International Institute for Environment and Development

Strengthening Citizens' Oversight of Foreign Investment: Investment Law and Sustainable Development

SUSTAINABLE MARKETS INVESTMENT BRIEFINGS

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BRIEFING 2:

Investment treaties

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This is the second of a series of briefings which discuss the sustainable development issues raised by legal arrangements for the protection of foreign investment. The briefings are based on legal research by IIED and its partners.[2] The goal is to provide accessible but accurate information for human rights, development and environmental organisations working on issues raised by foreign investment in low- and middle-income countries.

Briefing 2 explains how investment treaties between states work to protect and promote foreign investment.

What is an investment treaty?

Bilateral investment treaties (BITs) are agreements between two states aimed at promoting investment flows between them. They pursue this goal by establishing international obligations concerning the entry and/or treatment of investment by nationals of one state in the territory of the other state. In so doing, they may take the protection of foreign investment beyond the requirements of general international law (stemming for instance from customary international law or the general principles of law; see Briefing 1, Box 1.2). Bilateral investment treaties are often negotiated on the basis of "model BITs" developed by capital-exporting countries and promoted by them as templates for agreement.

Recently, provisions on investment protection have also been included in broader agreements for the promotion of international trade, such as the North American Free Trade Agreement (NAFTA) and a range of economic partnership agreements, as well as in multilateral sectoral treaties, such as the 1994 Energy Charter Treaty. Investment-related provisions are also included in treaties relating to the World Trade Organisation (WTO), particularly the General Agreement on Trade in Services (GATS) and the Agreement on Trade-Related Investment Measures (TRIMs). The GATS and the TRIMs are binding for the 150 states that have joined the WTO, and are enforced through an effective inter-state dispute settlement system at international level.

Provisions on the treatment of foreign investment

Investment treaties mainly concern the treatment of foreign investment after its entry into the host state. As investment treaties aim to promote investment flows, they tend to focus on providing safeguards for foreign investment vis-à-vis the host state. They pay much less attention to the obligations that foreign investors must comply with in the exercise of their activities, particularly in relation to human rights and environmental standards.

So-called "treatment" provisions typically include:

- The "national treatment" and "most-favoured-nation" principles, whereby the host state must apply to foreign investors a treatment no less favourable than that applied to its own nationals (national treatment) and/or to nationals of other states (most-favoured-nation).
- "Fair and equitable treatment", whereby the host state must treat foreign investment according to a minimum standard of fairness, irrespective of the standards it applies to domestic investment under its national law.
- "Full protection and security", whereby the host state must take steps to protect foreign investment from damage caused by third parties (e.g., armed militias in the arbitral award *Asian Agricultural Products*[3]).
- Provisions on currency convertibility, profit repatriation and related aspects, which allow investors to repatriate returns from their activities in the host state.

Investment treaties may also regulate "performance" or "local content" requirements. These link admission of foreign investment to targets or other kinds of commitments to promote use of local businesses, domestically-produced products, or the local workforce. Although BITs usually do not prohibit these requirements, some recent treaties do

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restrict their use (e.g. several recent US treaties). In WTO Member States, requirements concerning use of domestic products are prohibited by the TRIMs Agreement.

These diverse provisions are important to reassure foreign investors that they will be able to reap the benefits of their investment, although evidence on the extent to which investment decisions are influenced by investment treaties is mixed. For instance, while Salacuse and Sullivan (2005) find that investment treaties promote investment flows, Perry (2002) finds little empirical evidence to support this conclusion. In addition, some of these provisions may hinder the ability of host states to pursue sustainable development goals. Three examples demonstrate this.

1. Although local content requirements can limit the economic efficiency and profitability of an investment, they may also promote local development through strengthening the linkages between foreign investment and the local economy (UNHCHR, 2003). For instance, performance requirements were used extensively by South Korea and Taiwan, and played an important role in the economic development of these countries.

2. National treatment requirements may make it more difficult for host states to take affirmative action favouring disadvantaged groups. For instance, South Africa's National Water Act 1998 provides favourable treatment in water allocation for those who suffered from apartheid-era racial discrimination. This may result in differences of treatment between disadvantaged nationals and foreign investors, and thus run counter to national treatment obligations – unless specific exceptions to such obligations are negotiated and included in the treaty (UNHCHR, 2003).

3. "Fair and equitable treatment" provisions have been relied on by investors to claim standards of protection beyond the minimum treatment required under general international law. The latter is itself controversial, and is thought only to cover extreme cases of arbitrary treatment (*Neer v Mexico*). Broadening "fair and equitable treatment" beyond this minimum standard can unduly restrict the host state's room for manoeuvre in regulating foreign investment in its territory – particularly because the rather vague wording of this standard (what is "fair" treatment?) may enable investors to claim violations for a broad range of host state measures.

The "fair and equitable treatment" standard has sparked considerable debate within NAFTA, where arbitrators found that environmental measures adopted by host states in the absence of minimum transparency requirements violated the fair and equitable treatment standard included in the NAFTA treaty (*Metalclad v Mexico*). In 2001, the NAFTA Free Trade Commission issued a "Note of Interpretation" clarifying that "fair and equitable treatment" under NAFTA does not require treatment *beyond* the minimum standard of treatment already required by international law. Recent NAFTA arbitrations have adopted a narrower interpretation of "fair and equitable treatment" (e.g. in the *S.D. Myers* and *Methanex* awards). However, broader interpretations of "fair and equitable treatment" as requiring states to ensure "stability and predictability of the investment environment" have been followed outside NAFTA – for instance, in *CMS Gas Transmission*.

Despite recent developments within NAFTA, continued civil society vigilance is needed to make sure that "fair and equitable treatment" does not become a catch-all basis for investors to challenge the legality of host state measures that negatively affect their interests.

Expropriation, stabilisation and arbitration

Aside from generating direct tensions with policy for sustainable development, investment treaty provisions can also have the effect of exacerbating tensions that are generated elsewhere – in general international law, in contractual arrangements between foreign investors and host states, or in other legal instruments. These problems are briefly outlined here and are tackled in more detail in Briefings 3, 4 and 5.

Investment treaties usually include provisions setting conditions for the expropriation (or "taking") of the investor's property rights – essentially, action by the host state that deprives the investor of the ownership, control and/or economic benefit of the investment. Typically, host states can only expropriate investors' assets in a non-discriminatory way (i.e. not discriminating between foreign and domestic investors, or between foreign investors), in pursuit of a public purpose, observing procedural safeguards ("due process"), and in any case only if accompanied by payment of compensation based on specified standards.

The pursuit of goals like the realisation of human rights or environmental protection constitutes a "public purpose" for expropriation. In *Sawhoyamaxa Indigenous Community v Paraguay*, the Inter-American Court of Human Rights found that the restitution of ancestral lands to indigenous communities that had been unwillingly deprived of those lands constituted a public purpose under the expropriation provision of the Germany-Paraguay BIT. In that case, land restitution entailed the taking of land interests protected under the BIT; and the expropriation clause in the BIT was used by Paraguay as a justification to resist restitution. The Court clarified that the enforcement of investment treaties "should always be compatible with the American Convention [on Human Rights]", which generates rights for individuals that cannot be sold off by states (para. 140).

A particularly problematic area relates to the broad definition of expropriation usually embodied in investment treaties. This commonly encompasses "regulatory taking" – regulation that negatively affects an investment project to such an extent that it must be deemed to have been expropriated. Broad definitions of "taking", coupled with tight conditions for its legality (especially with regard to payment of compensation), may undermine the ability of host states to enact new regulation in pursuit of sustainable development goals – namely, where this regulation affects the value of ongoing investment projects and thus triggers the obligation to pay compensation. These issues are discussed in Briefing 3.

Host states may agree to provisions that further strengthen the protection of foreign investment through clauses embodied in foreign investment contracts – the agreements concluded between host states and foreign investors. These may commit the host state not to change the regulatory framework governing the investment project in a way that negatively affects the project ("stabilisation clauses" – see Briefing 4). Bilateral investment treaties can reinforce the legal value of these clauses – providing double protection to foreign investors.

For example, states that are parties to an investment treaty may commit themselves to honour contractual undertakings vis-à-vis nationals of the other state (see e.g. Article 10 of the Energy Charter Treaty). This kind of commitment is called an "umbrella clause", because it provides a general "umbrella" for violations of *contractual* commitments (e.g. stabilisation clauses) to become a breach of the investment *treaty* – not just of the investment contract (*CMS Gas Transmissions v Argentina*). However, for this to happen, the wording of the investment treaty must be specific enough (*Salini v Jordan*).

Since they reinforce the legal value of stabilisation clauses, umbrella clauses may further tighten the constraints on regulation stemming from those clauses. These issues are discussed in Briefing 4.

Investment treaties commonly include provisions on international arbitration. On the basis of these provisions, disputes between a state party and an investor national of the other state are settled by international arbitration rather than by the domestic courts of the host state (as would be the case otherwise). This raises significant issues in terms of transparency and accountability, and of balancing commercial and non-commercial needs – issues that are tackled in Briefing 5.

With specific regard to arbitration clauses embodied in investment treaties, there have been reports of distortions such as "treaty-shopping": investors whose home state has not signed an investment treaty with the host state elect a home state of convenience in order to bring arbitration proceedings (Peterson and Gray, 2003). The loose requirements on the investor's nationality used in most investment treaties (which usually refer to the state of incorporation) enable investors to identify a home state of convenience with relative ease even if they have little real connection with that state.

Eroding host states' control over incoming investment

Investment treaties mainly concern the treatment of foreign investment after its entry (i.e. admission) into the territory of the host state. They tend not to place any obligation on the home state to facilitate investment abroad (e.g. through insurance schemes and tax breaks); nor any obligation on the host state to admit foreign investment into its territory. This means that the host state retains control over the entry of foreign investment into its territory – although the treaty may call on state parties to regulate in "favourable" terms the entry of investment from the other state party.

However, some BITs (particularly those based on the US model BIT) go beyond this, and regulate entry and treatment in the same way. In these cases, the principles that usually regulate only treatment (such as "national treatment" and "most-favoured-nation" – see above) apply also to entry. The effect is to limit the host state's control over investment inflows. In addition, in WTO Members, the General Agreement on Trade in Services has important implications for the entry of foreign investment in the service sector. Among other things, it requires states not to discriminate against foreign service providers in the establishment of branch offices within their territory – though this only applies to the service sectors for which each state has agreed to be bound.

"Entry" provisions erode the host state's control over the admission of foreign investment into its territory. They may affect the capacity of the host state to prioritise certain investments over others, and undermine its negotiating power vis-à-vis incoming investors, which in turn is key to negotiating terms and conditions that maximise the investment's contribution to sustainable development.

Towards a rethink of investment treaties?

The issues discussed in this briefing highlight the need for a rethink of investment treaties, in order better to integrate sustainable development concerns. In recent years, there has been growing momentum towards just that. For instance, the International Institute for Sustainable Development (IISD) has recently developed a "Model International Agreement on Investment for Sustainable Development" (Mann et al, 2005), which is designed to provide the basis for investment treaty negotiations at bilateral, regional or international level. The Model Agreement explicitly links promotion of foreign investment to pursuit of sustainable development. It also addresses some of the issues raised in this briefing – including through provisions explicitly limiting "fair and equitable treatment" to the "minimum treatment" required under international law; through allowing local content requirements; through addressing "treaty-shopping" problems; and through provisions that balance investors' rights with duties and responsibilities on environmental and social impact assessment, anti-corruption, and respect for international human rights and labour standards. ●

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2 Particularly through "Lifting the lid on foreign investment contracts", coordinated by IIED; and "Global project finance, human rights and sustainable development", coordinated by the University of Essex in partnership with IIED. The briefings are specifically based on: Lorenzo Cotula, 2007, "The legal arrangements underpinning project finance: Tensions between the international protection of foreign investors' property rights and evolution in human rights and environmental standards", London, IIED, unpublished report; and Lorenzo Cotula, forthcoming, "Stabilisation clauses and evolution of environmental standards in foreign investment contracts", *Yearbook of International Environmental Law*.

The briefings also draw on Dominic Ayine, Hernán Blanco, Lorenzo Cotula, Moussa Djiré, Candy Gonzalez, Nii Ashie Kotey, Shaheen Rafi Khan, Bernardo Reyes and Halina Ward, 2005, "Lifting the Lid on Foreign Investment Contracts: The Real Deal for Sustainable Development", London, IIED, Sustainable Markets Group Briefing Paper.

3 On the nature and value of arbitral awards, see Briefing 5.

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