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The Convergence of China's Foreign and Domestic Investment Regimes and China's Investment Treaty Commitments

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The Convergence of China’s Foreign and Domestic Investment Regimes and China’s Investment Treaty Commitments

Seung Chong & C.L. Lim

The Ministry of Commerce of the People’s Republic of China has issued a Draft Foreign Investment Law that proposes to cause the convergence of the PRC’s foreign and domestic investment regimes. That convergence in its current form will result in existing rights of foreign investors being extinguished or compromised. We discuss the loss of such rights in the light of the types of investors’ remedies that are currently provided for under China’s Bilateral Investment Treaties. In doing so, we show how the issues raised by the newly proposed investment regime can be framed as claims under the various standards of PRC treaty protection and the particular complexities that arise for consideration. This article is an assessment of the propensity and prospect of future arbitration claims concerning a complex draft law that, whether legislated in its current or in an amended form, will have significant commercial and economic implications. This matter is probably the single most important issue today in China corporate practice and we believe it has a strong investment law and arbitration dimension that demands to be explored and explained.

1 INTRODUCTION

On January 19, 2015, the Ministry of Commerce of the People’s Republic of China released a draft “Foreign Investment Law” for public comment. The draft Foreign Investment Law is at once an ambitious as well as a workman-like overhaul of the PRC’s foreign investment regime. This article focuses on a specific provision of the Draft Law which, while seemingly limited, has a profound effect on the current foreign investment regime in China and raises a potentially important issue under China’s bilateral investment treaty commitments.

The article discusses the current foreign investment regime, some of the proposals detailed in the Draft Law, and their impact on the current regime and on

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the rights of investors, before turning to the impact of the Draft Law on China’s investment treaty obligations.

2 IMPACT OF THE DRAFT LAW

2.1 CHINA’S FOREIGN INVESTMENT REGIME AND ITS HISTORICAL DEVELOPMENT

China’s modern engagement with foreign investment began with her Open Door Policy made known in December 1978 at the historic Third Plenary Session of the Eleventh Central Committee of the Communist Party of China. The communiqué of the Third Plenum asserted that the PRC would be “actively expanding economic cooperation on terms of equality and mutual benefit with other countries.”¹ The Open Door Policy was made flesh a little over half a year later when the National People’s Congress promulgated the Equity Joint Venture Law.²

The Equity Joint Venture Law permitted a foreign investor to invest, together with a PRC investor, in a domestic PRC legal entity with separate legal personality for the first time. Hitherto, interaction with foreign counter-parties had been on an arm’s length basis. With the Equity Joint Venture Law, we now had a commingling of funds and a co-destination of risk and reward in a common enterprise. Of course, a foreign investor was not free to invest at will and was still subject to foreign investment restrictions and limitations, but it was a momentous step.

The Equity Joint Venture Law was subsequently followed by the Contractual Joint Venture Law.³ The Contractual Joint Venture Law was similar, but it admitted three different possibilities. First, it allowed Chinese-foreign cooperation without the formation of a separate legal vehicle and thus approximated to a partnership. This structure was suited for offshore petroleum exploration consortia. Secondly, unlike the equity joint venture format, a contractual joint venture allowed a foreign investor and a PRC investor to share profits and to bear losses in a proportion that was different from their equity holdings in the joint venture company. So, for example, a foreign retailer could enter into a 50:50 contractual joint venture with a PRC retailer where the PRC retailer could be distributed a profit reflecting a fixed rent for the use of its retail premises and a variable amount based on turnover. The aggregate of both these elements might be less than 50% of the overall profits, but the PRC party might have priority in payment. Thirdly, it also allowed, when profits were distributed, the foreign investor to recover its

² Law on Chinese-Foreign Equity Joint Ventures of the People’s Republic of China 1979 (as amended).
investment ahead of its PRC partner, provided the ownership of the fixed assets of the contractual joint venture would vest in the PRC partner without the need for compensation on the expiry of the joint venture term. This effectively gave the parties the means to structure a transaction with the equivalent of a preferred dividend to one of the investors. So, for example, in a sector where the foreign investor had made a significant contribution of equipment (e.g., mobile telephony base stations, transmitters, and towers), it could recover its capital investment and a preferential dividend ahead of the PRC partner. In return, at the end of the operating life of the venture, the fixed assets comprising all the hardware would belong to the PRC partner.

The Contractual Joint Venture Law was in turn followed by the Wholly Foreign-Owned Enterprise Law. The Wholly Foreign-Owned Enterprise Law was a landmark piece of legislation because it allowed a foreign investor to own and manage its operations in the PRC by itself. For the purpose of this article, we will focus on the equity joint venture and the contractual joint venture in order to illustrate the issues that we wish to discuss.

In the meantime, on the domestic legal front, the National People’s Congress promulgated the Company Law in 1995. Under the PRC Company Law, two corporate forms were created: the limited liability company and the company limited by shares. Here, we began to see some convergence between the foreign investment regime and the domestic regime. As the equity joint venture company, contractual joint venture, and the wholly foreign-owned enterprise do not have a share capital, they are considered to be limited liability companies. Consequently, that part of the PRC Company Law applicable to limited liability companies applies also to the equity joint venture company, contractual joint venture, and the wholly foreign-owned enterprise to the extent that their respective sui generis laws do not speak to a particular issue. In practice, however, because these sui generis laws and their associated legislation were quite extensive and developed, the PRC Company Law did not impact these entities in a meaningful way.

2.2 Illustrative Features of the Equity Joint Venture and Contractual Joint Venture

The jurisprudential basis of the equity joint venture and contractual joint venture stems from their own sui generis law. In order to invest in the PRC, a foreign investor selects which “gateway” legal vehicle to use and the legal regime applicable to that vehicle is codified in the relevant law and its corresponding implementing regulations. These sui generis corporate forms have certain key

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features, some of which are common to both the equity joint venture and the contractual joint venture. In this section, we discuss some of these key features. In the following section, we discuss how the Draft Law would affect these features.

2.2[a] Amount of Permitted Debt Determined by Ratio between Total Amount of Investment and Registered Capital

Equity joint ventures and contractual joint ventures do not have a share capital. They have a registered capital that is not divided into shares. Registered capital is essentially equity and, when it is fully contributed, it is paid-up capital. They also have a concept of total amount of investment. The total amount of investment of a joint venture company comprises the aggregate of the amount of registered capital and permitted debt. The amount of permitted debt is calculated by reference to the amount of registered capital using pre-determined debt-to-equity or “thin capitalization” rules. The joint venture is not permitted to borrow debt in excess of what is permitted.\(^5\)

In contrast, neither a limited liability company nor a company limited by shares under the PRC Company Law have a concept of total amount of investment and therefore do not have a statutory cap on indebtedness. A limited liability company has registered capital and a company limited by shares has share capital.

2.2[b] Transfer of Equity Interest Requires Agreement of All Investors

Where a foreign investor in an equity or contractual joint venture wishes to transfer any part of its registered capital to another party, whether or not the proposed transferee is an existing investor, the transferor must obtain the agreement of all the other investors. This is a very powerful right of the other investors because no investor can transfer its equity unless it obtains the consent of all its co-investors. It is effectively an absolute veto right.\(^6\)

In the case of a limited liability company under the PRC Company Law, a transfer of equity to an existing investor does not require the consent of any of the investors. A transfer of equity to a person other than an existing investor requires the approval of more than half of all the investors.\(^7\)

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\(^5\) Exceptions can be made for Renminbi debt and short-term foreign currency loans.


\(^7\) *Ibid.* at para. II-1.5.05; PRC Company Law, Art. 72.
As we will discuss further below, this disparity of treatment between the local and foreign investor is removed in the Draft Law which, if passed, will also result in the removal of an existing foreign investor’s right.

2.2[c]  **Board of Directors Is the Highest Decision-Making Body**

Because equity joint ventures and contractual joint ventures do not have share capital, they do not have shareholders as such but rather investors who own a proportion of the registered capital. It follows from this that there is no shareholders’ meeting. The highest decision-making body is the board of directors whose directors are appointed by the investors. In contrast, in the case of a limited liability company under the PRC Company Law, the highest decision-making body is the shareholders’ meeting.

2.2[d]  **Preferred Dividend and Early Recovery of Investment Permitted in a Contractual Joint Venture**

As we have mentioned, a contractual joint venture allows the parties to share profits and bear losses in a proportion that is different to their share of registered capital. This allows an investor to obtain a preferential dividend or to recover its investment ahead of other investors. In the case of a limited liability company under the PRC Company Law, there are no means to create a structure that can accommodate such a preferential dividend or early recovery of investment.

2.2[e]  **Unanimous Board Approval Required for Certain Key Corporate Actions**

In the case of an equity joint venture, unanimous board approval is required for the following key corporate actions: amendment of the articles of association; termination and dissolution of the joint venture company; increase or reduction of registered capital; and merger or division of the joint venture company.\(^8\) If a minority investor has board representation, then it effectively has a veto right over these corporate actions.

2.3  **The Draft Law and Its Impact on China’s Current Foreign Investment Regime**

The Draft Law seeks to bring full convergence between the foreign investment regime and the domestic regime. Article 170, the ultimate clause of the Draft Law, states:

\(^8\) A similar list applies to a contractual joint venture company.
The Law shall come into force as of [month] [day], 20[...]. The Law on Chinese-Foreign Equity Joint Ventures, the Law on Wholly Foreign-Owned Enterprises and the Law on Chinese-Foreign Contractual Ventures shall be simultaneously repealed.9

Upon the repeal of these laws, equity joint ventures and contractual joint ventures are to be converted into limited liability companies.10 Article 157 of the Draft Law provides for a period of three years for the transition to occur. The rationale for repealing these sui generis laws is explained in the Notes to the Draft Law. Essentially, the Notes state that the sui generis laws (also referred to as the “Three Foreign Investment Laws”) are not suited to the continuing reform and opening up of the PRC and conflict with the PRC Company Law.

There is another reason: as part of the negotiations for a bilateral investment treaty with the United States, the United States has stipulated the grant to foreign investors of pre-establishment national treatment as a precondition, i.e., that foreign investors should be afforded the same treatment as PRC investors prior to establishing a presence in the PRC. It is therefore a little ironic that it is this investment liberalization objective, i.e., the convergence of foreign investment law and the domestic regime, which could now cause concern from an investment treaty perspective.

As we have discussed in section 2.2, both equity joint ventures and contractual joint ventures have certain built-in statutory features. An investor which has entered into an equity joint venture or contractual joint venture would have done so relying on the statutory protections laid out in the relevant law. So, for example, the investor may not have had to have been troubled by any need to have elaborate restrictive transfer provisions with rights of first refusal or, indeed any such provisions at all, on the basis that it could simply rely on its absolute statutory right to control transfers by a fellow investor. Or it might have been the case that a minority investor was unable to negotiate strong minority rights for itself, but it could nonetheless fall back on its statutory minority rights. These statutory rights are particularly important to minority investors as they do not have to bargain for them. They are conferred wholesale by law. After the convergence envisaged under the new Draft Law, these rights would be abrogated and the position of these investors would approximate more to a minority investor in a company where the maxim of “majority rules” applies. Foreign investors, particularly those in a minority position, that have entered into joint ventures with state-owned enterprises are particularly prejudiced.

9 Our view is that the implementing regulations of these laws would also be automatically and impliedly repealed upon the repeal of the laws themselves. As the “head” laws are repealed, there would be nothing to implement.

10 Contractual joint ventures without separate legal personality are to be converted into partnerships under the PRC Partnership Law.
In looking at how the rights of investors may be affected, it is also necessary to look beyond statutory rights. Typically, these rights would also have been incorporated into the joint venture contract and the articles of association. So the same right is actually manifested in three different ways: a statutory right; a private contractual right between the investors as set out in the joint venture contract; and a private contractual right set out in the articles of association binding on the joint venture company and the investors (whoever they may be from time to time) in the company. The main difference between the right as set out in the joint venture contract and the right as set out in the articles of association is that the joint venture company is bound by the articles of association and thus also has to honor those rights.

The question that arises is this: upon the repeal of the Equity Joint Venture Law and the Contractual Joint Venture Law, what happens to the private rights set out in the joint venture contract and the articles of association? Can these private rights exist and survive independently of the original enabling law?

Turning first to the joint venture contract, it can be argued that: (i) the joint venture contract is a private treaty between the parties to the contract which is independent of the corresponding law and so the parties should be contractually bound to honor its terms; (ii) even if the language of the joint venture contract does not dovetail with the language of the PRC Company Law as it applies to limited liability companies, the parties should interpret and perform its terms in a manner that best reflects their intention.

Against these arguments are the following. The joint venture contract only became effective when it was approved by the approval authority acting pursuant to the Equity Joint Venture Law and Contractual Joint Venture Law, as the case may be. If these laws are repealed, then it can be argued that the joint venture contract ceases to be effective because the basis upon which the contract became effective no longer exists. The fact that the joint venture contract may contain language that says the parties should perform their obligations under the contract as best reflects their original intent where the contract cannot be performed or its purpose is frustrated will be of no use if the contract itself—and thus the saving language—is extinguished.

Turning to the articles of association, the position seems to be clearer. Similar to the joint venture contract, the articles of association only became effective when they were approved so the same reasoning applies. In addition, if the joint venture company is converted into a limited liability company under the PRC Company Law, it would be difficult to argue that the existing articles of association applicable to one legal species would continue to apply mutatis mutandis to another species of legal vehicle.

We examine each of the key features discussed in section 2.2 in turn.
2.3[a]  *Majority Abuse of Financing*

The conversion of an equity joint venture or contractual joint venture to a limited liability company under the PRC Company Law means that there is no longer a concept of total amount of investment and thus the company will not have a statutory cap on borrowing. A minority investor in the company that does not have the means to control or block excessive borrowing by the company will now be at risk from the controlling investor over-borrowing, and majority abuse of financing, as there is no longer a statutory cap.

Limitations on borrowing might be contained in the joint venture contract or articles of association. For example, the parties may have agreed that all the directors of the company are required to approve borrowing in excess of a pre-determined amount. However, as discussed, the risk is that the joint venture contract and articles of association might no longer be in effect in which case the minority investor will not have the benefit of this private protection.

2.3[b]  *Loss of Veto Rights on Transfers of Equity Interest*

The repeal of the Equity Joint Venture Law and Contractual Joint Venture Law will result in an investor no longer having a veto right to block a co-investor transferring registered capital to another party. This loss is particularly acute for minority investors as this veto right is a valuable right which can be traded for other commercial advantages. Once the joint venture company is converted into a limited liability company under the PRC Company Law, a minority investor will be subject to majority rule. Even if the veto right has been replicated in the joint venture contract or articles of association, there is the risk that they might no longer be in effect.

2.3[c]  *New Risks of Majority Abuse in Decision-Making*

Upon repeal of the Equity Joint Venture Law and the Contractual Joint Venture Law, the highest decision-making body will cease to be the board of directors whose directors are appointed by the investors. Instead, the highest decision-making body in the case of a limited liability company will be the shareholders at general meeting. A minority investor may have previously achieved a carefully calibrated and agreed degree of control through its participation on the board of directors. This would now be rendered, effectively, irrelevant once the highest decision-making body becomes the shareholders’ meeting. A minority investor will be subject to majority rule. Again, even if the minority investor’s rights are
replicated in the joint venture contract or articles of association, there is no assurance that those rights would survive.

2.3[d] Possible Loss of Preferred Dividends and Early Recovery of Investment from a Contractual Joint Venture

In a case where a contractual joint venture contract allows the parties to share profits and bear losses in a proportion that is different to their share of registered capital or permits an investor to recover its investment ahead of other investors then, as discussed above, there is a risk that the contract will be extinguished upon the repeal of the Contractual Joint Venture Law. In such a case, these rights will be lost when the joint venture company is converted into a limited liability company unless the other investors agree to reinstate the original terms. In addition, these features cannot be accommodated within the framework provided by the PRC Company Law.

2.3[e] Loss of Veto Right for Certain Key Corporate Actions

We noted earlier that, in the case of an equity joint venture, unanimous board approval is required for certain key corporate actions such as the amendment of the articles of association. Upon conversion to a limited liability company, such approval will no longer be required. A minority investor which has board representation will therefore lose its veto right over those matters.

3 INVESTMENT TREATY PROTECTION

From an investment treaty perspective, the issue which could arise is a familiar one; namely, whether a host state can enact laws with an overtly neutral effect or even laudatory intent, but which may have an inadvertent and insidious consequence for the investor, and if so, whether that state should be permitted to do so without redress.

The manner in which the issue ought to be approached will be determined by the available forms of protection under China’s bilateral investment treaties (BITs) with the home/national state of the foreign investor. Assuming that threshold requirements such as nationality and a successful assertion that the investor’s venture amounts to an investment are met, there will be two broad types of substantive protection.

The first consists of the “relative” protective standards of most favored nation (MFN) treatment and national treatment (NT). These appear, on the face of China’s latest regulatory reforms, to be unproblematic. For the purposes of China’s
MFN commitments under its various BITs, all foreign investors will be put on the
same footing, without any differentiation between investors on the basis of their
particular foreign nationality.\footnote{The use of fairly generously worded MFN clauses in some PRC BITs should, however, alert us to the
possibility of disparate levels of protection between the several PRC BITs. Thus, a higher standard of
protection may be found for the investors of national state X by virtue of an MFN clause in a BIT
between the PRC and state X which in turn imports a higher standard of protection which the PRC
may have accorded to the investors of state Y. One example which comes to mind, and which will be
explained further below, is where the fair and equitable treatment (FET) clause in the treaty between
the PRC and state Y provides an express guarantee of legal stability.}

Similarly, for any PRC investment treaty commitments to national treatment,
Chinese national and foreign national investors will be governed by the same
regime.\footnote{As for the differential treatment under the current regime for foreign investors and the regime for
local investors, the simple explanation for the non-application of national treatment protection is that
PRC BITs have traditionally been careful not to accord national treatment protection. This practice is
currently changing, and the likely advent of the national treatment rule under a highly anticipated
China-United States BIT which would include “pre-establishment” national treatment (i.e., market
access) will be a watershed.}

It is in the second class of so-called absolute standards—“absolute” because
they do not depend upon showing a difference in treatment relative to others,
unlike the MFN and NT standards of protection—where future claims by foreign
investors and/or their shareholders against the PRC might lie (assuming that the
Draft Law is passed as law in substantially the same form as it now stands). The
three main treaty standards are fair and equitable treatment, full protection and
security, and the rule governing expropriation. We will deal with them in turn,

together with umbrella clauses, before turning to some features of China’s BITs,
and their application to some of the problems we have outlined earlier.

3.1 Fair and Equitable Treatment, and Full Protection and Security

In recent years the fair and equitable treatment (FET) standard of protection has
been extended so as to protect investors from unfair or inequitable disruptions to
the legal, regulatory, or commercial stability which, in the view of various
tribunals, investors ought to be able to expect.\footnote{See, e.g., Katia Yannaca-Small, *Fair and Equitable Treatment Standard: Recent Developments*, in *Standards of
Investment Protection*, 111, 121 (August Reinisch ed., Oxford U. Press 2008).} At the same time, the full
protection and security (FPS) standard, which for long was seen to ensure the
physical security of the person or property of the foreign investor, has also been
expanded to include the assurance of a stable legal and business environment for
the foreign investor's investment. Today, there are signs of an overlap between FPS and FET in this regard.\textsuperscript{14}

Thus in Occidental \textit{v. Ecuador}, the tribunal resorted to the Preamble to the United States-Ecuador BIT and held that Ecuador was obliged to provide a “stable business and legal framework for investment.” Stability had become an essential element of FET. The tribunal went on to hold that, as such, breach of FET automatically entails breach of FPS.\textsuperscript{15} In \textit{Azurix v. Argentina}, Azurix's expropriation claim was rejected, but the tribunal in that case found that the City of Buenos Aires’ actions were arbitrary and had therefore violated the FET and FPS standards. Citing \textit{Occidental}, among other tribunal awards, the tribunal in \textit{Azurix} considered that there is an “interrelationship” between FET and FPS and that FPS extends in scope beyond the protection and security provided by the police and physical security. Rather, FPS extends to the “stability afforded by a secure investment environment.”\textsuperscript{16} This reading, said the Tribunal, is supplied by the word “full.”\textsuperscript{17} Having found a FET violation, the tribunal also found a FPS violation.\textsuperscript{18}

Such protection is also closely related to a growing acceptance by tribunals, however much criticized, of a need to protect investors' legitimate expectations. This is discussed in the next section.

It is useful to add, at this juncture, that the potential causes of action against China need not be limited by the protection of legal stability, business stability, or legitimate expectations. Fair and equitable treatment could also extend to any lack of due process in the promulgation of the Draft Law, or any claim of bad faith, discrimination, or lack of transparency. There is a voluminous jurisprudence on all these “heads” of the fair and equitable treatment standard.

As for full protection and security, in extending the FPS standard of protection towards assuring the investor of a stable legal and investment climate, it is important to bear in mind that the appropriate standard of protection is neither to be equated with strict liability for any legal or business disruption nor with a guarantee of the investor's success in its investment. The seminal authority on this issue is \textit{AAPL v. Sri Lanka} where the tribunal had emphasized there that it was “not aware of any case in which the obligation ... was construed as [an] absolute obligation which guarantees that no damages [sic] will be suffered, in the sense that any violation thereof creates automatically a ‘strict liability’ on behalf of the host State.”\textsuperscript{19} This standard was affirmed in \textit{Saluka v. Czech Republic}. The \textit{Saluka} tribunal

\textsuperscript{14} Giuditta Cordero Moss, \textit{Full Protection and Security}, in Reinisch (ed.), \textit{supra} n. 13, 142, 146.


\textsuperscript{16} \textit{Azurix v. Argentina}, ICSID Case No. ARB/01/12, ICSID, Decision of Jul. 14, 2006, para. 408.

\textsuperscript{17} Ibid.

\textsuperscript{18} Ibid.

had cited the earlier Award of the tribunal in *Tecom* in which the latter tribunal had stated that the FPS standard is not absolute. It does not imply strict liability on the part of the host state. Instead, “due diligence” or, as the *Wena* tribunal had also put it, “vigilance” is required. In short, all that is required is that reasonable measures ought to have been taken to protect assets and property.20 Similarly, “vigilance” was upheld as the appropriate standard in *Noble Ventures v. Romania.*21

3.1[b] Protection of Investors’ Legitimate Expectations

The protection of legitimate expectations is an important category within the rubric of the fair and equitable treatment of investors. It has been described by the tribunal in *Saluka* as “the dominant element” of the FET standard,22 and has (together with the protection of expectations to legal and commercial stability, discussed above) an especially direct application to the facts surrounding the intended enactment of China’s new Draft Law. Indeed, Newcombe and Paradell consider the protection of the investor’s expectation to a stable legal and administrative framework, discussed earlier, to be a subset of it.23

The doctrine of legitimate expectations has been developed largely in the Awards of tribunals in recent years.24 The *locus classicus* remains the *Tecom* tribunal’s statement of the principle that the host state was in that case required “to provide to international investments treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment.”25 The *Tecom* tribunal had considered that the doctrine derived from the principle of good faith under international law. In essence, it overlaps with the need to ensure the stability of the legal and commercial environment surrounding the investment.26 However, in the absence of a specific verbal or written representation or a contractual commitment, investors will most likely have to argue that in the present case, they were entitled to the application of the law as

22 *Saluka*, supra n. 20, para. 302.
they found it at the time of the investment. But such cases typically deal with the failure to apply the law existing at the time the investment was made. It is, and ought to be, harder to argue that host state laws cannot, unless a contrary commitment was made, be subject to any subsequent change. MacLachlan, Shore, and Weiniger cite *Thunderbird v. Mexico* for the proposition that the absence of a specific representation suggests that the claimant’s claim should not succeed. As the *Thunderbird* tribunal had put it, the expectation of the investor must also be “reasonable and justifiable.”

Such skepticism has recently also been expressed most forcefully by a number of other commentators. Dr Andrés Rigo Sureda cites the admonishment of the Annullment Committee in *MTD Equity v. Chile* that investors’ expectations cannot replace the terms of the investment treaty and the protection actually provided therein. Crawford echoes this view, and rejects the substitution of contractual and treaty commitments with the investor’s subjective expectations. According to this viewpoint, which is reflected in tribunal Awards, the fact that investors must bear some risk, exercise their own due diligence, and may have to act with an eye to political and legal-regulatory changes which ought to have been anticipated bears emphasis. Similarly, Sornarajah has expressed skepticism of the idea that international investment law can provide substantive protection to investors in the absence of a specific contractual or other additional commitment.

But there is no denying the source of such controversy, which is the very fact that investment tribunals have been willing to extend such protection to claimants in the absence of a contractual or other commitment not to alter the legal regulatory regime which existed at the time the investment was made. To the criticism that this could not have been intended by host states in their treaty commitments, tribunals have also cited the commitment to accord fair and equitable treatment to investors, or as we have seen the word “full” in the treaty commitment to accord full protection and security.

At the end of the day, a balance must be struck between the expectations of the investor and the regulatory space to be accorded to a host state. However, the

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27 *MTD*, supra n. 25, at 122.
33 Sornarajah, supra n. 24, at 355.
situation is different where there has been a specific representation or commitment made by the host state. A host state could create such an expectation not just through contractual commitments, the terms of a specific license, or in unilateral written or verbal assurances, typically where the investor's dealings have been with a state-owned enterprise, but also through the host state's national laws. Newcombe and Paradell caution that what counts is that the expectation must be “justifiable and reasonable based on objective criteria.” Commentators who are skeptical about the protection of legitimate expectations would no doubt require that, in the case of an alleged guarantee in a national law, an express and specific assurance should be found in the national law itself. Thus, in LG & E v. Argentina, the claimant relied upon stipulations in Argentine law; namely, “key guarantees in the Gas law and regulations” and in particular Decree 1738/92 which had guaranteed payment in U.S. dollars prior to Argentina's subsequent “pesification policy.”

3.1[c] Is Legitimate Regulation a “Defense”?

It would be odd to think that the host state has no “defense” in such cases. M. Sornarajah puts the point simply: “foreign investment has to work within the regulatory framework of the host state.” In other words, what precisely is that framework if it is not one which also accepts legal and regulatory change? Sornarajah raises the point in relation to the rule against uncompensated expropriation, but the point is a broad one. So far as the protection of legitimate expectations is concerned, MacLachlan, Shore, and Weiniger have also written of the need for a “reasonable degree of regulatory flexibility ... to respond to changing circumstances in the public interest.” But how reasonable must that degree of flexibility be or, put differently, what is the degree of regulatory flexibility which an investor is required to expect? They cite a famous passage in Saluka v. Czech Republic: “whether frustration of the foreign investor's expectations was justified and reasonable, the host State's legitimate right subsequently to regulate domestic matters in the public interest must be taken into consideration as

35 Newcombe & Paradell, supra n. 23, at 282.
36 Ibid.
38 Here we use the term 'defense' loosely, and it is not to be confused with the defenses (proper) which are available under the international law of state responsibility.
39 Sornarajah, supra n. 24, at 115.
40 MacLachlan et al., supra n. 26, at para. 7.113.
The question essentially boils down to what the standard of “equitable treatment” requires, which in turn requires the investment tribunal to balance the investor’s rights against the host state’s rights. The investor’s rights cannot be equated with vested property rights. This suggests a risk that the quality of justice delivered at the hands of investment tribunals could vary, like the equity courts of old, “with the length of the Chancellor’s foot.”

In sum, there is no “defense” as such which a host state can plead, unlike the current legal defenses to state responsibility of force majeure, duress, necessity, corruption, or a fundamental change of circumstances, none of which seem applicable to the present facts. Rather the host state is accorded a sufficient degree of regulatory flexibility which is weighed in the balance in establishing whether there has been a breach of the treaty standard of protection.

It is in that light that China’s purpose of introducing the Draft Law will need to be scrutinized closely.

3.2 Treaty Umbrella Clauses

Some forms of investment could be protected by additional contractual promises, including the possibility that the terms of the existing “three laws” regime (for Equity Joint Ventures, Contractual Joint Ventures and Wholly-Owned Foreign Enterprises) having been incorporated into relevant contractual agreements between foreign investors and Chinese state-owned enterprises. Legal advisors to foreign investors will be particularly alert to these possibilities, including the operation of so-called “umbrella clauses” in the PRC BIT. These are treaty clauses which purport to extend the force of treaty law commitments to contractual commitments.

In the umbrella clause situation, a treaty clause could provide for the observance of not only contractual but also other kinds of commitments made under legislation or administrative regulation. Thus, Article 10(2) of the current, third version of the PRC Model BIT states that: “Each Contracting Party shall observe any commitments it may have entered into with the investors of the other Contracting Parties as regards to their investments.” Such a clause found its way into the second version of the PRC Model BIT roughly from 1990 onwards, although there are also earlier PRC BITs containing such clauses. There are,
however, important variations between the various PRC BITs containing umbrella clauses which may limit the effect of these clauses. In the jurisprudence on umbrella clauses generally, some tribunals have suggested that the phrase “any commitment” is expansive, perhaps even too expansive, but the words “it may have entered into” could also convince a tribunal that the commitments referred to are of a sufficiently specific nature and would in any case encompass contractual commitments for these contain specific rights. Much will also depend upon the wording of the particular PRC BIT, such as an express requirement that the commitments should be “specific.” There is also a genuine argument to be made that the word “commitments” in the umbrella clause in Article 10(2) encompasses legislative and administrative commitments, provided that the particular BIT does not preclude it.

3.3 RULE AGAINST UNCOMPENSATED EXPROPRIATION

Historically, most international investment claims were claims for compensation for expropriation, or damages for unlawful takings. Such claims now include claims of creeping, indirect, or regulatory expropriation. In a classic statement from the NAFTA arbitral jurisprudence, creeping or indirect expropriation includes “covert or incidental interference with the use of property which has the effect of depriving the owner ... of the use or reasonably-to-be-expected economic benefit of property.” Unlike a traditional taking of foreign-owned property, title to the property need not have passed to the host state. The Award of the Iran–United States Claims Tribunal in Starrett Housing Corp. v. Iran is a seminal authority on the position under general international law:

it is recognised in international law that measures taken by a State can interfere with property rights to such an extent that these rights are rendered so useless that they must be deemed to have been expropriated, even though the State does not purport to have

See further, Shan & Gallagher, infra n. 57, at 176–177 for a five-fold classification of different forms of restrictive wording.

SGS v. Philippines, ICSID Case No. ARB/02/6, ICSID, Decision of January 29, 2004, para. 115 (“The term ‘any obligation’ is capable of applying to obligations arising under national law, e.g. those arising from a contract”).


Noble Ventures v. Romania, supra n. 21, para. 51.

Shan & Gallagher, infra n. 57, at 176.

SGS v. Pakistan, supra n. 48, at paras 166–73.

Shan & Gallagher, infra n. 57, at 176 assert the examples of the China-Austria BIT (1985) and the Jordan-China BIT (2001) which confine such commitments to “any contractual obligations” in respect of “approved” investments only.

Metalclad v. Mexico, ICSID Case No. ARB(AF)/97/1, ICSID, Decision of Aug. 30, 2000, para. 103.

Starrett Housing Corp. v. Iran, IUSCT Case No. 24, Interlocutory Award No. ITL 32-24-1, IUSCT, Award of Dec. 19, 1983.
expropriated them and the legal title to the property formally remains with the original owner.

What is notable is that some PRC BITs expressly provide for indirect expropriation, as in the example of the Germany-China BIT.55

As most readers of this journal are no doubt already aware, expropriation even if proven is not unlawful per se. Subject to the precise terms of the investment treaty whose protection the claimant invokes, typical legality requirements for a lawful expropriation—in other words, the preconditions for a finding of lawful expropriation—are that the taking should be (i) for a public purpose; (ii) non-discriminatory; and (iii) compensated. It pays to emphasize the last requirement in the present case. Under the usual treaty formulation of the rule found in contemporary treaties, this could mean prompt, adequate, and effective compensation. Often, there is a further stipulation of a fourth requirement that (iv) due process should also be observed.

The concept of public purpose, or public benefit, interest, good, or welfare is usually unproblematic. It is both a customary and a treaty concept. It must be clearly understood, however, that it is not a defense as such. Where a public purpose for the expropriation exists, compensation is still payable. Rather, the public purpose criterion is merely one of several preconditions for a lawful expropriation which is therefore compensable. However, the requirement is easily met in the eyes of most tribunals. This may be the result of a perceived general reluctance by tribunals to substitute their own judgment for the host state’s barring any incidence or showing of bad faith on the part of the host state, or the existence of some similar overt political motivation for the expropriation. The ADC tribunal’s Award was only a notable departure from this general trend.56

Other points which claimants could emphasize are any possible discriminatory effects, which at least on the face of it are absent from the current Draft Law. However, a claim could still focus on a technical due process violation. More will be said below about such claims.

4 SOME PRINCIPAL FEATURES OF CHINA’S BILATERAL INVESTMENT TREATIES

Beyond the usual need to ascertain the exact available rights of the investor under the specific provisions of individual bilateral investment treaties, there are a number

56 ADC v Hungary, ICSID Case No. ARB/03/16, ICSID, Decision of Oct. 2, 2006. See also Siemens v Argentina, ICSID Case N o. ARB/02/08, ICSID, Award of Feb. 6, 2007.
of features that should also be borne in mind in the present context. These arise from the fact that PRC BITs are distinctive, varied and evolving.

The evolution of China’s BITs since China adopted its Open Door Policy is usually described in terms of the various “generations” of BITs. What is meant is that Chinese BITs during different periods were similar to each other. The first-generation BITs were those concluded between 1982 and 1989; the second generation are those following China’s accession to the ICSID Convention and were concluded between 1990 and 1997; while the third generation are those concluded after 1998. These correspond to the three versions of the China Model BIT, the latest and current version being the third, which is the version we will refer to in our discussion below unless otherwise stated.

4.1 Derivative Shareholder Claims

In the present context, we are dealing with what international law would treat as a “shareholder claim,” that is, a claim by an investor, and this is unlikely to cause significant issues.

A problem usually arises where the harm is inflicted on the local company in the host state in which the foreign investor has a share, in this case, the joint venture company. The example here would be where the articles of association to which the company itself is a party is extinguished. In such a case, the harm would be suffered by the company and not the shareholders themselves.

It is sometimes said that derivative shareholder claims ought not to be allowed. But this argument has not been upheld in the practice of investment tribunals where the definition of investment in the BIT is sufficiently broad.


58 Ibid. at 143, 145 et seq.

59 This had been Argentina’s objection to jurisdiction in CMS v. Argentina, ICSID Case No. ARB/01/8, ICSID, Decision of July 17, 2003, para. 59. The problem is usually traced to the International Court of Justice’s rejection of a “derivative shareholder” claim in the Barcelona Traction case, [1970] I.C.J. Rep. 3, paras 39, 42, which had involved a claim brought by the shareholders’ national state against the host state. The Court rejected the claimant’s standing on the basis that it is the national state of the foreign company which ought to bring the claim. The basis for that ruling lay in the reasoning that it was a general principle of law that the existence of separate corporate personality usually prevents the piercing of the corporate veil. However, the court acknowledged that there is a “theory” that the case is rather different where the national state of the company is the host state itself, i.e., where no other state can bring a claim on behalf of the company. The facts in the subsequent ELSI case, [1989] I.C.J. Rep. 15, came very close to this situation, with the only difference being that the dispute involved a company whose national state was the host state itself. In such a case, it has been suggested that the shareholders’ national state ought to be allowed to bring a claim. Stephen A. Kubiatowski, The Case of Electtronica Sicula S.p.A.: Toward Greater Protection of Shareholders’ Rights in Foreign Investments, 29 Columbia J. Transnat’l L. 215, 231–32, 234, 244 (1991).

this regard, BITs, including China’s BITs, typically employ a broad definition of “investment” to include shares, stock, and other forms of equity and this is not confined to cases where the investor has control or majority shareholdings but can also include minority shareholdings.\textsuperscript{61} There is therefore nothing particularly unusual about the breadth of China’s usual definition of investment in its treaties, and this should therefore not constitute an undue obstacle in the present case.\textsuperscript{62}

In any case, the harm in the present case is that caused to the foreign shareholder itself, even though, in some cases, there may also have been harm caused to the company.

China’s BITs (such as those with Gabon, Germany, and Argentina),\textsuperscript{63} typically, also allow “indirect” investments. In the case of the China-Germany BIT, this means that the shareholder can invest through a company in Germany which it owns “fully or partially.”\textsuperscript{64} Sometimes, as in the case of the BIT with the Seychelles,\textsuperscript{65} this could extend to investments through a third country by shareholders from the other Contracting Party.\textsuperscript{66} In some cases, as in the case of the New Zealand-China Free Trade Agreement (FTA),\textsuperscript{67} the third country is required either not to have or to first disown its own right to a claim.

What China has done, however, is to apply an “admissions model” of investment, for example in the China-Germany BIT of 1983, China-Switzerland BIT of 1986, China-Japan-Korea Trilateral Investment Agreement of 2012, and China-Canada BIT of 2012.\textsuperscript{68} But insofar as approved investments are concerned, no undue difficulty should arise. Typically, market access rights are not granted in the current slew of PRC BITs, i.e., China’s past treaties typically do not grant a pre-establishment right to national treatment (below).\textsuperscript{69} Presently, the United States has required such market access rights as a precondition to having a China-United States BIT, which at the time of writing has substantially been concluded. It marks a new, fourth and emergent generation, of China’s BITs.

\textsuperscript{61} Ibid. at paras 46–48, 62–65 and the Awards cited therein.

\textsuperscript{62} Shen, supra n. 55, at 551.

\textsuperscript{63} China-Gabon BIT (1997), Art. 1; China-Germany BIT (1983), Art. 1; and China-Argentina BIT (1992), Art. 1.

\textsuperscript{64} Shan & Gallagher, supra n. 57, at 147.

\textsuperscript{65} China-Seychelles BIT (2007).

\textsuperscript{66} Ibid. Art. 2(2). See Shan & Gallagher, supra n. 57, at 147–48.

\textsuperscript{67} China-New Zealand FTA (2008), Art. 135.

\textsuperscript{68} China-Germany BIT (1983), Art. 2; China-Switzerland BIT (1986), Art. 2; China-Japan-Korea Trilateral Investment Agreement (2012), Art. 2; and China-Canada BIT (2012), Art. 3.

4.2 Nationality and national treatment

Nationality itself, which is required to establish the admissibility of the investor’s claim under the BIT of its choosing, is determined for the purposes of China’s BITs through the use of single or, in some of the more restrictive PRC treaties, multiple criteria such as nationality, domicile, residence, or place of business. Incorporation, seat, and control can also be used in combination in establishing the nationality of corporate entities, although in some cases they are used in the alternative.

Recall, however, that national treatment may not be available. Traditionally, the commitment is likely to be absent, to have been couched in best endeavors language, or is stated to be without prejudice to domestic laws. Even in the newer PRC BITs, pre-existing restrictions on national treatment may be grandfathered, as in the China-Germany BIT, and China-ASEAN Treaty. Pre-establishment rights currently do not exist and will only likely be gradually introduced in the treaties which China is currently negotiating, prefiguring the emergence of a new “fourth generation” of PRC BITs. Article 6 of the Draft Law itself provides that foreign investors making investments in the PRC should be entitled to national treatment. Ironically, it is this attempt to confer national treatment, in anticipation of China’s future treaty commitments to national treatment, that makes the issues discussed in this article relevant. China’s assumption, it may be supposed, is that the Draft Law would largely be unproblematic because its current BITs eschew a commitment to national treatment. However, this only protects China as host state from claims to violations of national treatment. It would not necessarily shield the Draft Law, if enacted in its present form, from other sorts of treaty claims which we go on to discuss below.

4.3 Most favored nation treatment

Most favored nation treatment, as we have noted at the outset of this article, is typically available and one finds the use of familiar formulations such as the

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70 Shan & Gallagher, supra n. 57, 152. See also the discussion in Elodie Dulac, The Emerging Third Generation of Chinese Investment Treaties. Transnational Dispute Management (TDM) 7.4, 5–6 (2010).

71 Ibid. at 155.

72 See Shen, supra n. 35, 556–559; Schill, supra n. 69, 97–100; Congyan, Cai, China-US BIT Negotiations and the Future of Investment Treaty Regime: A Grand Bilateral Bargain with Multilateral Implications 12 J. Intl Econ. L. 457, 461 (2009). For an example of a PRC BIT which does not contain a national treatment clause, see the China-Ethiopia BIT (1998); for one containing best endeavors language only, see China-United Kingdom BIT (1986), Art. 3(3); and for an example of a BIT containing a “without prejudice to domestic laws and regulations” clause, see China-Djibouti BIT (2003), Art. 3(2).

73 Ibid. at 558–59. See Protocol to the China-Germany BIT (2003), s. 3 Ad Arts 2 and 3 and China-ASEAN Treaty (2009), Art. 6.
extension of such treatment, in the case of the China-New Zealand FTA, to the “management, conduct, operation, maintenance, use, enjoyment and disposal” of the investment.\textsuperscript{74} It is therefore likely to be the wider form of guarantee of MFN treatment. Crucially, this would allow nationals of contracting states to the earlier PRC BITs to enjoy the more ample protection found only in later PRC BITs.\textsuperscript{75} Sometimes a pre-establishment clause is also inserted into the MFN commitment, as in the case of China’s BITs with Japan and Finland.\textsuperscript{76}

\subsection*{4.4 Fair and Equitable Treatment, and Full Protection and Security}

Fair and equitable treatment and full protection and security are widely present in PRC treaties.\textsuperscript{77} The examples of the New Zealand-China FTA and the ASEAN-China Treaty are especially interesting,\textsuperscript{78} since both FET clauses expressly refer to legal stability.\textsuperscript{79}

\subsection*{4.5 Expropriation}

As for expropriation, the current PRC Model BIT contains all the usual expected elements. The expropriation must be for a public purpose, it must be non-discriminatory, and it must be compensated. While it does not use the term “due process,” the Model BIT requires compliance with “domestic legal procedure.”\textsuperscript{80} Shan and Gallagher do not express a clear view on the significance of this difference in wording,\textsuperscript{81} and investors and their advisors should clearly be alert to the possible argument that this is not the same as “due process” in the international sense. They should be ready to dispute any attempt to limit the standard of due process which is ordinarily to be expected. Article 4(2) of the Model BIT also states that compensation:

\begin{itemize}
  \item \textsuperscript{74} China-New Zealand FTA (2008), Art. 139.
  \item \textsuperscript{75} See supra n. 55, at 563.
  \item \textsuperscript{76} Ibid. at 565. See China-Japan BIT (1988), Art. 2(2) and China-Finland BIT (2004), Art. 3(3).
  \item \textsuperscript{77} Ibid. at 570. Also see Schill, supra n. 69, at 106, and Dulac, supra n. 70, 11, 13.
  \item \textsuperscript{78} China-New Zealand FTA (2008), Art. 143(2) and China-ASEAN Treaty (2009), Art. 7(2).
  \item \textsuperscript{79} See supra n. 55, at 571. China-New Zealand FTA (2008), Art. 143 and China-ASEAN Treaty (2009), Art. 7(1); Cai, supra n. 72, at 468. There is, however, an interesting controversy regarding the content and scope of the FET clause contained in the China-ASEAN Treaty. It has been said that the FET clause there only protects legal stability. The phrase “refers to” suggests that the clause refers exclusively to legal stability. In contrast, in the China-New Zealand FTA, the FET clause in that treaty “includes” legal stability. For discussion of this point, see Dulac, supra n. 70, at 12.
  \item \textsuperscript{80} This has been followed in most of China’s BITs. However, exceptions do exist, for example in China-Yemen BIT (1998), Art. 4(1) and China-Ukraine BIT (1992), Art. 4(1). See Cai, supra n. 72, at 475.
  \item \textsuperscript{81} Shan & Gallagher, supra n. 57, at 163. See also Leon Trakman, China and Investor-State Arbitration, UNSW Law Research Paper No. 2012-48, 36 (October 2, 2012).
\end{itemize}
shall be equivalent to the value of the expropriated investments immediately before the 
expropriation is taken or the impending expropriation becomes public knowledge, 
whichever is earlier. The value shall be determined in accordance with generally rec-
ognised principles of valuation. The compensation shall include interest at a normal 
commercial rate from the date of expropriation until the date of payment. The 
compensation shall also be made without delay, be effectively realisable and freely 
transferable.\textsuperscript{82}

However, China traditionally adopted the socialist practice oft-found also in 
the former Soviet and older Eastern European BITs of limiting recourse to 
investment arbitration regarding expropriation only to disputes about the amount of compensation pertaining to expropriation; as opposed to disputes about the incidence or occurrence of the expropriation itself. Even after its accession to the 
ICSID Convention in 1990, signaling the newer second generation of PRC BITs, 
and references in treaties such as the China-Lithuania BIT of 1993 to ICSID 
arbitration,\textsuperscript{83} this limitation was retained by notifying ICSID of China’s treaty 
intent under Article 25(4) of the ICSID Convention. This practice, however, began 
to change beginning with the China-Barbados BIT of 1998, and in China’s 
subsequent BITs with Botswana (2000), the Netherlands (2001), and in the new 
China-Germany BIT.\textsuperscript{84} However, as it has been observed, not all PRC BITs 
which adopt a more liberal approach towards the submission of disputes over 
expropriation to arbitration refer the dispute to ICSID as opposed to ad hoc 
arbitration.\textsuperscript{85}

The socialist approach adopted in the earlier PRC BITs has not, however, 
always been upheld by tribunals and in at least one instance the High Court in 
England and Wales.\textsuperscript{86} In one case the tribunal went so far as to scorn the very 
distinction sought to be drawn, and in a rigorous review of existing Awards treated 
disputes concerning the amount of compensation as disputes predicated upon

\textsuperscript{82}Ibid. This clause has been adopted in the more modern BITs, for instance in China-Germany BIT 
(2003), Art. 4(2).

\textsuperscript{83}See China-Lithuania BIT (1993), Art. 8(2)(b).

\textsuperscript{84}China-Barbados BIT (1998), Art. 9(2); China-Botswana BIT (2000), Art. 9(3); China-Netherlands BIT 
(2001), Art. 10(3); and China-Germany BIT (2003), Art. 9.

\textsuperscript{85}See Noah Gallagher & Wenhua Shan, Chinese Investment Treaties: Policy and Practice, 36 (OUP 2009); 
Juan Stampalija, Chinese Bilateral Investment Treaties: A Case of ‘Internal Fragmentation’, in International 
Economic Law after the Global Crisis: A Tale of Fragmented Disciplines, 329, 333–34 (C.L. Lim & Bryan 
Mercurio eds, CUP 2015).

\textsuperscript{86}See Saipem S.p.A v. Bangladesh, ICSID Case No. ARB/05/07, ICSID, Decision of Mar. 21, 2007; Telenor 
Mobile Communications A.S. v. Hungary, ICSID Case No. ARB/04/15, ICSID, Decision of Sep. 13, 
2006; Czech Republic v. European Media Ventures S.A. [2007] EWHC 2851 (Comm), per J. Simon, 
Contra Berschader v. Russian Federation, SCC Case No. 080/2004, SCC, Decision of Apr. 21, 2006; 
interpretation of PRC-Laos BIT (1993), Art. 8(5).
whether an expropriation has taken place.\textsuperscript{87} In another case, although the tribunal upheld the restrictive clause,\textsuperscript{88} it also found the restrictiveness of the arbitration clause to have been cured by the operation of the MFN rule in the treaty.\textsuperscript{89} However, there remains some considerable disagreement on this issue and the authorities are now fairly split.

None of these peculiarities is necessarily decisive in affecting our analysis given earlier. It is only important to be alert to the possibilities flowing from some of these features which have characterized China’s BIT practice. What matters ultimately remains whether, in cases where claims might be brought against China following the eventual enactment of the new foreign investment law, there may have been a violation of the investor’s expectation of legal and business stability, or a deprivation of the benefit of the investment (i.e., indirect or regulatory expropriation), regardless of the absence of any malevolent intent. It is in fact ironic if the reforms are largely intended to benefit foreign investors.

The principal bases for such claims would lie in the usual fair and equitable treatment, full protection and security and expropriation clauses and these clauses, as we have tried to show, take a fairly familiar form in China’s BITs. In contractual arrangements, contracts would have to be scoured for additional commitments as these will likely feature in ascertaining any specific (additional) commitments which have been undertaken by the host state or its agencies to preserve the rules of the existing regime. Such additional contractual commitments could also, in turn, be captured by the operation of treaty umbrella clauses.\textsuperscript{90}

\textsuperscript{88} See also Czech Republic v. European Media Ventures, supra n. 86.
\textsuperscript{89} In the specific context of PRC BITs, some scholars have argued for the expansion of rights through MFN clauses in order to better protect foreign investments, see Aaron M. Chandler, BITs, MFN Treatment and the PRC: The Impact of China’s Ever-Evolving Bilateral Investment Treaty Practice, 43 Intl Law. 1301, 1308–1310 (2009). This, however, has been strongly criticized in China, see An Chen & E-Nuo Gu, Should the Perspective of South-North Contradictions Be Abandoned? 14 J. World Inv. & Trade, 320, 338–340 (2013); see also Monika Heymann, International Law and the Settlement of Investment Disputes Relating to China, 11 J. Intl Econ. L. 507, 520–521(2008). In Tza Yap Shum v. Republic of Peru, ICSID Case No.ARB/07/6, ICSID Decision of Jun. 19, 2009, paras 213–216, while the MFN clause (Art. 3) in the China-Peru BIT (1994) was held to be broad enough to cover procedural matters, this ‘Maffezini’ approach was rejected on the basis of the more specific wording contained in the dispute resolution clause (Art. 8(3)). In the meantime, the new generation of PRC BITs has started to include language clearly excluding the application of the MFN clause to dispute settlement provisions, see China-Canada BIT (2012), Art. 5(3); China-Japan-Korea Trilateral Investment Agreement (2012), Art. 4(3); and China-Tanzania BIT (2013), Art. 4(3).
\textsuperscript{90} Article 10(2) of the Chinese Model BIT contains the following umbrella clause: “Each Contracting Party shall observe any commitments it may have entered into with the investors of the other Contracting Party as regards their investments”; see Shan & Gallagher, supra n. 57, at 176. For China’s BITs containing umbrella clauses, see China-Jordan BIT (2001), Art. 9(2), and Trinidad & Tobago-China BIT (2002), Art. 13(2). However, it should be noted that an umbrella clause does not appear in all China’s BITs, especially not in those concluded in the early years, see discussions in Schill, supra n. 69, at 110, and even some of the recent ones, see discussion in Dulac, supra n. 70, at 17.
5 SCOPE AND APPLICATION OF PRC BIT PROTECTION IN LIGHT OF THE DRAFT LAW

We have already seen that repeal of the Equity Joint Venture Law and Contractual Joint Venture Law will result in investors losing statutory rights which form part of their package of rights that they rely on in protecting their interests. Their contractual rights, both those that mirror the statutory rights as well as those that do not, i.e., those that the parties have freely agreed, are also at risk. This means that investors would have to renegotiate their rights de novo with no assurance that their counter-parties will agree to the same terms. Some counter-parties may take the opportunity to gain a strategic advantage, perhaps going as far as to engineer a dismantling or major reordering of the relationship. Other contracts ancillary to the joint venture contract may also be affected, either through cross-default clauses (by virtue of termination of the joint venture contract) or because their terms are no longer commercially relevant in the light of the change in the contractual position and dynamics between the parties.

If, taking the most obvious example, a state-owned enterprise can sell its equity in a joint venture company against the wishes of a minority foreign investor that no longer has a veto right to block such a transfer, the foreign investor would end up with a new co-investor it did not plan to be a co-investor with. It would also not have the benefit of contractual terms to the extent those terms have been extinguished.

We will need to assume that it will not be possible to obtain judicial assistance or relief to block the sale and to restore the parties to the status quo ante so the investor will need to quantify its loss. The loss to such an investor could be determined as follows, being the aggregate of: (i) the difference between the value of the investor’s interest under the current legal regime, i.e., with the benefit of statutory rights, and the value of the same interest under the new regime, i.e., without the benefit of those rights; (ii) an amount representing damages for loss of opportunity; and (iii) an amount representing damages for loss of bargain under ancillary contracts.

5.1 FAIR AND EQUITABLE TREATMENT, AND FULL PROTECTION AND SECURITY

Assuming that the Draft Law will remain substantially unchanged, the most immediately apparent claims will be those for violations of FET, FPS, and a BIT rule against uncompensated expropriation. While the Draft Law seems to possess a

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91 Even if it is revised before the eventual passage of the law, the fundamental problem remains unaltered; namely, the perceived need for the convergence of the current sui generis regime for foreign investors and the present domestic regime for domestic investors.
laudatory intent, the existence of bad faith is not always required for establishing a claim to a violation of FET. The obvious categories of FET and FPS claims would be for violation of the expectation of a stable legal and business environment, and possibly other legitimate expectations depending upon the facts of each case. One imagines that in the central case, specific assurances could have been given in the form of a contractual commitment or in the promise or grant of a license. Should such a commitment be found, there is also scope for an investment treaty claim to be made under the contract where a contract exists. If so, there is an even chance that the particular PRC BIT relied upon contains (either on its own or through the operation of an MFN clause) an umbrella clause requiring the observance of contractual and other specific commitments.

Any lack of due process in the promulgation of the Draft Law, or the existence of bad faith, discrimination, or lack of transparency, could be a violation of FET. However, assuming a reasonable rigor of the current consultation phase of the Draft Law, this is perhaps unlikely. The bar is high. The jurisprudence of tribunals concerning claims of due process violation generally require arbitrary, grossly unfair, unjust or idiosyncratic, or discriminatory conduct, or such conduct which offends judicial propriety. In other words there must be a gross denial of justice or manifest arbitrariness.

As for full protection and security, China would, in the hypothetical case of foreign investor claims being made, need to show that it was vigilant in protecting investors’ rights in the course of enacting the new Draft Law. There is no strict liability imposed on China. On the other hand, Awards such as that in the Eurotunnel dispute suggest that it would not be sufficient for China to show that any FPS obligation imposes only an “obligation of means,” or commits China only to a best endeavors rule. Much will depend upon future facts, as the current consultations phase unfolds, showing China’s vigilance in protecting investors’ rights. The higher the quality of the consultation process in the legislative process, the better the case China would have in arguing that it has not failed to protect diligently investors’ rights in enacting the new legal regime.

94 Umbrella clauses are a vexed issue due to conflicting lines of authority, but see, e.g., Crawford, supra n. 31, for a typology.
Do investors in the present case have a legitimate expectation to be provided “treatment that does not affect the basic expectations that were taken into account by [them in making] the investment?” A key question would be whether China’s current legal regime for foreign investment “guarantees” the rights being discussed. Such guarantees, abrogation of which might then be said to be unfair and inequitable, may find their source in the very laws which have been replaced. Otherwise, the breach of an international legal obligation would become justified by the new national laws whose very international legality is called into question. The underlying principle probably has a concomitantly wider application. Professor Jeswald Salacuse has discussed the expectations which a state has created through “its laws and acts,” and which may have in turn caused an investor to invest. In such a case, Salacuse argues that “it is generally unfair for the State to take subsequent actions that fundamentally deny or frustrate those expectations,” more specifically in changing the laws “in ways that significantly frustrate or cancel the expectations that the State itself has been instrumental in creating.” States can change their laws, they may continuously seek out the best policy options and implement them through legal change, but they must, however, compensate the investor. It is important to emphasize that, according to this view, the expectation is created by the host state’s national law only if that law caused the investor to make the investment, i.e., the national law was actually relied upon by the investor.

We have mentioned that the entitlement of a host state to regulate domestic matters legitimately and in the public interest is not a “defense” against a breach of a treaty standard of protection. The host state is permitted a measure of regulatory autonomy but there are limits to legitimate regulation. Factors which ought to be taken into account include the degree to which the current reforms have an objective, as opposed to a subjective, basis, and the notion that foreign investors should not bear the disproportionate burden of legal reforms.

It is in this context that China’s purpose of introducing the Draft Law because of a need to standardize the rights of foreign and domestic investors will not necessarily be accepted as an objective reason if the standard of protection for foreign investors falls below the international law standard of protection.

100 Ibid. at 232.
101 MacLachlan et al., supra n. 26, at 7.132–7.139. For discussion of the relevant standard of treatment under FET, and especially the “relativity” of the standard of vigilance or diligence expected of the host state, see further, Sureda, supra n. 30, at 83–92.
102 The point has its roots in the early twentieth-century history of foreign investment protection and recalls the argument made by Mexico to the United States that the application of a local, Mexican standard of property protection amounts to equal treatment and non-discrimination. The answer by the then US Secretary of State, Cordell Hull, was that this was only acceptable so long as the national
5.2 Treaty umbrella clauses

As we have noted, the feasibility of a successful claim under an umbrella clause will depend upon the wording of the particular PRC BIT, for example, whether the word “commitments” in the umbrella clause in Article 10(2) of the current version of the PRC Model BIT encompasses legislative and administrative commitments.

This last could be important, since the Contractual Joint Venture Law, for example, states that:103

The State shall protect the legal rights and interests of contractual joint ventures as well as the PRC and foreign partners in accordance with the law.

The Contractual Joint Venture Implementing Regulations, in turn, provide that:104

A contractual joint venture enterprise that independently develops its business management activities within the scope of the approved contractual joint venture enterprise agreement, contract and articles of association and in accordance with the law shall not be interfered with by any organization or individual.

Investors and their advisors are likely to focus upon these commitments and press them to their full extent under a BIT umbrella clause. Notwithstanding the umbrella clause, they are in any case well-advised to assert the significance of such commitments when seeking to establish a legitimate expectation of legal stability under the FET and/or FPS standards of treaty protection. Where the Contractual Joint Venture Law states that the PRC state “shall protect the legal rights and interests of contractual joint ventures as well as the PRC and foreign partners in accordance with the law,” the argument would be that there is an expectation—or even an internationally enforceable promise, in the case of an umbrella clause claim—that “the law” will not change. Similarly, the Contractual Joint Venture Implementing Regulations’ reference to the right of enterprises acting “in accordance with the law” not to be interfered with could be construed in like manner. The argument could also arise, as it has arisen elsewhere, that contracts with state-owned enterprises may have incorporated the terms of such legislative and administrative commitments.105

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103 Contractual Joint Venture Law, Art. 3.
104 Contractual Joint Venture Implementing Regulations, Art. 3.
5.3 Claims for indirect expropriation

There could also be claims for indirect or regulatory expropriation. It is important to notice that although China as the host state may gain nothing from depriving the foreign investor of the value of its investment, this, as we have discussed earlier, is not a requirement for a showing of indirect expropriation.

5.4 Demonstration of specific and quantifiable prejudice

Questions concerning the establishment and calculation of the loss or harm suffered by the foreign investor will, naturally, arise. Such questions could be extremely complex and uncertain in the present situation where the claim is for a loss of rights exercisable against third parties constituting a breach of the FET standard. Failure to show such loss or harm, and to condescend to particulars, will likely be fatal to an investor’s claim. Dr Tudor puts it thus:

This damage has to be quantified and qualified. The Investor may not claim general damage; he has to identify the exact type of damage or right breached by the State’s action or omission.

In GAMI v. Mexico, the tribunal required a “demonstration of specific and quantifiable prejudice” and that the “prejudice must be particularised and quantified.” Beyond the need to also establish factual causation, the particular complexity which the likely claim of loss or damage will face in the present situation lies in the possibility that the loss or harm upon which a particular claim (or part of an investor’s claim) lies may also be too remote.

In the case of a deprivation of a statutory right under the current foreign investment regime, it may be queried whether the loss of the right led to harm or loss which was directly caused by China, as opposed to the joint venture counter-party which may or may not be connected to the PRC state and whose acts may or may not be attributable to the PRC. It cannot be over-emphasized that the requirement that the loss or harm must be specific, quantified, qualified, and condescend to particulars must be met both for founding the claim against the PRC and for the calculation of recoverable losses for compensation or damages.

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106 In the case where the domestic counter-party in a joint equity or contractual venture is a state-owned enterprise, a direct benefit or gain to the host state could conceivably be established on the facts of the case.
108 Ibid. para. 110.
110 Ibid. para. 110.
Thus, the loss or damage must be sufficiently proximate, foreseeable, or “adequately caused” or “direct.”

Having said that, insofar as the calculation of compensation or damages is concerned, what is only required is a showing that the particularized loss or harm is compensable under the particular head, say for “lost profits,” and that the particularized loss was foreseeable. Such foreseeability need not extend to quantum itself. Thus, for example, the precise quantum or amount of lost profits actually claimed need not be foreseeable.

There are further considerations which apply to claims of uncompensated expropriation in particular since, unlike a FET claim, expropriation cannot be shown without showing harm or injury. What this means, according to Ripinsky and Williams, is that the central focus will be on the “value of the expropriated investment.” The way the present facts would complicate the issue has to do, again, with causation since the claim could involve the actions of a third party, namely, the domestic joint venture counter-party. At best, the responsibility of China may in this regard only be partial as its conduct is merely a concurrent cause of the loss or harm. But a more fundamental issue than that of apportionment is the very existence of any liability on the part of the PRC. The PRC’s own conduct must be sufficient to found the expropriation claim, and this could therefore also limit any award of damages. In the case of indirect expropriation, where often the very fact that it is indirect would tend to lead to non-compensation due to its silent or unacknowledged nature, claims for additional heads of damages would arise which would have to satisfy a separate causation analysis.

5.5 Remoteness and the Question of “Joint and Several Liability”

In short, beyond the need to also establish factual causation, the loss or damage must not be too legally remote. The issue here goes like this. The claimant may argue that the actions giving rise to a treaty claim, i.e., the change to the foreign

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111 Sergey Ripinsky & Kevin Williams, Damages in International Investment Law, 135–36 (BIICL 2008).
113 Ripinsky & Williams, supra n. 111, at 142.
116 In other words, the need for an analysis of causation re-emerges for the additional heads of loss claimed; Ripinsky & Williams, supra n. 111.
117 GAMi v. Mexico, supra n. 109, para. 110.
investment regime resulting in a loss of rights by the claimant, are directly attributable to the host state. Where the joint venture counter-party, whose invocation of its newly found rights causes the foreign investor loss or harm, is a state-owned enterprise (SOE) then it may also be claimed that it is no more than an emanation of the state itself. As a result, both the SOE’s invocation of its new rights and the PRC’s passing of the new law would be attributable to the PRC and it may be said, in such a case, that the PRC has directly caused the loss or harm.

However, where the Chinese counter-party cannot be considered an emanation of the PRC itself, there will be a third-party element present in any claim of damage, loss, or harm based upon the deprivation of statutory rights by the change in PRC law. The argument which could then arise is that the PRC’s passing (in due course) of the new law was simply too remote, in addition to being part of the exercise of the host state’s normal regulatory powers, in situations where the joint contractual or equity venture counter-party’s actions loomed so large as to have severed the chain of causation altogether. If such a case could be made out, then the PRC is not liable at all.\(^\text{118}\) Some readers might think this unlikely since the change in the law would have directly deprived the investor of the rights which it could otherwise have asserted to protect itself from the loss.

At the same time, what is also clear, under the rules of state responsibility, is that the state is not automatically absolved simply because multiple parties are involved.\(^\text{119}\)

One preliminary question which may arise in this connection will be whether the PRC joint venture counter-party (whether or not connected to the state) is required to renegotiate the joint venture agreement and other ancillary agreements and to enter into new agreements in order to restore the claimant’s extinguished rights and, if it does not, whether the loss suffered by the claimant is then too remote. The better view may be that the joint venture counter-party is not obliged to renegotiate the parties’ contractual arrangements to restore the claimant’s lost rights. The new regime may be equally alien to the counter-party and to expect it to enter into amended agreements presumes wrongly that the parties are content to resume their contractual relations under the new regime without more. If the counter-party benefits from a regulatory windfall, then that is merely a consequence of the implementation of the new regime.

The difficulty with the existence of multiple tortfeasors lies in the ill-developed position under the international law of state responsibility on the


question of joint and several liability. The general rule is that international law only recognizes independent liability.\textsuperscript{120} There is authority which could suggest that in such cases, where the Chinese counter-party cannot be said to be a mere emanation of the PRC, there were several independent “tortfeasors” against whom recovery of damages should therefore be apportioned in cases where a part of the injury is severable from the others.\textsuperscript{121} But the argument could also be made that the PRC’s actions alone (assuming that they are not too remote) caused the entire loss.\textsuperscript{122}

Beyond the broad parameters described earlier, it would be difficult to make general statements about the features of likely claims. Much will depend upon the transactional details and history of the investment, as well as the way in which the particular loss or damage has, according to the investor, manifested in the specific case.

6 CONCLUSION: PROSPECT OF CLAIMS AND AVAILABLE REMEDIES

China may have taken the view that any claims which might be raised are simply a risk which the new measures will just have to face, and that the general absence of national treatment commitments in its previous BITs avoids any difficulty which could arise with treaty claims. It is also difficult to imagine companies and shareholders who do business in China wanting to bring a claim against China in the abstract, or rushing to enter investor-state claims against China. Based on past experience, there is also a reluctance to press such claims. Whether there will be claims in the future will depend upon the seriousness of the actual loss or damage caused by the removal of a previous statutory right which a foreign investor had enjoyed and which the investor and its legal advisors consider that it was entitled to continue to expect.

An important issue in this regard concerns the kinds of remedy which may be sought. Assuming that there has been a lawful expropriation, just compensation is payable. By treaty this would typically be measured against the full value of the loss plus interest until the date of payment. International law, however, prescribes no ready-made formula for the calculation of such compensation. But as we have seen, the Chinese Model BIT supplies a treaty definition which accords with the


\textsuperscript{121}See Petrobart, supra n. 115, at 81; CME, supra n. 119, para. 583.

\textsuperscript{122}CME, supra n. 119, paras 580–81. See further Ripinsky & Williams, supra n. 111, at 147–148.
Hull formula of prompt, adequate, and effective compensation.\textsuperscript{123} In the event of an unlawful expropriation—this is to say, a non-fully compensated expropriation—the usual remedy would be restitution. It is only where restitution is impossible that damages would become an acceptable substitute. What is now beyond serious controversy is that compensation for a lawful expropriation, and damages for an unlawful expropriation are not the same thing. Here, as Ripinsky has observed, creeping expropriation will, due to its unacknowledged nature, almost always be unlawful.\textsuperscript{124}

In the event where there are contractual commitments whose abrogation is attributable to the host state, breach of such a commitment could render the expropriation unlawful, depending upon the tribunal’s exact approach, and the existence of such contractual commitments could also feature in the calculation of damages.\textsuperscript{125}

It remains to be seen whether it would not have been better to adopt some form of grandfathering of pre-existing rights instead of wholesale relocation to the newly proposed regime, or indeed whether China’s legislators will still do so when the Draft Law is eventually promulgated. It is hoped that this article will contribute to the debate that will lead to a decision. What this article has attempted to do is to describe, in broad outline, the pertinence of the investment treaty dimension to China’s currently intended reform of its national foreign investment laws. The current Draft Law may yet be subjected to further change, and at the present time it is simply difficult to tell what kinds of changes these will be. Some form of grandfathering of existing investors’ rights ought to commend itself for serious consideration. It is not too late.

For now at least, the basic problem remains, namely, the proposed convergence of China’s current foreign and domestic investment regimes and therefore the extinguishment of the previous sui generis domestic legal regimes for foreign investment under the Contractual Joint Venture, Equity Joint Venture, and Wholly Foreign-Owned Enterprise Laws. Foreign investors will have to be alerted to possible changes to their legal rights. Where investors are affected by these changes, renegotiation of existing contractual and other arrangements will no doubt have to take place.

In all this, foreign investors might also wish to consider the kinds of investment treaty rights which we have sought to explain.

\textsuperscript{123} See further, Ripinsky & Williams, supra n. 111, at 78.
\textsuperscript{124} Ibid. at 69.
\textsuperscript{125} Ibid. at 70–71.
Author Guide

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[3] The article should contain an abstract of about 200 words.

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