory requirements.

With respect to host state policy space, the level of deference paid by tribunals has differed. Although a small number of tribunals have paid lip service to host states’ sovereign power to legislate, very few appear to have interpreted the investment treaty provisions in light of this power. There are a couple of notable exceptions however. With respect to investors’ right to fair and equitable treatment, the Parkerings tribunal makes it clear that investors’ legitimate expectations must be interpreted in light of host states’ right to legislate and investors cannot expect the legal environment to remain unchanged. The Parkerings case also establishes that tribunals are entitled to take account of public policy considerations when determining whether a host state has discriminated between the investor and other similar operations. In the area of expropriation, the Methanex and Saluka awards declare that a non-discriminatory regulation for a public purpose, which is enacted in accordance with due process will not be deemed expropriatory unless the host state has given specific commitments to the investor that it would refrain from such regulation.

The advances in investment arbitration come with an important disclaimer however. There is no doctrine of precedent in international investment arbitration - future tribunals are not bound by the decisions of tribunals in earlier cases. This means that although the cases discussed above demonstrate progress in this area, it is by no means certain that future tribunals, even faced with an identical factual situation, would decide in the same way. In the end, the only certain way to ensure that due regard is given to host state policy space is by express provisions in the treaties themselves.