Investment treaties and sustainable development: investment protection

Over 3,000 international investment treaties (IITs) are in force, and more are being negotiated. The signing and wording of these treaties drives important trade-offs between policy goals. Seemingly straightforward treaty provisions intended to reassure foreign investors that they will not be treated unfairly can have far-reaching implications for states’ ability to pursue other policy goals. As these trade-offs become clearer, some states are reconsidering their approach to IITs, and there is growing experience with ways to balance protecting investment with preserving policy space. All countries considering negotiating investment treaties need to ensure proper reflection and public debate on such policy choices. This briefing is the third in a series of four promoting debate on IITs and sustainable development.

An international investment treaty (IIT) aims to encourage businesses from one state to invest in the other state(s). The main way IITs promote such foreign investment flows is through ‘investment protection’ that guards against adverse action from the host state.

The argument runs as follows. Many states strive to attract foreign investment. But once an investment is made — for example a processing plant or oil pipeline is constructed — the investor becomes vulnerable to measures by the host state that undermine the project or its profitability. Investment protection is designed to mitigate this ‘political’ risk and reassure investors that they will not be treated unfairly, so creating incentives for companies to invest.

In practice, empirical evidence that investment protection promotes investment flows is mixed (for a discussion, see our related overview briefing). And unless appropriately framed, investment protection can expose states to compensation claims for losses suffered because of a wide range of public policy measures, and thereby restrict policy space (again, see the overview briefing).

Therefore, choices about whether or not to sign an IIT, and about the wording of such a treaty, require careful consideration and debate.

Standards of investment protection

Many treaties present broadly comparable terms, yet the wording can vary considerably, and so too can the protection to which investors are entitled. Commonly used standards of investment protection include:
It is important that governments fully appreciate the real costs and benefits of IITs

- ‘National treatment’ and ‘most-favoured-nation’ clauses typically require the host state to treat foreign investors or investments no less favourably than investments in similar circumstances by its own nationals (national treatment) or by nationals of other states (most-favoured-nation treatment).
- ‘Fair and equitable treatment’ clauses require the host state to treat foreign investment according to a minimum standard of fairness, irrespective of the rules it applies to domestic investment under its national law.
- ‘Full protection and security’ clauses are usually interpreted as requiring the host state to take steps to protect foreign investment from harm caused by third parties.
- Clauses that limit a government’s ability to expropriate foreign investments often state that any expropriation must be for a public purpose, be non-discriminatory, and that governments must follow due process and pay compensation according to specified standards.
- ‘Umbrella’ clauses require the host state to honour commitments it may have entered into, for example through contracts.
- Provisions on currency convertibility and profit repatriation allow investors to repatriate returns from their activities.

National treatment and most-favoured-nation provisions are ‘relative’ standards; they require the state not to discriminate against protected foreign investors and investments. For example, most-favoured-nation clauses can allow investors to claim more favourable treatment provided by other treaties — treaties between the host state and states other than the country where investors are based.

In contrast to national treatment and most-favoured-nation provisions, the other standards of investment protection are ‘absolute’: they establish minimum standards applicable to covered foreign investment irrespective of the treatment applicable to other investments.

Because standards of investment protection are often formulated in vague terms, a treaty’s implications may only be fully understood by considering how arbitral tribunals have interpreted and applied similar clauses when settling disputes (see the related briefing on investor-state arbitration). Arbitral tribunals are not bound to follow earlier awards, but in practice they do often refer to earlier awards in order to strengthen the authority of their own reasoning.

An example: fair and equitable treatment

A discussion of ‘fair and equitable treatment’ (FET) can help illustrate how investment protection standards operate, and how they can affect policy space. FET is the standard investors use most often to bring claims against states. Few would openly disagree with the notion that investors should be treated fairly. But establishing what is ‘fair’ or ‘equitable’ is not always straightforward. This leaves significant discretion to arbitral tribunals on how to interpret and apply this standard.

Arbitral tribunals consider respect for the ‘legitimate expectations’ that the investor had when making the investment a central requirement of FET. Some tribunals have held that FET requires consistency and transparency of government conduct. Some have also held that a stable regulatory framework is an ‘essential element’ of FET. An example is found in arbitrations brought under the US-Argentina investment treaty, the preamble of which refers to regulatory stability.

It is true that other tribunals have placed greater emphasis on the right of governments to regulate, and clarified that no investor may reasonably expect that applicable law will remain totally unchanged. But regulatory changes that violate ‘representations’ made to the investor which were capable of creating ‘legitimate expectations’ can expose the state to claims. So depending on how a state acts, changes in government conduct or in applicable rules may be deemed to have breached FET. This has led to numerous investor claims challenging a wide range of measures that pursued a public interest but adversely affected investments, including measures to improve the host country’s participation in the economic benefits generated by foreign investment; to protect the environment; to address historical injustices; or to protect public health (Box 1).

In other words, the implications of investment protection provisions can be far-reaching, and not limited to ‘investment policy’ alone. Additionally, court action by citizens against an investor, over which the government may have little control, can also expose a state to arbitration.

States can still adopt new policy measures but they may have to pay steep compensation bills if...
they wish to regulate in violation of a treaty obligation. Even if companies lose a case, the host governments may still face costly legal bills. Low-income countries may find it particularly difficult to pay large amounts in compensation, and may opt not to take public-interest measures if these would expose them to investor claims.

In addition, low-income countries may be exposed to investor claims because their governments or judiciaries may lack the capacity to meet the prescribed standards of protection. For example, one arbitral tribunal held that FET requires a government ‘to act in a consistent manner, free from ambiguity and totally transparent in its relations with the foreign investor’. This is an exacting requirement for many low-income country governments, particularly in complex investments that involve multiple (and often not well coordinated) government agencies, and approval processes spread over protracted periods.

**Shifts in treaty practice to protect policy space**

In response to concerns that the ways in which arbitral tribunals have interpreted FET and other investment protection standards may erode policy space beyond what governments intended to accept, some states have reconsidered their approaches.

These states are now seeking to balance investment protection with preserving policy space for the government to act in the public interest. These states include high-income countries such as the United States and Canada, which have seen their own public action challenged by foreign investors relying on generous investment protection regimes. They also include some low and middle-income countries that have become more vocal in IIT matters.

Not all countries have shifted approaches, however, and many continue to sign IITs featuring vague and unqualified standards of protection. Again using FET to illustrate, three developments exemplify more careful approaches to treaty drafting:

**Linking FET to customary international law.** The new model IITs developed by Canada and by the United States clarify that FET does not go beyond the international minimum standard of treatment already required by customary international law.

Customary international law is binding on states even if they have not signed a treaty (see the related overview briefing). It prescribes a minimum standard of fairness, but this is typically interpreted as only prohibiting egregious instances of arbitrary treatment. So equating FET to the customary standard should restrict the scope of investment protection, and preserve greater space for national policy.

Some recent awards, however, have suggested that the customary standard is itself evolving to be broader, and have adopted wider interpretations of that standard. In other words, there are no precise definitions of the international minimum standard of treatment required under customary law. So the extent to which more restrictive treaty formulations can help remains to be seen.

**More specific obligations.** The second example involves framing a standard around much more specific obligations, with or without reference to ‘fair and equitable treatment’. This may include an obligation not to deny justice in judicial or administrative proceedings, or not to subject the investor to unjustified harassment. For example, the Model Investment Treaty developed by the Southern African Development Community (SADC) features a standard of ‘fair administrative treatment’.

This standard commits states parties to “ensure that their administrative, legislative, and judicial processes do not operate in a manner that is arbitrary or that denies administrative and procedural [justice][due process] to investors of the other State Party or their investments…”. This more specific language is designed to safeguard foreign investment without exposing states to liabilities that are difficult to foresee.

**Level of development.** A third example requires tribunals to consider a country’s level of development when applying FET. For example, the FET clause of the Investment Agreement developed by the Common Market for Eastern and Southern Africa (COMESA) includes the following text:

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**Box 1. Restrictions on policy space: cigarette marketing legislation in Australia and Uruguay**

In 2010 and 2011, a global tobacco company filed arbitrations to challenge legislation aimed at discouraging smoking in Uruguay and Australia, respectively. The company argued that the measures violated the FET clause included in applicable IITs, and sought compensation.

In 2013, the government of New Zealand reportedly announced that it would wait to see the outcome of the arbitration against Australia before enacting similar anti-smoking legislation in New Zealand. The draft legislation was discussed by parliament in February 2014.
Notes


Conclusion

There is growing experience in formulating treaties to balance protecting investment with preserving policy space, and this experience can be drawn upon and further developed. This experience favours more specific wording over vague standards. Also, there is growing international guidance on multiple options for formulating investment protection standards. This guidance has been developed by the United Nations as well as think tanks and academics.16

When deciding whether to conclude an IIT, and how one should be worded, it is important that governments fully appreciate the real costs and benefits, including the far-reaching implications that investment protection commitments can have for public action aiming to support sustainable development.

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This briefing is part of a set of four aimed at promoting debate on investment treaties and sustainable development. Other briefings in the set cover the following topics:

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