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International Law of Foreign Investment at a crossroads: the need to reform

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I. Introduction.

International law of foreign investment is a unique class of public international law. It combines aspects of public and private international law. It applies to States but benefits multinational corporations which are not subject of public international law.

The international law of foreign investment has been the set of rules that apply to countries when foreigners undertake business in their territories. Initially an appendix of the doctrine of State Responsibility for Injury to Aliens, it has evolved to a dynamic set of rules and principles comprised in treaties and applied by institutional and ad-hoc arbitral tribunals.

Today international law of foreign investment is defined as the law that protects foreign investment and foreign investors. That law is comprised in several Bilateral Investment Treaties (BITs) signed between capital exporting and capital importing countries, in investment chapters of free trade agreements (FTAs), in conventions such as the one that creates an institutional arbitration center to settle disputes between the investors and States—International Centre for Settlement of Investment Disputes (ICSID)-- in a convention that creates a multilateral agency for risk guarantee—Multilateral Investment Guarantee Agency (MIGA)-- in principles of customary public international law, in soft law and in numerous decisions by institutional tribunals such as the International Court of Justice, the U.S.-Iran claim tribunals, ad-hoc arbitral tribunals and ICSID arbitral tribunals.

A myriad of countries have been brought into the idea that foreign investments are good for economic development and that being part of the system of international law of foreign investment is good to attract investments for it provides a sound and stable framework to do business and guarantees that foreigners will receive at least the international minimum standards.

To some extent it has been left for granted that the sole purpose of the international law of foreign investment is to promote and protect foreign investments. And although the international law of foreign investment is largely nourished by customary public international law, many of the new rules are consensual. States have voluntarily negotiated and approved rules among them where the beneficiaries have been investors either individuals or multinational corporations.

After decades of use, it is appropriate to say that the system of international law of foreign investment has been tested. In 2007 there were more than 2,500 BITs. Likewise, investors continue to file investment claims against States to reach 125 pending cases at the ICSID in 2008, of which 67 have been filed against Latin American countries.[1] There were also more than 100 known non-ICSID investor-State arbitration cases. But there are signs that the international law of foreign investment needs to be reformed.

This essay presents the positive and negative aspects of the international law of foreign investment. It also presents some ideas to consider for reform. The essay is divided into nine sections: Section two deals with the impact of IIAs in the economies of countries; section three deals with the purpose of international law of foreign investment from the perspective of countries and how that purpose has been considered by the arbitral tribunals; section four addresses the policy restriction concerns of some countries; section five deals with the criticism of inconsistency found in investment arbitral awards; section six deals with the impression that the system is biased on behalf of the investors and looks at the number of known arbitral awards to demystify it; section seven addresses the issue of investors' responsibility. Finally, some ideas are presented for future reforms of the system of international law of foreign investment.

II. Impact of IIAs.

IIAs are usually referenced as having a positive impact for development. Allegedly, the possibility of increased investment disputes brought about by IIAs may motivate host countries to improve domestic administrative practices and laws in order to avoid future disputes. " IIAs are important not only because of their potential international impact in terms of attracting foreign direct investment or sending positive signals to foreign investors. Equally significant are promotion of transparency, due process and strict application of the rule of law, which are the best means of avoiding investment disputes."[2]

The World Bank has stressed that well-functioning law and justice institutions and a government bound by the rule of law are important to economic, political and social development. For some countries foreign direct investments seem crucial for survival. UNCTAD's statistics have shown for years, that about 90% of total external capital for developing countries come from the private sector (about 50% from Foreign Direct

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[1] INTERNATIONAL CENTER FOR SETTLEMENT OF INVESTMENT DISPUTES (ICSID), PENDING CASES, *available at* http://www.worldbank.org/icsid/cases/pending.htm (last visited Jul. 20, 2006). *See also* U.N.CONFERENCE ON TRADE AND DEVELOPMENT, ISSUES RELATED TO INTERNATIONAL ARRANGEMENTS, INVESTOR-STATES DISPUTES AND POLICY IMPLICATIONS, U.N. Doc. TD/B/COM.2/62 (2005)

[2] U.N. CONFERENCE ON TRADE AND DEVELOPMENT, INVESTOR-STATE DISPUTE SETTLEMENT AND IMPACT ON INVESTMENT RULE MAKING, 2008, *available at http://www.unctad.org/en/docs/iteiia20073_en.pdf (last visited March 4, 2008)*

Investment (FDI), another 30% or so from commercial banks and about 10% from portfolio investment – only about 10% comes from multilateral or bilateral public sources). Thus, the adverse consequences of impairing that flow of capital to some developing country on *inter alia* jobs, income, effective public services, consumer choice and technological growth, and thus on development, seem obvious.

However, in real terms, the impact of IIAs has been uncertain. Studies show that the relation between IIAs and flow of foreign direct investment (FDI) is weak.[3] Signing IIAs and agreeing to international investment arbitration is not guarantee that foreign investors will make business in a given country. At most the international investment law framework creates a positive investment climate which diminishes the risk and with that the transaction costs of doing business. That added to the existence of a business opportunity, plus other business related factors could move the investors to choose that place as a location to invest. More and more there are indications that the mere acceptance of international investment law is not sufficient to attract foreign investments.

In Latin America, for example, the largest recipient of foreign direct investment is Brazil.[4] Of a total of $ 84 billion of foreign direct investment (FDI) inflow into Latin America in 2007, Brazil attracted more than $ 19 billion. Yet Brazil is not signatory of the ICSID Convention and has not ratified any BIT. Thus, the lack of adherence to the international investment law has not affected Brazil's foreign investments attractiveness.

On the other hand, international investment law might have a negative impact in terms of local governance. Through IIAs, for instance, foreign investors may escape local courts and not play a role on the dynamic to reform those institutions.

In that sense it has been argued that in some cases in developing countries already suffering from low-quality institutions the presence of international alternatives to adjudicatory or regulatory bodies may reduce local institutional quality, by not allowing strong political coalitions to be formed.[5] Foreigners would have no interest on putting pressure for changes in the judicial system, for instance, since they are subject to a special dispute resolution regime.

It has also been said that IIAs might reduce the interest of foreign investors in property and enforcement reforms in developing countries. Domestic reforms may be less likely and the country may even regress toward policies that harm domestic investors. Attempts to reform may fail, or no attempts at reform may be made at all. In such cases, the IIAs,

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[3]*See* Tobin, Jennifer and Rose-Ackerman, Susan, *Foreign Direct Investment And The Business Environment In Developing Countries: The Impact Of Bilateral Investment Treaties*, May 2, 2005, Yale Law & Economics Research Paper No. 293, *available at* http://www.law.yale.edu/outside/html/faculty/sroseack/FDI_BITs_may02.pdf (last visited Jul. 20, 2006)

See also Hallward-Dreimeier, Mary, *Do Bilateral Investment Treaties Attract Fdi? Only A Bit... And It Might Bite*, World Bank Policy Research Working Paper Series, Number 3121. Washington, World Bank

[4] Closely followed by Mexico. U.N.CONFERENCE ON TRADE AND DEVELOPMENT, WORLD INVESTMENT REPORT 2007, TRANSNATIONAL CORPORATIONS, EXTRACTIVE INDUSTRIES AND DEVELOPMENT, *available at* *http://www.unctad.org/en/docs/wir2007p1_en.pdf (last visited March 4, 2008)*

[5] Ginsburg, Tom, *International Substitutes for Domestic Institutions: Bilateral Investment Treaties and Governance*, International Review of Law and Economics, 25, 107-123 (2005)

although benefiting foreign investors, could have a negative effect on the trustworthiness of the business environment for domestic investors.[6]

Obviously IIAs are not the cause of weak legal reforms or law enforcement in developing countries, but they might not be helpful on reform efforts or might even make things worse by opening a discriminatory and unfair system of investment protection composed by two paths: the international one for some foreign investors and the weak one for the rest of businesses and for locals. More research needs to be conducted to determine the impact of international investment law in local governance and legal reforms, before a final judgment is issued. For now, we should only say that doubt has been expressed on the positive externalities the whole system of international investment law brings to developing countries in general.

Treaty-shopping for a most favourable home treaty has been highly criticized. Usually where no agreement is in place between the home country of an investor and the intended host state—or where an available agreement is deemed to be less favourable from an investor's perspective—there may be opportunities for investors to "shop" for a home country of convenience.

III-Fulfilment of the purpose of the international law of foreign investment.

Signatories of International Investment Agreements (IIAs) from developing countries seek to increase inward foreign investment flows. On occasions, this want for foreign investment is explicitly defined within the context of the larger purpose of promoting economic development. Countries enter into IIAs because they want to attract foreign investment but they want to do so because it is perceived that foreign investment are a means to foster economic development. Thus, the ultimate objective of countries when entering into IIAs is to foster their economic development, not protect foreign investments per se. In other words countries enter into IIAs to protect foreign investment because they foster economic development. An argument follows from there that foreign investments that are not instrumental to foreign investment should not be entitled to protection.

Examination of cases of investment dispute settlement demonstrates the relevance of an IIA's purpose approach on its interpretation. In some instances arbitration tribunals have considered an agreement's purpose in deciding issues of arbitral jurisdiction or in deciding the cases on the merits. However, not in all cases, the economic development purpose of the signatory countries when subscribing the international law of foreign investment has been taken into account by the arbitral tribunals.

In Salini Costruttori SpA and Italstrade SpA (Salini) v. Kingdom of Morocco (Morocco),[7] two Italian companies claimed compensation for damages from the Kingdom of Morocco under the Treaty between the Government of the Kingdom of Morocco and the Government of the Republic of Italy for the reciprocal promotion and

[6] *See* Tobin, Jennifer and Rose-Ackerman, Susan, *supra note* 3.
[7] *Salini Costruttori SpA and Italstrade SpA v. Kingdom of Morocco*, Decision on Jurisdiction, 23 July 2001, 42 ILM 609 (2003).

protection of investments due to a dispute that arose out of the construction contract related to a section of a highway joining Rabat to Fés. Morocco objected the tribunal jurisdiction based on different grounds, one of which referred to the argument that construction contracts did not qualify as investments under the ICSID Convention. On considering that objection the Tribunal pointed out that the ICSID Convention does not define the term investment. It then considered the criteria generally identified by the Convention's commentators, indicating that those were: existence of contribution, certain duration and risk participation. It also added that the operation should contribute to the development of the host State, as provided by the Convention's preamble.[8] The Tribunal found that the construction contract fulfilled the criteria. Even in the risk aspect, the Tribunal indicated that a construction project that lasts several years, for which total costs cannot be established with certainty in advance, created a risk for the contractor. Thus, a construction operation could be qualified as an investment, and the disputes that arose directly out of it were susceptible to be heard by ICSID. In connection with the economic development requirement the Tribunal mentioned that in most countries construction of infrastructure falls under the tasks to be carried out by the State or by other public authorities. It then mentioned that the highway in question served the public interest and that the claimant companies were also able to provide the host State with know-how in relation with the work.[9]

The Tribunal also mentioned that all the elements to be taken into account for defining when there is an investment in the context of the ICSID Convention may be interdependent. Thus, had the investment failed the test of any of the elements, for example, the one on economic development, the Tribunal would have had to reject the claim and declare that it did not have jurisdiction.

Noticeably, for the Tribunal to reach the conclusion that economic development was one of the elements to take into account in order to determine the existence of an investment according to the ICSID Convention, it looked at the purpose of that treaty as mentioned in its preamble.

Based on the Claimants' fulfilment of each of the criteria, the Tribunal found that the construction contract constituted an activity within ICSID jurisdiction and that disputes arising directly out of the contract would be heard before the Tribunal.

In Siemens, A.G. v. The Argentine Republic,[10] Siemens, a German firm, initiated ICSID arbitration against Argentina, based on alleged violation of the Germany-Argentina BIT after a contract to establish a migration control and personal identification system was suspended and then terminated. Argentina objected to ICSID jurisdiction based on eight arguments each of which was ultimately rejected by the Tribunal.

The Claimant argued that by virtue of the MFN clause of the Germany-Argentina BIT it was entitled to certain procedural benefits of the Argentina-Chile BIT. Argentina

[8] Id at paragraph 52.
[9] Id at paragraph 57
[10] *Siemens, A.G. v. The Argentine Republic*, Decision on Jurisdiction, Case No. ARB 02/8 (August 3, 2004)

objected to this claim, but the Tribunal analyzed the purpose of the Germany-Argentina BIT to find that the agreement was meant to promote investment and create conditions favourable to investors. The Tribunal ruled that interpretation of the BIT should account for such context, stating, “The Tribunal shall be guided by the purpose of the Treaty as expressed in its title and preamble. It is a treaty ‘to protect’ and ‘to promote’ investments…The intention of the parties is clear. It is to create favourable conditions for investments and to stimulate private initiative.”[11]

During the case, Argentina argued that if the Argentina-Chile BIT was applicable by virtue of the MFN clause, unfavourable provisions contained therein should also apply. The Tribunal responded that under the MFN clause only favourable provisions were applicable. In view of the inapplicability of unfavourable provisions and the purpose of the BIT, the Tribunal rejected Argentina’s objection to jurisdiction stating, “…an MFN clause…as its own name indicates…relates only to more favourable treatment. There is also no correlation between the generality of the application of a particular clause and the generality of benefits and disadvantages that the treaty concerned may include. Even if the MFN clause is of a general nature, its application will be related only to the benefits that the treaty of reference may grant and to the extent that benefits are perceived to be such.”[12]

Likewise, Argentina’s contention that had it intended to define the procedural terms of the MFN clause of the Germany-Argentina BIT, it would have done so explicitly in the Treaty was negated by the teleological reading of the treaty: to encourage and protect foreign investment. In this case, the Treaty’s purpose of promoting investment extended the Treaty’s protection beyond its text.

In <u>MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile,</u> [13] a Malaysian company made an investment in Chile to build a planned community in an urban section of Santiago. The company obtained a permit to invest in the form of a contract with Chile's Foreign Investment Commission. Subsequently, the investor learned of zoning regulations, contained in Chile's urban development and environmental policies, which designated the land on which the community was to be built as reserved for agricultural purposes. The investor initiated ICSID arbitration alleging indirect expropriation and unfair and inequitable treatment in violation of the MFN clause of the Malaysia-Chile BIT and the fair and equitable treatment provisions of the Denmark-Chile and Croatia-Chile BITs, which were applicable, as witnessed in the Siemens case, due to the general nature of MFN interpretation. The investor alleged that the government’s approval of the investment in spite of knowing of its impossibility violated the government’s obligation to provide fair and equitable treatment.

The Tribunal ruled that States are not limited in their authority under national laws or policies except to the extent that exercising that authority would contravene BIT obligations. As the purpose of the Malaysia-Chile BIT was to foster and promote foreign

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[11] Id at paragraph 81
[12] Id at paragraph 120
[13] *<u>MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile</u>* (Case No. ARB/01/7) (May 25, 2004)

investment, the fair and equitable treatment provisions of other BITs were applicable by means of the MFN provision to Malaysian investors. The Tribunal's decision made reference to the Treaty's purpose, stating, "…in terms of the BIT, fair and equitable treatment should be understood to be treatment in an even-handed and just manner, conducive to fostering the promotion of foreign investment."[14]

While the Tribunal ruled that the State's approval of an investment that was inconsistent with its urban planning regulations constituted a violation of fair and equitable treatment provisions, the panel also found MTD partially responsible. The Tribunal stressed that, "…BITs are not an insurance against business risk,"[15] and pointed out that under International Law, a State cannot be compelled to change a policy or pass a law. That is, the investor did not have the right to amendment of a land use policy. The investor was not denied a permit, but rather denied amendment of a regulation. Thus, while the failure to amend public policy was not considered expropriation, unfair treatment did occur, as the investor was admitted to invest under circumstances known by the State to make the investment inoperable. The Tribunal reached a decision whereby only a portion of the compensation claimed by the Malaysian firm was awarded because, "the claimant failed to protect themselves from business risks inherent to their investment in Chile."

In two controversial decisions the ICSID Tribunals reached different levels of control of the investors while fulfilling the purpose of Article 25(2)(b) of the Convention. In Amco Asia et al. v. Indonesia,[16] PT Amco was a locally incorporated company but controlled by the foreign parent company Amco Asia. The arbitration clause mentioned PT Amco as a potential party in the proceedings before ICSID. Indonesia objected to ICSID jurisdiction, arguing that it had not agreed to treat PT Amco as a foreign company. The Tribunal had to consider Indonesia's objection according to which PT Amco, was not controlled by Amco Asia, a company belonging to a national of the United States of America, because Amco Asia was controlled by a Hong Kong company which itself was owned by a Dutchman. The Tribunal rejected the search for indirect control beyond the first level of control and found that the search was restricted to the immediate control of the parent company over the local company.

By contrast, in SOABI v. Senegal[17] the ICSID Tribunal considered a treaty's purpose in determining jurisdiction, which, in turn, provided arbitrators with the support necessary to go beyond the analysis of a firm's direct control. SOABI, a Senegalese incorporated company, was controlled by a Panamanian company, which was controlled by Belgian citizens. When the consent to arbitration was given, Panama was not a Contracting State of the ICSID Convention while Belgium was. Senegal objected to ICSID jurisdiction, arguing that Panama was not part of the ICSID system and thus while SOABI could be considered a local company under foreign control, the foreigners who controlled the company were not nationals of a Contracting State of the Convention and therefore outside of ICSID domain. However, the Tribunal found that the purpose of the Convention's Article 25(2)(b) was to facilitate foreign investments through locally

[14] Id at paragraph 113
[15] Id at paragraph 178
[16] Amco Asia et al. v. Indonesia, Decision on Jurisdiction, 25 September 1983, 1 ICSID Reports 389 at 404-405
[17] *SOABI v. Senegal*, Decision on Jurisdiction, 1 August 1984, 2 ICSID Reports, 182-183.

incorporated companies so that they may qualify before ICSID. As a consequence of this interpretation, the Tribunal went beyond SOABI's direct Panamanian control, finding that Belgian nationals, in effect, controlled the company and rejected Senegal's objection to jurisdiction on this basis.

The Tribunals' different approaches concerning the application of direct control are reconciled on the interpretation of the purpose of Article 25(2)(b) of the Convention. As Article 25(2)(b) seeks to promote investment through the extension of jurisdiction to locally incorporated companies controlled by foreign nationals, the two arbitral decisions, while extending the analysis of direct control to different levels, were consistent with the Article's intention to grant jurisdiction to locally incorporated firms controlled by foreign nationals.

In Banro American Resources, Inc. and Societé Aurifére du Kivu et du Maniema S.A.R.L. v. Democratic Republic of Congo,[18] the Tribunal held that the ICSID Convention was not intended to provide the claimant with diplomatic protection and arbitration simultaneously.

The parent company, a national of Canada, had used the mechanism of diplomatic protection while an American subsidiary submitted the dispute to ICSID. The Tribunal stressed that "…once ICSID arbitration is available for settling a dispute related to a foreign private investment, diplomatic protection is excluded: the investor no longer has the right to seek diplomatic protection, and the investor's home State no longer has the right to grant the investor diplomatic protection."[19]

Furthermore, it was pointed out that it would be against the purpose and aim of the ICSID Convention to expose the host State at the same time to both diplomatic intervention and arbitration. On ruling in that direction, the Tribunal stated that a group of companies cannot avail itself of both diplomatic protection through its parent company and arbitration through a subsidiary.

The Tribunal also analyzed the subject of nationality of the company from a different perspective—the company with the nationality of the other Contracting State and the company giving the consent and in connection with whom the host State gave consent to arbitrate disputes involving them were not the same. The Tribunal held that a company could transfer to a subsidiary the consent it had granted to submit a dispute to ICSID as per the terms of the agreement where consent was originally granted. However, for the consent to be transferable, it had to have been previously granted. In the case in point, the consent could not have been granted or transferred because the parent company did not have the nationality of a Contracting State. Thus, if a claimant lacked the nationality of a Contracting State, ICSID could not have jurisdiction. The Tribunal also considered the possibility of the claimant having the nationality of a Contracting State but not having granted consent and the possibility of the host State granting consent but not including

[18] *Banro American Resources, Inc. and Societé Aurifére du Kivu et du Maniema S.A.R.L. v. Democratic Republic of Congo*, ICSID Case No. ARB/98/7, Decision of 1 September, 2000.
[19] *Id* at paragraph 15.

disputes involving the claimant. In both such cases, the Tribunal stated that it lacked jurisdiction.

On reaching its conclusion, the Tribunal established differences with two previous cases: one where a request to submit a dispute to ICSID was submitted by a member company of a group of companies while the consent was expressed by another company of the group; and the other where, following a transfer of shares, the request to submit the dispute to ICSID came from the transferee company while the consent had been given by the company making the transfer. The Tribunal stressed that in general it tends to be less formalistic and that ICSID is more willing to work its way from the subsidiary to the parent company rather than the other way around. "Consent expressed by a subsidiary is considered to have been given by the parent company, the actual investor, whose subsidiary is merely an 'instrumentality'," it said.[20]

As noted in Salini v. Morocco, Tribunals have used the Preamble of the ICSID Convention to require that contribution to a host's economic development is an element necessary to the definition of investments falling under ICSID arbitral jurisdiction. In Tokios Tokeles v. Ukraine[21](Tokios), the Tribunal again referred to the purpose of the ICSID Convention, but did so from a decidedly different perspective.

In Tokios, a firm incorporated in Lithuanian but of whom the majority of shares were owned by Ukrainian nationals, initiated arbitration against Ukraine, alleging the Ukrainian government breached the Ukraine-Lithuania BIT. Ukraine objected the Tribunal's jurisdiction, arguing, inter alia, that the Claimant was not a foreign investor and hence the dispute was between a State and its own subjects and not a matter to ICSID arbitration.

The Ukraine-Lithuania BIT defined foreign investors as those entities incorporated in the other State party. Based on that the majority of the Tribunal stated that the parties to a BIT were free to determine the criteria to determine nationality[22] and set the definition of investor and foreign control of a local entity for purposes of article 25 (2)(b) of the ICSID Convention. It was not up to the Tribunal to question the criteria used therein.

It stated: "…Contracting Parties are free to define their consent to jurisdiction in terms that are broad or narrow; they may employ a control-test or reserve the right to deny treaty protection to claimants who otherwise would have recourse under the BIT. Once that consent is defined, however, tribunals should give effect to it, unless doing so would allow the Convention to be used for purposes for which it clearly was not intended."[23]

The majority thus concluded that Tokios was a foreign investor under the terms of the BIT and rejected the Ukraine's objection to jurisdiction, stating, "In our view, however, neither the text of the definition of 'investment', nor the context in which the term is defined, nor the object and purpose of the Treaty allow such an origin-of-capital

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[20] *Ib* at paragraph 12.
[21] *Tokios Tokeles v. Ukraine*, Decision of April 29, 2004, Case No. ARB/02/18. http://www.worldbank.org/icsid/
[22] *Id* at paragraph 24.
[23] *Id* at paragraph 39.

requirement to be implied. The requirement is plainly absent from the text…the origin-of-capital requirement is inconsistent with object and purpose of the Treaty, which …is to provide broad protection to investors and their investment on the territory of the other party".[24]

The majority then held that, "the ICSID Convention contains no inchoate requirement that the investment at issue in a dispute have an international character in which the origin of the capital is decisive."[25] Regarding the Convention's purpose, the majority considered that the decision had not allowed, "the Convention to be used for purposes for which it clearly was not intended."[26]

The dissenting arbitrator stressed that the purpose of the ICSID Convention was to govern international investments: investments characterized by a trans-border movement of capital rather than investment disputes between a country and its citizens.[27] In the Dissenting Opinion, the minority arbitrator explains this distinction, stating, "…when it comes to ascertaining the international character of an investment, the origin of the capital is relevant, and even decisive. True, the Convention does not provide a precise and clear-cut definition of the concept of international investment –no more than it provides a precise and clear-cut definition of the concept investment–, and it is therefore for each ICSID tribunal to determine whether the specific facts of the case warrant the conclusion that it is before an international investment".[28]

The dissenting arbitrator also objected to the right of Contracting Parties to extend the Convention's jurisdiction, explaining, "…it is within the limits determined by the basic ICSID Convention that the BITs may determine the jurisdiction and powers of the ICSID tribunal, and it is not for the Contracting Parties in their BITs to extend the jurisdiction of the ICSID tribunal beyond the limits determined by the basic ICSID Convention."[29]

The doctrine of company law is based on assumptions regarding the costs and benefits provided by limited liability. Generally, it is understood that limiting shareholders' liability is socially beneficial as it allows a greater number of people to establish or own portions of a corporation and allows for greater specialization of a firm's functions and the externalization of business risks beyond its owners to creditors, who may be better suited to bare risk.[30] However, should the negative externalities produced by limited liability exceed those deemed acceptable; the legal personality of the company can be disregarded.

Thus, the abuse of legal personality that was apparent in Tokios offered arbitrators the means by which the formal definition of nationality could have been weighed against its

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[24] *Id* at paragraph 77.
[25] *Id* at paragraph 82
[26] *Id* at paragraph 39.
[27] Professor Prosper Weil dissented from the majority. http://www.worldbank.org/icsid/cases/awards.htm April 29, 2004, at paragraph 19.
[28] *Id* at paragraph 20.
[29] *Id* at paragraph 13.
[30] Easterbrook Franck H and Fischell Daniel R., Limited Liablity and the Corporation, 52 The University of Chicago Law Review, 52 (1985)

social costs. In Tokios¸ the use of a Lithuanian company owned by Ukrainian nationals to obtain international protection against Ukraine not only constitutes an abuse of the legal personality of the Lithuanian company but also puts at risk the whole international investment arbitration system, for investment disputes between States and their citizens -albeit disguised as foreigners- could be settled internationally.

The majority's decision to take a formalistic rather than an instrumentalist interpretation approach was contrary to the primary purposes of the ICSID Convention: to protect foreign investments. A teleological approach might have sought to disregard the legal personality based on the Ukrainian owners' abuse of it by means of pursuing international protection on behalf of a purely domestic investment.

In Champion Trading Company, Ameritrade International, Inc., James T. Wahba, John b. Wahba, Timothy T. Wahba v. Arab Republic of Egypt (Champion),[31] the Tribunal took a similar approach to that taken in Tokios. In Champion, the Claimants, all of which were shareholders of an Egyptian cotton trading company, alleged that the government of Egypt violated the terms of the U.S.-Egypt BIT and filed a claim through ICSID arbitration. Egypt objected to ICSID jurisdiction based on the argument that some of the individual Claimants had Egyptian nationality. The Claimants alleged that their real and effective nationality was American.

In looking at the issue of real and effective nationality, the Tribunal analyzed the Nottebohm ICJ decision and the A/18 decision from the IRAN-United States Claims Tribunal. The Tribunal quoted the A/18 decision and noted that, "real and effective nationality was indeed relevant 'unless an exception is clearly established.'" The Tribunal found that such an exception existed in Article 25(2)(a) of the ICSID Convention which expressly provides that a National of another Contracting State does not include any person who, on either the date of the consent or on the date when the request was registered, had the nationality of a Contracting State party to the dispute. The Tribunal found that the individual Claimants had mentioned their Egyptian nationality in the documents establishing the investment vehicle without any reference to their U.S. nationality. The Tribunal declared that it did not have jurisdiction in the dispute as presented by the individual Claimants. However, while the individual Claimants were forbidden from bringing a claim against Egypt due to their Egyptian nationality, the Claimants were also American nationals and shareholders of the corporate Claimants both of which were American companies. The Tribunal held that the corporate Claimants were considered foreign investors for purposes of the arbitration and rejected the Respondent's objection to jurisdiction for the corporate Claimants.

Although the Champion decision which was taken before Tokios, seems to have reached the same conclusion that Tokios reached later on, there are some differences. First, in Champion the shareholders of the corporate claimants had Egyptian and American Nationality. A factor that was not present in Tokios. Secondly, the references the Tribunal made to Nottebohm and A/18 decisions in terms of real and effective nationality

[31] In *Champion Trading Company, Ameritrade International, Inc., James T. Wahba, John b. Wahba, Timothy T. Wahba v. Arab Republic of Egypt* , decision of October 21, 2003. http://www.worldbank.org/icsid/cases/champion-decision.pdf

would have been useful to dismiss the argument that the corporate claimant was an Egyptian investor had the possibility of disregarding its legal personality been considered, because the real and effective nationality of the individual shareholders was American. Thirdly, the reference of Article 25 (2)(a) of the Convention which excludes dual nationals from invoking the protection of the Convention against the host country of the investment to which they are also nationals, only applies to individuals, not to companies of the other Contracting State when individuals with dual nationality are shareholders. Fourthly, the Tribunal in Champion, made a specific reference to article 32 of the Vienna Convention, which states that supplementary means of interpretation including the preparatory work of the treaty and the circumstances of its conclusion, can be used for interpretation in cases of ambiguity or unreasonable results. That provision could have allowed the hypothetical Tribunal to look at supplementary means of interpretation of the ICSID Convention to disregard the applicability of Article 25 (2)(a) if it led to an absurd or unreasonable result, such as the confirmation of ICSID jurisdiction to settle disputes between a State and a domestic investor.

Thus, it is likely that if faced with the same issue Tokios addressed, i.e., a national investor disguised as a foreigner, the Champion Tribunal would have used the argument of unreasonable result and would have explored the purpose of the ICSID Convention in depth to declare that it did not have jurisdiction over a dispute between a national and its State.

In sum, the evidence shows how important the purposes of the IIAs have been to interpret the international law of foreign investment when deciding investment arbitration disputes. Obviously, arbitrators are called to solve disputes, not to solve economic issues, but when the facts are analyzed and the legal instruments give room for considering economic development issues, a careful analysis of the interests of host countries should be undertaken and if possible weight should be given to the impact an award might have in the wellbeing of the citizens of that country.

The question is where arbitrators draw the line so that the rights and interests of the investors are protected as established in the relevant international investment law while economic development issues are considered. Stretching that line too far from the agreed law might impair the predictability expected in the international investment law. But not considering issues of economic development in the analysis of investment arbitration cases might also impair not only the compliance of the awards, but also the evolution of international investment law.

IV. Policy restrictions.

Additionally some countries fear that IIAs restrict their public policy authority. For instance, some wonder what the actual consequences of the Most-Favoured-Nation (MFN) clause would be. Did it mean that the country was committed to the deepest provision, among all BITs signed, of each issue?

Experiences with MFN, as reflected, *inter alia*, in Maffezini have not been happy ones. In *Maffezini*,[32] the Tribunal analyzed the MFN clause of the Argentina-Spain BIT in connection with the provisions of the Chile-Spain BIT, which did not require exhausting certain period of time before filing a claim.

The Tribunal noticed two principles: *res inter alios acta* and *ejusdem generis*. According to the first one the treaties are valid among the parties. According to the second one, the effect of a treaty can be extended via MFN clause to treaties of the same nature. The Tribunal ruled that in the absence of express provisions to the contrary, the provisions of investment disputes of another treaty of the same nature can be extended to an investor of a third country because the purpose of the BITs is to protect foreign investors and their rights, and because the provisions of investment disputes settlement are inextricably related to investment protection. The Tribunal also stated some exceptions to the ruling such as when consent to arbitration is conditioned to exhaustion of local remedies, when the parties have the option to choose between local remedies or international arbitration or when the parties have chosen an institutional arbitration.

The BITs' expropriation clause has been another matter of deep concern for some countries. On the one hand, there were restrictions on the way in which indemnity payments would be made. The BITs refer to "immediate payments, in convertible currency and freely transferable". Domestic legislation, however, in some cases is quite different, insofar as it determines that, in some cases, payments should be made for example by public authorities in the form of long-term Treasury Bonds. The divergence between BITs and domestic law would disadvantage national investors compared with their foreign counterparts. On the other hand, there was much uncertainty about the expression "measures tantamount to expropriation". The concept of indirect expropriation seemed overly flexible and vague and could be used by foreign investors, depending on the circumstances, to restrain the public sector's autonomy in setting economic, social, environmental, or urban policy.

The peculiarity of the BITs was that the State would be subject to international arbitration in a myriad of situations. At its most extreme, every investing party to a treaty might have the right to ask arbiters to interpret BIT provisions against national legislation. Some countries expressed their worries that the principle of the "exhaustion of domestic recourses" would be overcome. Others pointed out that, insofar as domestic investors would not have recourse to international arbitration, there was discrimination in favour of foreigners.

V. Inconsistency.

Lack of consistency between arbitral awards dealing with similar issues has been a source of common complaint. The so-called umbrella clause has been a case in point.

[32] *Emilio Agustín Maffezini v. Kingdom of Spain*, No. ARB/97/7, award of January 25, 2000

In *SGS v. Pakistan*,[33] a Swiss company, SGS, had entered into a contract with Pakistan to provide pre-shipment inspection services with respect to goods to be exported from certain countries to Pakistan. Subsequently, Pakistan notified SGS that the contract was terminated. Both Pakistan and SGS initiated separate legal actions in Switzerland and Pakistan for breach of contract. SGS also filed a request for ICSID arbitration alleging that Pakistan had breached the contract and had also violated the BIT between Switzerland and Pakistan.

Pakistan objected to the Tribunal's jurisdiction, inter alias, because the dispute as submitted by claimant had arisen out of actions and omissions with respect to a contractual arrangement between Pakistan and SGS, which had a choice of forum provision different from ICSID.

SGS argued that by virtue of an, arguable umbrella clause (article 11) in the relevant BIT,[34] a breach of contract was elevated to a violation of a BIT. Thus, when the contract was breached SGS had two actions against Pakistan, one for breach of contract and one for violation of the BIT.

The Tribunal appeared to be the first ICSID Tribunal facing the issue of whether a BIT provision could transform a purely contractual claim into a BIT claim. It held that "…under general international law, a violation of a contract entered into by a State with an investor of another State, is not, by itself, a violation of international law".[35]

The Tribunal then stated that "…it is not saying that States may not agree with each other in a BIT that henceforth, all breaches of each State's contracts with investors of the other State are forthwith converted into and be treated as breaches of the BIT".[36]

However, in that case the Tribunal found that that was not the intention of the parties to the BIT, for which it rejected SGS's argument about article 11. The Tribunal pointed out that that article contained an obligation to constantly guarantee the observance of the commitments the State has entered into with respect to the investments of the investors of the other Contracting Party. Those commitments could imply implementing rules to give effect to contractual or statutory undertakings or could preclude a State from taking actions short of denial of justice.

The Tribunal concluded that it did not have jurisdiction over the contractual claim or over the contractual claim transformed into a BIT claim by virtue of an umbrella clause. However, it retained jurisdiction over the other parts of the BIT claim.

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[33] *SGS Societé Générale de Surveillance S.A. v. Islamic Republic of Pakistan*, International Arbitration Report, Vol 18, # 9, September 2003.
[34] Article 11 of the Switzerland-Pakistan BIT provided: "Either Contracting Party shall constantly guarantee the observance of the commitments it has entered into with respect to the investments of the investors of the other Contracting Party"
[35] *Supra note* 33 at paragraph 167.
[36] *Id* at paragraph 173.

In <u>*SGS v. Philippines*</u>, the Tribunal was faced with a question similar to the one made in SGS v. Pakistan. Specifically the Tribunal had to determine whether a breach of contract is considered a violation of a BIT as per an "umbrella clause".

The Tribunal in SGS v. Philippines had to analyze article X(2) of the Switzerland-Philippines BIT, which read: "Each Contracting Party shall observe any obligation it has assumed with regard to specific investments in its territory by investors of the other Contracting Party".

The question in place this time was whether that provision gave the Tribunal jurisdiction over claims against the Respondent State that were essentially contractual.

The Tribunal held that, "…if commitments made by the State towards specific investments do involve binding obligations or commitments under the applicable law, it seems entirely consistent with the object and purpose of the BIT to hold that they are incorporated and brought within the framework of the BIT by Article X(2)"[37].

The Tribunal then concluded, "…Article X(2) makes it a breach of the BIT for the host State to fail to observe binding commitments, including contractual commitments, which it has assumed with regard to specific investments. But it does not convert the issue of the extent or content of such obligations into an issue of international law…"[38]

Similarly the tribunal in the <u>*Azurix v. Argentina*</u> [39]case adopted the narrower view, holding that Azurix could not mount a claim for alleged breaches of the supposed umbrella clause in the U.S.-Argentina treaty, because Azurix was not itself party to any of the contracts which it alleged Argentina to have breached. In the earlier CMS v. Argentina ruling, the tribunal had allowed the foreign investor to claim for breaches of the so-called umbrella clause, although the contracts alleged to have been breached had not been entered into by CMS, but rather by other corporate entities.

In another case, <u>*LG&E v. Argentina*</u>,[40] a tribunal held that the umbrella clause of the U.S.- Argentina BIT because specific undertakings in the country's Gas Law, other implementing regulations, and in an international publicity campaign which accompanied Argentina's privatization of its public utilities had been breached by Argentina.

VI. An unbiased system.

As noted before, international investment law has been motivated by two reasons: foreign investors' protection and countries' economic development.

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[37] *Id* at para 117.
[38] *Id* at para 128
[39] <u>*Azurix Corp v Argentina, Award*, ICSID Case No ARB/01/12, IIC 24 (2006)</u>, 14 July 2006
[40] <u>*LG&E Energy Corp and ors v Argentina*, Decision on Liability, ICSID Case No ARB/02/1, IIC 152 (2006)</u>, 03 October 2006

The evidence shows that the interests of the foreign investors have been protected. Foreign investors have encountered in international investment law a shield that not only protects their property rights and sets minimum international standards of treatment but also a mechanism to make that protection enforceable under the form of international investment arbitration.

However, international investment arbitration has not been biased against the interests of the countries or in favor of the interests of the investors; a factor that speaks about the independence and neutrality of that alternative dispute resolution mechanism.

For instance, until the year 2003 of 18 awards on the merits issued by ICSID arbitral tribunals, the claimants, i.e., the investors prevailed in 10 awards, whereas in 8 awards their claims were dismissed and the States prevailed. In the context of NAFTA, the investors had prevailed in 2 awards and the States had prevailed in 4 awards.[41] More recent data available from investment arbitration cases filed under ICSID, UNCITRAL rules[42]or in other arbitration centers[43] shows a similar picture: Out of 46 cases where there was a partial or final award on the merits and where jurisdiction was upheld, investors prevailed in 27, but lost to the States in 19, including 4 in favor of the United States of America and 4 in favor of Mexico under NAFTA. [44] In 2006, of 46 cases where a final or partial award had been issued, the claims were dismissed entirely in 19 and wholly or partially upheld in 27.

But even in the cases where claims have been upheld, up to 2007 for all cases where claimants have been successful, 33.6% of requested compensation has been awarded. Additionally, the arbitral tribunals have awarded costs only in 18.5% of the cases and even in those cases, not all the costs have been awarded for recovery. The average costs awarded has been $ 2.4 million.[45]

Likewise, for developing countries under financial stress exorbitant awards could have a tremendous impact in economic development policies and affect their implementation. Perhaps for this reason, tribunals should consider issues such as level of poverty of the country in question, amount of public debt, fiscal deficit, along with the relevant arguments of the merits and impose awards --when needed-- that protect foreign investment but do not impair the economic development of the recipient countries. For example, in an investment arbitration case against Ecuador, the investor, American petroleum company Occidental was awarded $ 71 million.[46] For a country with 12 million people living below an annual income of $ 3,260 per capita, with a long term debt

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[41] WORLD BANK, WOLRD DEVELOPMENT REPORT 2004, chapter 9, box 9.4, page 181
[42] UNITED NATIONS COMMISSION FOR INTERNATIONAL TRADE RULES (UNCITRAL) RULES. *Available at* http://www.uncitral.org/ (last visited Jul. 20., 2006)
[43]Other arbitration centers such as the London Court of International Arbitration (LCIA) or International Chamber of Commerce (ICC) have issued investment arbitration awards, some of which are *available at.* http://ita.law.uvic.ca/
[44] *Id.*
[45] Richard Walck, "Current Statistics on Investment Treaty Arbitration", May 2, 2007, Presentation at the American Bar Association.
[46]U.N.CONFERENCE ON TRADE AND DEVELOPMENT, OCCASIONAL NOTE INTERNATIONAL INVESTMENT DISPUTES ON THE RISE, U.N. Doc. UNCTAD/WEB/ITE/IIT/2004/2 (NOVERMBER 29, 2004). By the time of publication of the article a newspaper reported that an arbitral Tribunal in the Azurix Copr V. The Argentine Republic had issued an award ordering Argentina to pay Azurix $ 165.2 million. Information *available at* http://www.clarin.com/diario/2006/07/18/elpais/p-01001.htm (last visited Jul. 20, 2006)

of $ 16 billion, a GDP of $30 billion[47] and a debt service of ratio of 31%, [48] an award of that magnitude could mean significantly less money devoted to economic development.

If we add the arbitration costs to the amount of the awards, the impact could be higher. Costs of investment arbitrations are high. In average costs of these cases range around $ 2 million in fees with around $ 400 thousand in pure costs under the low range. In some cases the fees have been as high as $ 4 million, as happened in Metalclad Corporation v. Mexico.[49]

VII. Investors' responsibility.

But abuses of legal personality can take place. Economic development reasons are not considered to disregard the legal personality of the subsidiary in order to ascertain the responsibility of the parent company. As it is at the moment, under article 25 (2)(b) ICSID Convention the legal personality of a wholly owned subsidiary can be disregarded but not for purposes of liability.[50] Accordingly, the purpose of the Convention's Article 25(2)(b) was to facilitate foreign investments through locally incorporated companies so that they could qualify to present claims at ICSID. Hence when the parties to the Convention have agreed to consider a local subsidiary as a foreign entity due to foreign control, the legal personality is disregarded on behalf of international law protection. Disregarding the personality of the local subsidiaries in order to consider them as nationals of the parent company's country works well for the interests of the investors who by this means would be entitled to international law protection in spite of the fact that the legal form of the subsidiary is that of a domestic entity. However, when the subsidiaries of foreign companies incur into activities that are inflammatory to the interests of the host countries quite frequently it is argued that those entities are independent and separate, that they are incorporated in the host country and subject to its laws and that responsibility for their acts should not be extended to the parent company.

[47] WOLD BANK, WORLD DEVELOPMENT INDICATORS, *available at* http://devdata.worldbank.org/data-query/ (last visited Jul. 20, 2006)

[48] THE ECONOMIST WORLD IN FIGURES 2006, page 41.

[49] The U.S. Government asked the losing party, the investor, for payment of $ 4 million in legal costs. This figure does not take into account the costs of a review of the award undertaken by a Canadian court. U.N. CONFERENCE ON TRADE AND DEVELOPMENT, OCCASIONAL PAPER, *supra note* 43.

[50] ICSID CONVENTION. Convention on Settlement of Investment Disputes Between States and Nationals of other States, Sept. 10, 1964, 1 U.S.T. 1270, 4 I.L.M. 524 (also known as the Washington Convention), Article 25

(1) The jurisdiction of the Centre shall extend to any legal dispute arising directly out of an investment, between a Contracting State (or any constituent subdivision or agency of a Contracting State designated to the Centre by that State) and a national of another Contracting State, which the parties to the dispute consent in writing to submit to the Centre. When the parties have given their consent, no party may withdraw its consent unilaterally.

(2) "National of another Contracting State" means:

(b) any juridical person which had the nationality of a Contracting State other than the State party to the dispute on the date on which the parties consented to submit such dispute to conciliation or arbitration and any juridical person which had the nationality of the Contracting State party to the dispute on that date and which, because of foreign control, the parties have agreed should be treated as a national of another Contracting State for the purposes of this Convention.

Thus, for the sake of balance international investment law instruments should also provide for circumstances under which the personality of the subsidiary should be disregarded in order to attain the parent company and make it responsible for the doings of entities under its control. Arbitrators should also consider that possibility when it is clear that the parent company is dodging responsibility by arguing the separation of legal personalities. Doctrines such as that of representation, piercing the corporate veil and *abus de droit*,[51] among others could be of use to arbitral tribunals willing to look beyond the corporate form.

In addition, given the nature of the ICSID arbitral tribunals and given the fact that their decisions are not binding and do not create precedent many decisions are inconsistent and frequently different tribunals facing similar issues take opposite decisions.

The signals for reform of the international investment arbitration system are coming from different countries. Bolivia has withdrawn from ICSID. Ecuador has notified ICSID that disputes involving natural resources, oil gas and mineral will not be submitted to its jurisdiction. In Ukraine the High Commercial Court said that any agreements among shareholders of Ukrainian joint stock companies containing non Ukrainian choice of law provisions or international arbitration clauses are null and void.

VIII. Proposal.

Thus, the proposal is not to return to gunboat diplomacy or to the Calvo doctrine according to which foreign investors had no right to international arbitration but had to be subject to the local courts. The proposal is not to the return of diplomatic protection for claiming State Responsibility for Injury to Aliens as the sole mechanism of protection of foreign investors. Rather the proposal is to a better and much more balanced system of international law of foreign investment; one where the economic development interests of the host countries play a role in the context of the negotiations of IIAs and in the context of dispute settlement procedures. Likewise mechanisms of responsibility of the parent company for the actions of the local subsidiary need to be devised. Similarly binding codes of conduct for multinationals need to be developed or incorporated into the IIAs where corporate good governance and environmental and social responsibility are covered. UNCTAD,[52] for example has advocated for establishing investor responsibilities directly in the IIAs, rather than leaving the host country with the right to impose them through its domestic laws. One way to do this is through a list of activities that are to be avoided such as human right violations or labor or environmental wrongdoings. Another way is to impose obligations that foster the host country's development. But the host country needs to have recourse to enforce the lack of compliance, not only against the subsidiary, but also against the parent and even the whole corporate group.

The mechanism of dispute settlement needs not only be reformed to provide for instruments that can guarantee consistency such as a permanent revision tribunal, but it also needs to be adapted to the needs of the poor countries which cannot cover the high

[51] CHENG, BIN, , GENERAL PRINCIPLES OF LAW APPLIED BY INTERNATIONAL COURTS AND TRIBUNALS, 121 (1987)
[52] UNCTAD, DEVELOPMENT IMPLICATIONS OF INTERNATIONAL INVESTMENT AGREEMENTS, 2007.

expenses of those procedures. A system of legal assistance to poor countries is probably something to be considered. That system can include capacity building mechanisms for Governments and private sector. For the former, capacity building can improve the countries' investment climate and thus avoid being subject to investment disputes. But the poorest countries lack the expertise and funds to defend themselves in the highly costly investment disputes. This is an area that requires special attention by the international cooperation.