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CURRENT TRENDS IN INTERNATIONAL INVESTMENT AGREEMENTS – NEW LEGAL CHALLENGES FOR DEVELOPING COUNTRIES

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I. Introduction

A marked increase in the conclusion of legal instruments for the Protection of Foreign Investment has characterized the international legal environment for the attraction of foreign investment in recent times. These legal Instruments have taken the form of the traditional Bilateral Investment Promotion and Protection Treaties (BITs) as well as Bilateral Free Trade Agreements and Regional Economic Integration Agreements containing substantive chapters on investment protection. According to a recent UNCTAD study, more than 2300 Bilateral Investment Promotion and Protection Agreements and about 150 Trade and Economic Integration Agreements with substantive investment chapters have been concluded. As the study pertinently observes:

> "The legal architecture of Investment Agreements has also evolved considerably during this period and a growing body of jurisprudence poses new questions of interpretation and implementation to governments and investors in both developed and developing countries".[1]

A clear trend towards bilateral and regional Economic Partnership Agreements is becoming increasingly evident in the South Asian region. Sri Lanka has concluded Free Trade Agreements with India and Pakistan, while a Comprehensive Economic Partnership Agreement with India with a separate chapter containing substantive provision on investment promotion and protection is under negotiation. In addition, trade barriers are also being

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1 Making the Most of International Investment Agreements: A Common Agenda - Conference Paper prepared for a Symposium Co-organized by ICSID, OECD and UNCTAD –12 December 2005, OECD Headquarters, Paris.

progressively liberalized at the regional level. Member States of the South Asian Association for Regional Cooperation (SAARC) have concluded a South Asian Free Trade Agreement (SAFTA). To facilitate its implementation, a Regional Investment Promotion and Protection Agreement are also under discussion.

A novel element in Economic Integration Agreements (EIAs) is that the investment chapters of these agreements are linked to overall trade and developmental goals, with the objective of widening and deepening economic integration. There is, therefore, a need to re-negotiate existing bilateral agreements within a broader context of achieving GATS plus treatment in the services sector under the umbrella of EIAs. The investment chapters in Economic Integration Agreements are required to facilitate the liberalization of the Services Sector in the context of greater economic integration. These imperatives pose new challenges for the developing host countries of Asia and Africa.

Two principal issues arising from this new negotiating environment, which are proposed to be discussed within the scope of the present article are, firstly, the question of pre-investment coverage for foreign investment under Economic Integration Agreements and secondly, the much discussed issue of the legal demarcation between measures amounting to indirect expropriation and governmental regulatory measures, which has arisen in the context of emerging NAFTA jurisprudence. Both these issues pose critical policy and legal challenges to developing host States.

II. Pre-Investment Coverage

As a matter of general approach, the Bilateral Investment Agreements regulate the observance of international minimum standards of legal protection to foreign investments in the post-establishment phase. In other words, the obligations of the host State for the promotion and protection of foreign investment arise in respect of investments, which are duly admitted into the territory of a host State, in accordance with its laws and regulations and with regard to their maintenance and operation in the host State.[2]

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[2] The traditional clause in BITs providing for treatment of foreign investment in the post-establishment phase provides: " Neither Contracting Party shall in its territory subject investments admitted in accordance with the provisions of Article 2 or returns of nationals or companies of the other Contracting Party to treatment less favourable than that which it accords to investments or returns of its own nationals or companies or to investments or returns of national or companies of any third State.

Current Free Trade Agreements in contrast, seeks to provide coverage in the grant of National/Most Favoured Treatment to investments even in relation to the establishment of an investment.[3] The coverage extended to investments in the pre-establishment phase is with a view to achieving the overall objective of deeper economic integration.

Among issues that have engaged the particular attention of the host States in the context of Free Trade and EIAs is the question whether pre-establishment coverage should be limited only in respect of specifically identified sectors which are of significance to the achievement of the overall national developmental goals, rather than an across the board application of the Agreement at the pre-establishment stage.

Another issue that arises for consideration is the standard of treatment to be extended in the pre-establishment phase. While a liberal approach would be to limit the minimum standard of treatment to Most Favoured Nation treatment across the board at the pre-establishment stage, to ensure non-discrimination among foreign investors in the admission of investments, a more conservative approach would be to accord national treatment only in respect of specifically identified sectors of importance to the host State.

One of the critical issues raised in this area is the applicability of international dispute settlement provisions to disputes arising in the pre-establishment phase. Sri Lanka was confronted with this issue in an international arbitration before the International Centre for Settlement of Investment Disputes (ICSID), in the case of *Mihaly International Corporation vs. The Government of Sri Lanka*.[4] The key issue, which arose in these proceedings, was whether the jurisdiction of ICSID should be liberally widened to cover a new category of disputes in the form of pre-investment expenditure,

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Neither Contracting Party shall in its territory subject nationals or companies of the other Contracting Party, as regards the management, use, enjoyment or disposal of their investments, to treatment less favourable than that which it accords to its own nationals or companies or to nationals or companies of any third State" (Article 3 of UK-Sri Lanka Bilateral Investment Promotion and Protection Agreement)

3 For eg. see Article 10.4 of the Dominican Republic – Central America – United States Free Trade Agreement providing for the grant of Most Favoured Nation Treatment : "Each Party shall accord to investors of another Party treatment no less favourable than that it accords in like circumstances, to investors of any other party or of any non-Party with respect to the establishment, acquisition, expansion, management, conduct, operation and sale or other disposition of investments in its territory."

4 ICSID Arbitration: *Mihaly International Corporation Vs. The Government of Sri Lanka*: Award dated 1st March 2002 (Case No. ARB/00/2).

notwithstanding the fact that the proposed investment project failed to materialise and was ultimately abandoned. Hence, the question for determination was whether such expenditure amounted to an "investment" for the purposes of invoking jurisdiction, in terms of Article 25 of the ICSID Convention.

In rendering its award on preliminary objections to jurisdiction taken up by the Government of Sri Lanka, the ICSID Tribunal rejected the assertion of the investor – that the term "investment" be given a broad interpretation, so as to include pre-investment expenditure. From a developing country perspective, the majority opinion adopted by the Tribunal is consistent with the idea that the primary objective of international Investment Agreements is to encourage long term commitment of resources to the host State and to include only capital flows with a particular maturity as falling within the definition of the term "investment".[5] However, certain observations made in a concurring opinion of one of the Arbitrators, that the protection mechanism of ICSID should be available to those who are encouraged to embark on large scale expensive private foreign investment infrastructure projects, is a matter that would give rise to considerable concerns on the part of developing host States, taking into account the fact that this reasoning could also trigger a different approach in future arbitrations, to that followed by the majority in the Mihaly Arbitration.

While addressing this issue, one important element that must be borne in mind is that the pre-investment tender processes in respect of large-scale private foreign investment infrastructure projects, almost always involves a number of unsuccessful potential investors as tenderers. On the basis of an expansive interpretation of the term "investment", each one of such unsuccessful tenderers could potentially pursue a claim against the host State in respect of pre-investment expenditure incurred in developing a project proposal. If the ICSID protection is liberally extended to cover such expenditure, the impact of defending such a bundle of claims, on the

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5 In presenting its arguments before the ICSID Tribunal, the Government of Sri Lanka stressed that the purpose of the ICSID Convention was to facilitate foreign investment of the type that promotes and sustains economic development. Such investment involves not only the transfer of substantial assets from an individual or enterprise in one country to an enterprise in another, in exchange for a right to participate in the earnings of the other enterprise, for a reasonable length of time, but also meaningful control by the investor over the transferred assets or foreign enterprise in which such assets are invested.

vulnerable economies of developing countries would be of a potentially de-stabilizing nature. The economic cost of defending multiplicity of legal claims by potential foreign investors, sometimes before multiple arbitration fora, all arising out of one transaction would necessarily involve substantial resource implications for host developing States.

A plethora of cases which arose, particularly, in relation to the North American Free Trade Agreement (NAFTA), has given rise to much discussion on the possibility of consolidation of multiple claims and the need for avoiding of multiplicity of claims arising from a single set of measures.[6] Such measures, as well as provision for possible dismissal *in limine* of unmeritorious claims currently under consideration within the ICSID Convention Framework, deserve close attention to ensure the efficiency of the arbitral process and in order to generate the confidence of host States in the dispute settlement process.

In determining the question of pre-investment expenditure, it would also be necessary to have regard to the fact that the 'a priori' consent clause in BITs through which a State consents in advance to submit to international arbitration in respect of future disputes, must be interpreted and applied in the context of its innovative and *sui generis* character in international treaty law. These clauses which grant an individual investor, the right to pursue a claim against a host State, in his own right without the intervention of his home State, constitutes a significant departure from the traditional position reflected in customary international law, where an individual lacks the international legal personality to pursue such claims.

It is submitted, therefore that International Tribunals need to be cautious in liberally invoking the 'a priori consent' of a State in respect of a new class of disputes such as those involving pre-investment expenditure. It is quite possible that had the issue presented itself at the time of negotiating a BIT, a host State would most likely have excluded such disputes from the scope of

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[6] Approximately 40 ICSID proceedings have been instituted against Argentina on the basis of BITs concluded in the 1990s. The majority of these claims alleging expropriation have been instituted consequent to the devaluation of the Argentinean Peso in December 2001, a measure described by the Argentine Government as a public economic emergency – See further below. An OECD Study has observed that: "There is a legitimate concern that multiple cases brought against a single country, based on a single measure, could be a major source of inconsistent Awards." Improving the System of Investor – State Dispute Settlement – An Overview – A Background Information Document prepared by the OECD Secretariat – sub para n (1).

the arbitration clause. A contrary approach to liberally expand international arbitration jurisdiction could lead to a cautious approach by developing host States with regard to the scope of arbitration clauses in the new types of investment agreements, given the uncertain legal terrain they would be venturing into.[7]

III. Indirect Expropriation and the Right to Regulate through Governmental Regulatory Measures

The second issue, which is of critical concern to host countries, is the legal demarcation between the right to regulate in the interest of public welfare and the concept of indirect expropriation. Recent arbitral decisions, particularly those rendered under NAFTA, has given rise to a growing concern on the part of host States, that the concept of indirect expropriation may become applicable to regulatory measures adopted by a government, aimed at protecting the environment, health and other welfare interests and society. Commentators on International Investment Law point out that while disputes on direct expropriation arising out of measures of nationalisation marked the investment related litigation of the 1970s and 1980s, the definition of "indirect expropriation" is likely to become a dominant issue in contemporary international investment law.

The new US model BIT as well as Free Trade Agreements concluded by the US[8] provide explicit criteria to determine indirect expropriation. The Annexures on Expropriation, in the US Model stipulate that:

> "The determination of whether an action or series of actions by a Party, in a specific fact situation, constitutes an indirect expropriation, requires a case-by-case, fact-based inquiry that considers, among other factors:
> (i) the economic impact of the government action, although the fact that an action or series of actions by a Party has an adverse effect on the economic value of an investment, standing alone, does not establish that an indirect expropriation has occurred;

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7 See further, Robert N. Hornick, "The Mihaly Arbitration – Pre-Investment Expenditure as a basis for ICSID Jurisdiction" *Journal of International Arbitration*, vol. 20, no. 2, April 2003. Also, Arbitration under the ICSID Convention: Claims by Unsuccessful Tenderers for Public Works Contracts as "Investment Disputes" Paper prepared for the Commonwealth Secretariat by Thomas Roe: LM SCJ (04) 8.

8 See for eg: US-Free Trade Agreements with Australia (1 March 2004) Chile (6 June 2003) Central America (28 January 2004) Morocco (15 June 2004) and Singapore (6 May 2003).

(ii) the extent to which the government action interferes with distinct, reasonable, investment-backed expectations; and
(iii) the character of the government action."

In addition, the US model also addresses the issue of indirect expropriation and the right to regulate:-

> "Except in rare circumstances, non-discriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety and the environment, do not constitute indirect expropriations. "[9]

Providing an explicit criterion to define 'indirect expropriation' is widely seen as a response to the unsettled jurisprudence emerging in this field. The group of cases arising out of NAFTA that have addressed the regulatory expropriation issue accorded primacy on the effect of a measure on an investment as the relevant factor, in determining whether a taking or expropriation had occurred and ruled that the purpose of the measure was not a relevant concern. Thus in the Metaclad case**,** Metaclad Corporation alleged that its operation of a hazardous waste land fill was affected by an ecological Decree of the Government of Mexico, giving rise to a duty to compensate by Mexico, on the basis of an "indirect expropriation". The Tribunal found that the Decree violated Article 1110 of NAFTA and stated that in order to determine an indirect expropriation, the Tribunal 'need not decide or consider the motivation nor intent of the adoption of the ecological decree'. The Tribunal further stated:

> "Expropriation under NAFTA includes not only open, deliberate and acknowledged takings of property, such as outright seizure or formal or obligatory transfer of title in favour of the host State, but also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use of reasonably to be expected economic benefit of property, even if not necessarily to the obvious benefit of the host State."[10]

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9 For Text, see, "Indirect Expropriation" and the Right to Regulate in International Investment Law" Document prepared by Investment Division, Directorate for Financial and Enterprise Affairs, OECD, (September 2004), p. 21.

10 See Metalclad Corp. Vs. Mexico (Award of Aug. 30, 2000) Also in S D Myers Vs. Canada Case, the analysis turned primarily on the effect of a regulatory measure on a foreign investor and not the purpose of the measure (Award of Nov. 13, 2000) *International Legal Materials,* p. 408.

Thus, the purpose of the measure was not considered to be a relevant concern, its effect being the relevant factor.

Similarly, in the Tecmed case, in the ICSID arbitration, the Arbitral Tribunal stated:

> "Under International Law, the owner is also deprived of property where the use or enforcement of benefits related thereto is exacted or interfered with to a similar extent, even where legal ownership over the assets in question is not affected, and so long as the deprivation is not temporary. The government's intention is less important than the effects of the measure (ie. the economic value of the use, enjoyment or disposition of the assets or the rights affected by the administrative action or decision have been destroyed or neutralized) on the owner of the assets or on the benefits arising from such assets affected by the measures; and the form of the deprivation measures is less important than its actual effects."[11]

On the other hand, the unsettled nature of the emerging jurisprudence in this area is reflected in the NAFTA arbitration of *Feldman Vs. Mexico*, where the Tribunal noted that:

> "Governments must be free to act in the broader public interest through protection of the environment, new or modified tax regimes, the granting or withdrawal of government subsidies, reduction or increases in tariff levels, imposition of zoning restrictions and the like. Reasonable government regulations of this type cannot be achieved, if any business that is adversely affected, may seek compensation and it is safe to say that customary international law recognizes this."[12]

These developments underline the dilemma that the Tribunals confront in drawing the legal demarcation between different forms of indirect expropriation and the policy space of governments to act in the public interest.

The question then arises as to whether in responding to the legal uncertainty arising out of the jurisprudence in this field, the attempts to provide explicit criteria on the lines of the US model, points towards a

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11 *TECMED Vs. Mexico* (ICSID Case No. ARB (AF)/00/2 – Award of 29 May 2003).

12 Final Award of 16 December 2002.

solution to the issue, by way of greater legal stability in defining "indirect expropriation".

An area of particular concern for host States would be criteria (ii) above in the US model, which provides as a relevant factor, the extent to which the governmental action interferes with "distinct, reasonable, investment backed expectations". There is considerable debate, for example, as to whether an investor's expectations should be measured at the time the investment was made and whether the investors should reasonably expect governmental regulatory measures to change with time, as circumstances demand.[13] Some commentators have argued that in certain situations, "policies in force earlier might have created legitimate expectations, both of a procedural and substantial nature, [14] while others prefer a more restrictive approach as in the Methanex Arbitration, to determine " reasonable investment-based expectations" namely : "Specific Commitments …… given by the regulating government to the then putative foreign investor contemplating investment that the government would refrain from such regulations."[15]

What clearly emerges from these differing approaches is the complexity of applying the "reasonable investment backed expectations" criteria as a general yardstick. In the final analysis, "reasonable investment backed expectations" would need to be applied taking into account the specificities of a given situation, and the policy demands of a host State in a changing economic environment.

The use of the term "except in rare circumstances" in the proviso, introduces a further area of ambiguity from a host government's point of view, since this would mean that even non-discriminatory regulatory action on the part of a host State to protect legitimate public welfare activities could

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13 Report of the Advisory Committee on International Economic Policy regarding the Model US Bilateral Investment Treaty presented to the Department of State (February 2004).

14 Francisco Orrego Vicuna, Regulatory Authority and Legitimate Expectations: Balancing the Rights of the State and the Individual under International Law in a Global Society", *International Law Forum*, Vol. 5, no.3 (2003), p. 188.

15 See Jan Paulsson, President, London Court of International Arbitration, *"Indirect Expropriation: Is the Right to Regulate at Risk?"* Paper presented at Symposium Organized by ICSID, OECD and UNCTAD – Making the Most of International Investment Agreements. 12th December 2005 (Paris) Citing *Methanex Corpn. Vs. United States of America* Award of 5 August 2005.

be interpreted by an Arbitral Tribunal as tantamount to indirect expropriation, giving rise to compensation, in a given situation.

The legal uncertainties surrounding the issue of "reasonable investment-backed expectations" and the use of the term "in rare circumstances" in the proviso, together with the increasing tendency in NAFTA related jurisprudence to give predominant effect to the impact of a measure on an investment, irrespective of purpose, collectively pose substantial legal challenges to host countries through a gradual restriction of the policy space of the State to take regulatory measures in the public interest. What clearly emerges from the growing jurisprudence and treaty practice is that this area of law is still evolving and at an early stage of development. Some commentators have advocated the use of criteria such as the bona-fide character of a regulatory measure and the observance of due process with regard to such measures as elements which would inject some element of objectivity to the applicable criteria and element stability to the growing tension between indirect expropriation and government regulatory measures.

Thus, Jan Paulsson argues: "To escape liability under international law the relevant regulation must be legitimate and bona-fide; it will fail that test if the stated objective is shown to be false as in S.D. Myers, when a Canadian restriction was revealed not to be motivated by environmental concerns, but rather a stratagem to protect national business interests. Regulatory acts must be consistent with due process. An inquiry into the public benefit would violate due process, if it is perfunctory, one – sided or otherwise skewed against the investor. "[16]

Similarly, in the *Feldman vs. Mexico Case*, the Tribunal adopted the non-discriminatory and bona-fide character of a measure as the dividing line between indirect expropriation and lawful regulatory measures.[17]

Recent studies by UNCTAD have identified the uncertainty over the scope and content of the expropriation obligations in their application to regulatory measures by a host Government as an issue of vital concern for host States. Crystallisation of legal criteria to harmonize the tension between indirect expropriation and the government regulatory measures must await the outcome of evolving State practice in the context of negotiating new

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16 Ibid. n. 15.

17 Ibid.n. 12.

generation BITs, FTAs and EIAs as well as related arbitral jurisprudence. This call for constant vigilance on the part of host States in dealing with these complex and challenging issues in the new negotiating environment.