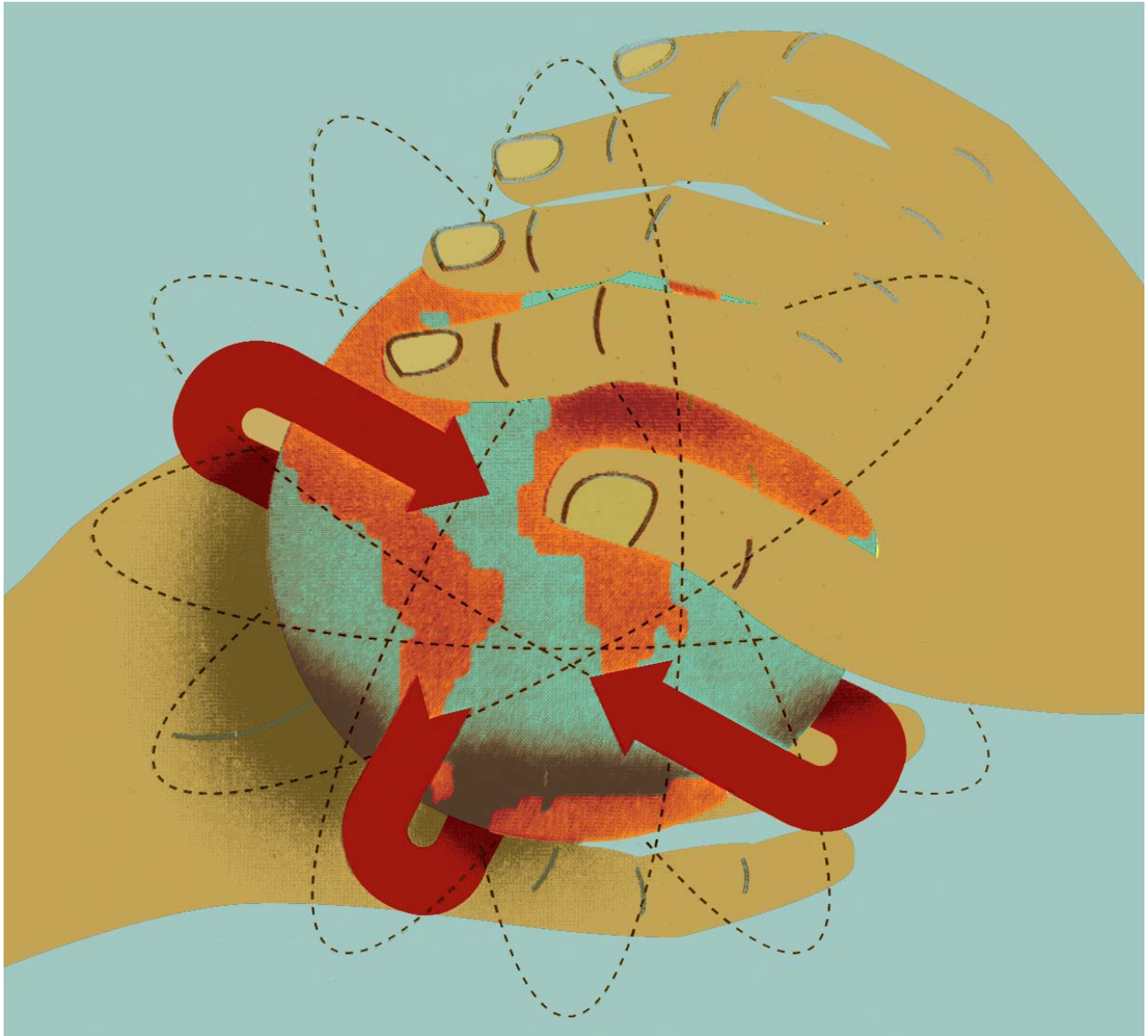




# Investment treaties

## Taking advantage of the protections on offer



Bilateral and multilateral investment treaties have flourished in recent years and can provide a means of reducing the risks involved in international investment.

Ian Meredith and Clare Tanner explain the typical protections such treaties can offer investors and outline recent developments in the area.

The risks associated with foreign investment are all too familiar to those in the international business community. Contractual obligations give investors some comfort that they will receive the expected returns on their investment, particularly if compliance with those obligations can be achieved by reference to international arbitration.

However, in developing or politically unstable countries in particular, direct or indirect actions by a host government can mean that these contractual promises are of limited or no value. These problems are compounded where the state is also a party to the contract and, for example, a change of government results in attempts to avoid obligations entered into by a previous regime.

Illustration: Andy Baker



## Definition of investment: an example

The International Centre for the Settlement of Investment Disputes (ICSID) will only accept jurisdiction where the dispute relates to an “investment”. An ICSID tribunal often looks to the relevant bilateral or multilateral investment treaty (BIT or MIT) to assist it in determining whether the transaction in question qualifies as such. The China/UK BIT, for example, defines investment as follows:

- “Investment” means every kind of asset accepted as investment by a contracting party in its territory in accordance with its laws and regulations and, in particular, though not exclusively, includes:
  - moveable and immovable property and any other property rights such as mortgages, liens or pledges;
  - shares, stock and debentures of companies or interests in the property of such companies;
  - claim to money or to any performance under contract having a financial value;
  - copyrights, industrial property rights, know-how and goodwill; and
  - business concessions conferred by law or under contract permitted by law, including concessions to search for, cultivate, extract or exploit natural resources.
- The term “investment” includes investments existing at the date of entry into force of this agreement and the change in the form in which assets are invested does not affect their character as investments.

Historically, the risks associated with foreign investment meant that investment capital was slow to flow between countries. To address this, a network of extra-contractual protection for investors has developed. These protections are often found in bilateral and multilateral investment treaties (BITs and MITs) between states.

The earliest of these treaties were concluded in the 1950s but their number has proliferated since the 1980s. A recent development of particular interest has been the entry by the People’s Republic of China (China), a country with fast developing investment opportunities, into “new generation” BITs with Germany, The Netherlands and Finland (the latter is still awaiting ratification).

This article provides an overview of the issues surrounding investor protection and specifically:

- Outlines the protective features of extra-contractual investor protections such as BITs.
- Describes the interaction between contractual and treaty remedies.

- Explains the mechanisms available for obtaining a remedy for breach of extra-contractual protections, and the jurisdictional issues that may arise when seeking such a remedy.

- Sets out the advantages of China’s new generation BITs (*see box, China BITs: a new generation*).

The article also provides some general tips on structuring investment transactions to take advantage of the protections that may be available under BITs and MITs (*see box, Entering into an investment contract: some tips*).

### Protective features

BITs between states are not in common form but tend to share certain features. They generally provide that the state that is hosting the investment will grant certain protections to an investor from the other contracting state. As illustrated by case law, these protections typically include:

- **Protection from expropriation without compensation.** A change in government or economic crisis can result in host

states trying to gain economic advantage by nationalising privately held economic interests. To prevent such arbitrary measures, a BIT may require host states to pay compensation in the event of expropriation.

In one recent example, a UK company, the Vestey Group Limited, owned around 350,000 acres of land in Venezuela. In 2001, the Venezuelan government introduced a new land law that led to the creation of a Land Institute to examine title to land holdings and to assess if the land had been used productively. Certain farms belonging to Vestey were found to lack title and to be unproductive. Vestey was concerned that the finding would result in locals squatting on the land. Vestey began a claim under the UK/Venezuela BIT relying, among other things, on its entitlement to be protected from expropriation without compensation. The claim was settled on terms.

The recent moves by President Morales’ government in Bolivia to seize foreign owned energy assets looks set to start a new round of BIT claims based on expropriation.

- **Protection from treatment less favourable than that offered to nationals.** The attractions to a national government of offering better terms to its own nationals than foreign investors are clear. Foreign investors do not vote or provide local support for unelected governments. The ability of local investors to, for example, obtain raw materials at a better price than foreign investors makes the foreign investment less competitive and less attractive. A requirement to treat nationals and non-nationals alike is therefore of significant value.

In one recent case, Occidental Exploration and Production Company (Occidental), a US company, entered into an agreement with a state owned company in Ecuador (*OEPC v Ecuador (LCIA Case No. UN 3467)*). The contract granted Occidental the right to carry out the exploration and exploitation of hydrocarbons in a certain area of the Amazon Basin. Occidental assumed virtually all of the costs and in return received a percentage of the oil produced and the right to export it. Occidental paid value added tax (VAT) on the costs and, as an exporter, sought reimbursement of that VAT from the Ecuadorian tax authority, the Internal Revenue Service (*Servicio de Rentas Internas*)

(SRI). A dispute arose between Occidental and the SRI as to whether Occidental was entitled to a refund of VAT.

The arbitral tribunal that heard Occidental's treaty claim found that Occidental was entitled to a VAT refund and SRI's failure to make the refund meant that Ecuador was, among other things, in breach of its obligation, under its BIT with the US, to provide Occidental with treatment no less favourable than that offered to nationals.

Ecuador's Ministry of Energy has recently announced moves to wind up Occidental's activities in the country alongside new hydrocarbons legislation increasing the state take from oil revenues. Occidental has responded quickly, filing a request for arbitration alleging further breaches of the BIT between the US and Ecuador.

■ **Fair and equitable treatment.** This is a developing concept but some broad trends can be identified. They include a requirement that a host state maintains a stable investment environment (in contrast, for example, to the economic crisis in Argentina in the late 1990s). The reasonable expectations of the investor when making the investment may also form the basis of a fair and equitable treatment claim.

For example, in *CMS Gas Transmission Company v Argentine Republic* (ICSID Case No. ARB/01/8), CMS Gas Transmission, a US company, acquired a shareholding in a local gas utility company, TGN, in Argentina. TGN was created following the privatisation of the gas industry. CMS's case was that the regulations establishing TGN and the terms of TGN's licence established a regime under which tariffs were to be calculated in US dollars and to be adjusted every six months by reference to a US price index. Following the Argentinean economic crisis disputes arose as to the calculation of the tariff. In 2002 an emergency law was introduced which terminated TGN's right to adjustment of the tariff and calculation of the tariff in US dollars.

The ICSID arbitral tribunal that heard the matter found that Argentina had breached its obligation to provide fair and equitable treatment, under its BIT with the US, because guarantees provided to CMS, which were key to the decision to invest, were withdrawn by the government and the investment environment changed dramatically.

■ **Provision of full protection and security.** A host state must take steps to protect the assets of foreign investors. For instance, in *Wena Hotels Limited v Arab Republic of Egypt* (ICSID Case No. ARB/98/4), Wena, a UK company, entered into an agreement with a state owned Egyptian Company, EHC, to develop and run two hotels in Luxor and Cairo. EHC repossessed both hotels and evicted Wena. The Egyptian courts ruled that the eviction was illegal. The hotels were returned to Wena but all the fixtures and fittings were missing.

The arbitral tribunal found that Egypt had failed to provide Wena with full protection and security, in accordance with the requirements of the Egypt/UK BIT. It was unclear whether Egyptian officials, other than officials of EHC, participated in the repossession and eviction. However, Egypt was aware of EHC's intention to repossess the hotels and failed to stop it. In addition, once the seizures occurred, Egypt did not take prompt action to return the hotels to Wena.

■ **The right to the free transfer of investments and returns.** Foreign investors are likely to find their investments to be of limited value if there is no mechanism for them to transfer their returns to their home state or elsewhere. Under many BITs, currency control regulations or other actions freezing funds can be challenged.

The types of protections described above may also be available to an investor as a result of MITs such as the North American Free Trade Agreement (NAFTA) and the Energy Charter Treaty.

### Interaction between contractual and treaty remedies

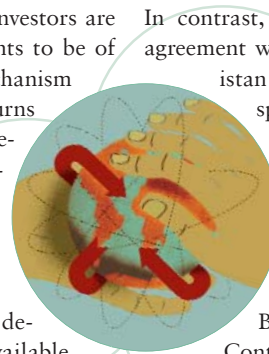
Whether investor protection measures appear in a BIT, an MIT or in a contract with a host state, there is an analytical distinction to be drawn between breaches of treaty type extra-contractual obligations and breaches of contractual obligations. Tribunals have found that whether there has been a breach of treaty type obligations and whether there has been a breach of contract are different questions. Each of these claims will be determined by reference to its own proper or applicable law. As a matter of principle, the same set of facts can give

rise to different claims grounded on different, contractual and extra-contractual, bases.

In some cases an "umbrella clause" within a BIT or MIT may mean that failures to observe contractual commitments amount to breaches of that treaty. For instance, SGS, a Swiss company, entered into an agreement with the government of the Philippines to provide an import supervision service (*SGS Société Générale de Surveillance SA v Republic of the Philippines* (ICSID Case No. ARB/02/6)). SGS alleged that the Philippines had failed to make certain payments due under the contract and that this failure amounted to a breach of the Switzerland/Philippines BIT, which provides that: "Each Contracting Party shall observe any obligation it has assumed with regard to specific investments in its territory of the other Contracting Party". In this case, the arbitral tribunal found that the BIT's umbrella clause meant that failures to observe contractual commitments were in effect breaches of the BIT.

In contrast, SGS also entered into an agreement with the government of Pakistan to provide pre-shipment inspection services of goods to be exported to Pakistan (*Société Générale de Surveillance SA v Islamic Republic of Pakistan* (ICSID Case No. ARB/01/13)). The Switzerland/Pakistan BIT provides that: "Either Contracting Party shall constantly guarantee the observance of the commitments it has entered into with respect to the investments of the investors of the other Contracting Party".

SGS alleged that Pakistan was in breach of its contractual obligations and that this failure amounted to a breach of the Switzerland/Pakistan BIT. In this instance, the tribunal found that there was no clear and persuasive evidence that, in adopting the above clause, both Switzerland and Pakistan intended that all breaches of each state's contracts with investors of the other state were to be converted into breaches of the BIT. As a result, the tribunal found it had no jurisdiction over claims submitted by SGS that were based on alleged breaches of the agreement and which did not also constitute or amount to breaches of the substantive standards of the BIT.



## Entering into an investment contract: some tips

When entering into an investment contract it is important to:

- Check the availability of investor protection, including umbrella clauses, before entering into the contract (and not after a dispute has arisen). When determining the appropriate structure for a transaction, consider the investor protections that are potentially available in addition to other factors such as the tax implications, corporate governance requirements and funding consequences of that structure.

- Consider the types of dispute that may arise given the circumstances of the investment. This may influence which of the potentially applicable treaties is most attractive to an investor.

- Identify which treaty is applicable. Some investment treaties were entered into a number of years ago. Changes in the political landscape, such as the fragmentation or change in the name of a state, may mean that it is not immediately apparent which treaty is applicable. For example, the UK has entered into a BIT with the People's Republic of the Congo but not with the Democratic Republic of the Congo (formerly Zaire).

- Consider the possibility of structuring the transaction so that the nationalities of the parties involved (including that of the investment vehicle) mean that they have rights under one or more BIT or MIT. This could involve:

- including an explicit statement in the contract as to the investor's nationality. The 1993 International Centre for the Settlement of Investment Disputes (ICSID) model clause 6 provides that: "It is hereby stipulated by the parties that the Investor is a national of [name of another Contracting State]";

- if the investment vehicle is a national of the host state, making explicit in the contract that the vehicle will be treated as a national of another contracting state because of foreign control. The 1993 ICSID model clause 7 provides that: "It is hereby agreed that, although the Investor is a national of the Host State, it is controlled by nationals of [name of other Contracting

State(s)] and shall be treated as a national of that/those State(s) for the purposes of the Convention".

Note that the developing concept of nationality may enable claims to be brought by majority or even minority shareholders and also enable the nationality of a corporate entity to be assessed by more than one test.

- Include an explicit statement in the contract that the transaction constitutes an investment. The 1993 ICSID model clause 3, for example, provides that: "It is hereby stipulated that the transaction to which this agreement relates is an investment".

- Structure the transaction to meet as many of the features of an investment as possible, which will make it easier to surmount the jurisdictional hurdle involved in seeking ICSID arbitration.

- Consider combining an ICSID clause with a clause referring to an arbitral institution that does not have the same jurisdictional requirements where the investment status of a transaction is uncertain.

- Incorporate investor protection measures into the contract when contracting directly with a host state. These measures should:

- commit the host state to providing investor protection;

- state that the transaction is an investment;

- state the nationality of the investor; and

- provide for a reference to ICSID arbitration.

- These measures may be vital if, for example, the investor is a national of a country with no BIT with the host state or the protections available under the particular BIT are limited. Provisions in contracts giving direct access to treaty type protections are most common in the natural resources sector, such as oil and gas concession agreements.

The interaction between contractual and treaty remedies is further illustrated in the case of *Impregilo*, an Italian investor, which was leader of a joint venture established to construct hydro-electric power facilities in Pakistan (*Impregilo SpA v Islamic Republic of Pakistan (ICSID Case No ARB/03/3)*). *Impregilo* concluded two contracts with the Pakistan Water & Power Development Authority (WAPDA) that were never fully performed due to alleged violations by Pakistani authorities.

The Italy/Pakistan BIT does not contain an umbrella clause and so *Impregilo* could not rely directly on such a clause. However, *Impregilo* alleged that:

- Pakistan was in breach of its obligation to provide fair and equitable treatment and to protect it against unjustified or discriminatory measures.

- Pakistan's conduct was tantamount to expropriation.

*Impregilo* relied on, among other things, breaches of contract by WAPDA to make out these claims. The tribunal found that:

- The contracts in issue were concluded between *Impregilo* and WAPDA and not between *Impregilo* and Pakistan.

- Under Pakistani law, which governed both contracts and the status and capacity

of WAPDA for the purposes of the contract, WAPDA was a legal entity distinct from the state of Pakistan.

The tribunal found that the BIT did not extend to breaches of contracts concluded by such an entity and, as a result, the tribunal had no jurisdiction under the BIT to entertain *Impregilo's* claims based on alleged breaches of the contract.

The *Impregilo* tribunal went on to find that a breach of contract might constitute a violation of a BIT but to do so it must be the result of behaviour going beyond that of an ordinary contracting party. The state, in the exercise of its sovereign authority and not as a contracting party, may

breach the obligations assumed under the BIT. The threshold to establish that a breach of contract amounted to a treaty breach was a high one.

### Obtaining a remedy

While obtaining the right to investor protection is important, unless there is a mechanism to obtain a remedy for a breach of this right, its value is minimal. Domestic courts are unlikely to provide a solution. In many parts of the world lack of neutrality and political pressure on the judiciary mean that courts are unlikely to award a foreign investor with a remedy against the state. International arbitration is the obvious answer and, with the specific needs of investor protection disputes in mind, the International Centre for the Settlement of Investment Disputes (ICSID) was established by the 1966 Washington Convention (the Convention) under the auspices of the World Bank.

ICSID is an established and internationally respected arbitral institution. ICSID tribunals only accept jurisdiction over disputes arising from investments between a contracting state and the nationals of another contracting state. Many, but not all, BITs provide that any dispute will be referred to ICSID arbitration. For example, the UK/China BIT provides for settlement of disputes by a single international arbitrator, an ad hoc arbitral tribunal or an ad hoc tribunal established under the UNCITRAL Arbitration Rules (this BIT differs in style to the new generation of China BITs (see box, *China BITs: a new generation*)).

The particular advantage of ICSID arbitration to an investor is that, unlike most international arbitrations, the arbitration is not wholly confidential. References to arbitration are reported on the ICSID section of the World Bank website (see [www.worldbank.org/icsid](http://www.worldbank.org/icsid)). From a claimant's perspective, the publicity surrounding ICSID claims can provide useful leverage as there is a perception that where a country faces a number of investor protection claims this acts as a disincentive to investment. Decisions of ICSID tribunals are also generally published.

The trend towards more open ICSID arbitrations is illustrated by an arbitration,

## China BITs: a new generation

The development of China as a capital exporting state, and pressure from other capital exporting states, has led to a change in the climate of opinion within the country. This has resulted in a new generation of Chinese bilateral investment treaties (BITs), which contain broader types of investor protection measures than the old-style BITs. To date, China has entered into new generation BITs with The Netherlands, Germany and Finland (the latter is still awaiting ratification).

Under old-style China BITs (such as that between the UK and China), the only issue capable of reference to international arbitration is the amount of compensation due if a foreign investor has suffered expropriation (see *main text*, *Protective features*). As a foreign investor may have poor prospects of establishing, for example in the domestic Chinese courts, that it has suffered expropriation, the real value of the protections available under these old-style BITs is limited.

In addition to containing substantive investor protections, the new generation of BITs provide for the submission of disputes to the International Centre for the Settlement of Investment Disputes (ICSID) for arbitration. For example, The Netherlands/China BIT provides that a dispute between an investor and the host state will be submitted to ICSID or an ad hoc tribunal under the UNCITRAL Rules.

Parties investing in China may wish to structure transactions to take advantage of the protections available under the German and Dutch BITs. This may be achieved by channelling investment through a Dutch or German vehicle.

An alternative course may be to rely on most favoured nation (MFN) clauses in old-style BITs between China and other states. MFN clauses provide that a host state cannot treat investors from one state less favourably than those from another. The effect of MFN clauses is an area of debate. However, potentially, investors from countries with old-style China BITs incorporating MFN clauses may be able to take advantage of the rights granted to German and Dutch investors under the new generation BITs. (The question of whether MFN clauses provide substantive or procedural protections is an unresolved but important issue.)

against Malaysia, where memorials on jurisdiction were filed in recent months and are the first pleadings to be made available by ICSID (*Malaysian Historical Salvors, SDN, BHD v Malaysia* (Case No. ARB/05/10)). Facilities are also available at ICSID in Washington for non-parties to watch hearings (if the parties agree). Tribunals operating under ICSID rules of procedure have also allowed non-parties to make written submissions (if they meet criteria laid down by the tribunal). This may, or may not, assist the investor depending on the position taken by bodies such as interest groups or unions that are likely to make submissions.


### Jurisdictional issues

An ICSID tribunal will only accept jurisdiction over a claim that arises out of "an investment". The starting point for identifying whether ICSID has jurisdiction is the relevant BIT or MIT or definition in the contract.

The types of investment that appear in the definitions in BITs and MITs often include: property rights; interests in companies; money claims and rights to performance; intellectual property rights; and concessions. (For an example of a definition of investment in a BIT, see box, *Definition of investment: an example*.)

If a claim is to be brought before an ICSID tribunal, an investor may also have to establish that the transaction qualifies as an investment within the meaning of Article 25 of the Convention. There is no definition of an investment in the Convention but features that are suggestive of investment include:

- The duration of the project, including an expectation of a longer-term relationship.
- Regularity of profit and return.
- The assumption of risk by both sides.

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- A substantial level of financial commitment.
- Whether the operation is significant for the host state's development.

Some tribunals, such as that in *SGS SA v Republic of Philippines* (see above, *Interaction between contractual and treaty remedies*), have taken a liberal approach to the question of jurisdiction, relying on the definition of investment contained in the relevant BIT without referring to Article 25 of the Convention.

If an investor is a non-natural person, usually a company, the investor must have the

nationality of a contracting state and not the nationality of the host state on the date on which the parties consent to submit the dispute to arbitration. However, companies that are host state nationals will not be excluded if they are foreign

controlled. ICSID tribunals have generally looked to the place of incorporation, registered office, central administration or effective seat when determining the nationality of companies.

If an investor is an individual, an ICSID tribunal will only accept jurisdiction over a claim if the investor can establish that he possesses the nationality of a contracting state and does not possess the nationality of the host state. The investor must have the nationality of the contracting state on the date on which the parties consent to submit the dispute to arbitration as well as on the date on which the request is registered. Subject to certain exceptions, the nationality of an individual is determined by the law of the state whose nationality is claimed.

A host state and an investor may agree that the investor is of a specified nationality. While this does not automatically mean that the investor has surmounted the jurisdictional hurdle, an agreement on nationality will create a strong presumption in favour of the stated nationality.



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