International Investment Agreements

Their use and application by FDI Investors and issues for States

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Protecting Foreign Direct Investment

Making an investment into another state, known as foreign direct investment ("FDI"), generally carries a significantly different risk profile to investment in an investor's domestic market. FDI may be exposed to greater risks arising from the political, regulatory and economic environment of the state into which investment is made. State measures may prejudice the investment or even lead to state expropriation of an investor's assets.

The principal risks

The principal risks to which FDI is exposed include:

- political risk: political instability risks policy changes which may alter risk profile;
- judicial risk: jurisdictions vary in their approach to judicial independence and due process;
- discrimination: governments may implement measures to confer advantages on domestic businesses which prejudice FDI;
- economic risk: economic instability may affect FDI;
- civil unrest: may damage assets and prejudice FDI.

Protecting against FDI risks

It is not possible to protect FDI against all risks. Risks can, though, be managed by structuring investments to make use of International Investment Agreements (IIAs).

IIAs establish a framework of rights and obligations designed to protect FDI against such risks. Their purpose is to protect, and thereby facilitate, FDI. They do so by putting in place investor protections, based around rights including:

- minimum standards of fair treatment and guarantees against state expropriation;
- a dispute resolution procedure, which permits rights to be enforced through international arbitration, rather than in the courts of the host state, when a dispute arises;
- an entitlement to compensation where the host state breaches the protections available.

The main forms of IIA protection include:

- bilateral investment treaties (BITs): BITs are a form of agreement between two states by which each state confers protections on investors from the other state;
- multilateral investment treaties (MITs): MITs operate in much the same way as a BIT, but are made between multiple countries; examples include free trade agreements between multiple states and the Energy Charter Treaty for the energy industry;
- investment agreements entered into directly between the investor and the host state.

Some form of protection may also be available from domestic legislation in the host state.

A multi-layered approach, using a combination of these forms of protection, can maximise the protection available to investors.

Where are IIAs in operation?

IIAs are organised at bilateral, multilateral and regional levels. There are more than 2,500 IIAs in force worldwide. A searchable database of IIAs can be found **here.**

Where no treaty is in place between an investor's home country and the intended host country, an investor may 'forum shop' for a suitable home country from which to launch its investment; the same is true where a treaty between the host state and a third country provides a more advantageous basis for investment from the investor's perspective. Investors need to consider how to structure their investment to take advantage of IIAs.

Typical protections for investors

IIAs do not operate to one formula; inevitably there are variations in the rights and protections afforded to investors and the processes for enforcement of those rights and the resolution of disputes.

Common protections include:

General standards

- to afford fair and equitable treatment to investments made by investors from the other party state;
- to provide a secure environment and protection from threats or attacks targeted at FDI;
- international minimum standards: observance of rules of general international law;

Non-discriminatory treatment

- to prevent unreasonable or discriminatory measures (e.g. a denial of due process) against investors;
- to ensure investors from the other party state receive no less favourable treatment than nationals of the host state or of other third countries;

Expropriation

- to prevent expropriation or nationalisation of investments, except:
    - when taken in the public interest;
    - in line with applicable laws and due process;
    - without discrimination; and
    - on payment of prompt, adequate and effective compensation;

Transfer of investments and returns

- to permit the investor to repatriate capital and returns on investments, unless legitimate and clearly defined exceptions apply;

Umbrella clauses

- an 'umbrella clause' requiring the host state to comply with any other obligations it has entered into with the investor (which may permit an investor to bring contractual claims under the ambit of an investment treaty arbitration);

Dispute resolution

- a dispute resolution process, usually by way of international arbitration.

IIAs may include other protections such as the free movement of an investor's key employees.

Resolution of Disputes

International arbitration

IIA disputes typically provide for disputes to be resolved through international arbitration. The organisation most commonly designated by IIAs to hear and determine investment treaty disputes is The International Centre for the Settlement of Investment Disputes (ICSID).

ICSID's remit is limited, largely, to disputes between a state (or state agency or enterprise) and nationals of another state arising out of an investment.

Ratification of the ICSID convention does not, by itself, mean that the state submits to arbitrate all investments disputes through ICSID; that will be determined by the terms of the IIA.

Not all IIA disputes proceed through ICSID. Other dispute resolution organisations are sometimes nominated such as the ICC International Court of Arbitration amongst others.

Preconditions

The dispute resolution mechanisms of an IIA require careful consideration. Before launching arbitration, an IIA may impose preconditions such as obligations to negotiate, to litigate in the courts of a particular state or to wait a specified period before taking action, or some combination of similar preconditions.

Particular care needs to be taken where the IIA contains a 'fork in the road' clause, which imposes an obligation to elect for one dispute resolution mechanism (e.g. litigation in local courts) over another (e.g. arbitration), with the consequence that an election bars the right to pursue the alternative course.

Examination of the relevant IIA against IIAs between the host state and third states may also be worthwhile. If the dispute resolution mechanisms are less favourable when compared against those available to investors in other states, the protections of a 'most favoured nation' clause may permit arguments that the investor should be able to rely on the more advantageous protections offered to other investors.

Gateways Issues in IIA disputes

Two issues are central to the question whether claims may be brought:

- Does the investor qualify as an investor under the terms of the IIA?
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Who is an 'investor'?

Only a person who qualifies as an 'investor', within the meaning given to that term in the relevant IIA, will be able to pursue claims.

The definition of an investor will vary between IIAs, but it will typically mean either an individual who is a national of a state other than that in which the investment is made and which is a party to the IIA, or a corporate entity incorporated in such a state.

In an ICSID arbitration, the investor must also demonstrate that it is a national of another Contracting State of the ICSID Convention.

This issue can be complex in the modern world of multinational corporations. Particular complexities can arise where the investor is a corporate entity within a multinational group. They include where:

- the investor is a 'shell' holding company without substantial business activities in the state whose investors benefit from protection – some IIAs may deny protection to such companies;
- the investor is indirectly the owner of the investment via a holding company in a third jurisdiction – the investor claimant may

typically still be classified as an investor, but much may depend on the wording of the IIA and this situation may lead to claims by entities at different levels of the investor corporate structure;

- there are issues as to the timing of the investor's nationality – such issues may arise where a corporate investor did not hold the relevant nationality over the duration of the period between the events which gave rise to the claim and the commencement of the arbitrations, for example as a consequence of corporate restructuring;

- the investor is incorporated outside the state whose investors benefit from protections, but is controlled by an investor which is a national of that state – again, much may depend on whether the wording of the IIA permits claims in such circumstances.

Generally speaking, the broad drafting of many IIAs means that if a corporate entity is incorporated in a country which has entered into an IIA with the state which hosts the investment, it is capable of being an investor protected by the IIA, even if the ultimate beneficial owner of the IIA is a national of another state (but this may not always be the case and careful analysis of the IIA is required).

What is an 'investment'?

IIAs offer their own, generally fairly broad, definitions of qualifying investments, but they will typically include:

- property interests;
- shares and other interests (such as promissory notes or bonds) in companies in the host state;
- claims to rights under a contract;
- intellectual property rights;
- business concessions (for example, to exploit natural resources such as mining and fossil fuel licences).

If claims are brought in an ICSID arbitration, the claimant will, in addition, need to establish that the investment falls within the ICSID convention. The test generally applied in an ICSID arbitration assesses the investment by reference to the following criteria:

- a substantial commitment of funds or other assets of economic value;
- over a certain duration;
- involves the assumption of risk;
- contributes to the host state's development.

The approach of arbitral tribunals in applying these tests is variable and not beyond criticism.

Particular complexities can arise where:

- the IIA requires registration of all investments – it is always worthwhile exercising care in checking this point as a failure to register may exclude access to the protections on offer;

- the investment was made before the IIA came into force – the IIA may specify whether its protections extend to such investments but where it does not then the tribunal is likely to look at the date on which claim arose or notice of arbitration was given and if those dates are after the entry into force of the IIA, then they will probably fall within its scope;

- the investment is prevented before the investment contract is complete – there may be a question whether an intended investor can recover pre-contract expenditure where the host state takes action which causes the investment project not to start;

- the investment takes the form of portfolio investments (e.g. small shareholdings in companies in the host state, with little management control over the companies in question) or short term commercial loans – such investments may fall within a broad definition set out in a BIT, but may not meet the more rigorous criteria required to qualify under the ICSID convention.

IIAs within the EU

IIAs between EU member states

Many intra-EU IIAs exist, usually concluded prior to the accession of one member state. They are, however, a cause of tension between the EU institutions, which assert exclusive competence over investment disputes between member states and investors based within the EU, and arbitral tribunals which do not tend to support that view.

Particular concerns for the EU institutions include that arbitration clauses may deprive national courts of member states and the ECJ of their jurisdiction and incompatibility with EU law of provisions in pre-accession treaties.

One consequence is that valid IIA claims which succeed before an arbitral tribunal may face difficulties at an enforcement stage within the EU. For example, pre-EU accession benefits available to investors may constitute illegal state aid post-accession.

Pending formal resolution, investors within the EU find themselves caught between the political agenda of the EU and their apparently legitimate expectations of protections based on IIAs in force.

IIAs between EU member states and non−member states

It is the intention of the EU to phase out BITs from individual member states with non-member states in favour of uniform EU-wide BITs with non-member states.

Application of IIA's by FDI Investors

Structuring FDI

Legal due diligence at the pre-investment stage is essential. FDI investors will typically explore means of structuring an investment in a tax efficient manner; they should also explore the benefits of structuring the investment to take advantage of applicable IIAs. So called "Treaty Shopping" is legitimate, although care needs to be taken to structure the investment in a way which permits claims under the relevant IIA.

Considerations will include:

- identification of IIAs between the host county and third countries and assessing the advantages of launching the investment from one such country;
- if the home state does not have an IAA in place, exploring the scope for making the investment through a vehicle incorporated in a country which has a suitable IIA with the host country;
- verifying that the IAA is in force and is consistent with mandatory local law in the host state;
- examining the dispute resolution mechanisms available;
- exploring whether there is scope to negotiate favourable protections directly with the host state, in particular with a view to procuring guarantees that the investment framework

will remain stable and predictable;
such

guarantees are known as 'stabilisation clauses' and they will typically include provisions which 'freeze' local law that affects the investment for the life of the relevant project and which require the host country to indemnify the investor for loss caused by changes to local laws which hinder the investment project; stabilisation clauses are usually subjected to carve-outs which permit the host country to make changes aimed at improving socio-economic conditions for its citizens;

- if there are advantages to using the relevant IIA's provisions to manage likely taxation claims, rather than using the structure of Double Taxation Treaties.

Disputes

The use of IIAs to support investment policy making continues to see the implementation of new IIAs. In tandem, IIA arbitrations are also on the rise to enforce investors' claims against states.

UNCTAD publishes data on known investment state dispute settlement, although as many IIA arbitrations are subject to confidentiality the data will not capture all such claims. The data is available **here**.

The stakes in such claims tend to be high, with large sums at issue. The increasing availability of, and demand for, third party funding for investors' claims is likely to drive continued growth in IIA claims.

The London market for third party funding for litigation now exceeds £500m spread across a number of funds with individual funders being willing to provide legal costs funding in very large claims of £10m or more, if required.

Main issues in bringing IIA Arbitrations

In addition to the 'gateway' issues explored above, it is worth noting the following points which often require consideration, although the relevant treaty will always require careful assessment.

- Pre-conditions to arbitration:
    - Registration of investment;
    - Satisfying criterion for "Investor" and "Investment";
    - "Fork in the road" provisions requiring abandonment of claims in courts;
- Cooling off period, conciliation and notifying of claim;
- The correct arbitral institution and rules for the arbitration;
- Appointing the tribunal and the "seat" of the arbitration and the jurisdiction of any supervisory court;
- The substantive claim:
    - General standards;
    - Non- discriminatory treatment;
    - Expropriation;
    - Transfer of investments and returns;
    - Umbrella clauses and contacts between the investor and state.
- The award and enforcement under the New York Convention and other treaties.

Issues for States arising from IIAs

States need to:

- carefully consider the extent and terms of IIAs before entering into them;
- create standard IIAs;
- revise IIAs where appropriate and possible;
- have in place policies to ensure compliance with their terms so as to avoid claims being made under IIAs;
- make best use of the conciliation proceedings before arbitration commences, where practical and politically expedient.

Concerns for States regarding IIAs

States should pay particular attention to:

- how to properly exercise police powers and regulatory control, including where necessary expropriation;
- how to exercise regulatory measures within the scope of IIAs to protect:
  - health;
  - human rights;
  - social and economic objectives;
  - anti-corruption measures.

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Geraint is a seasoned litigator with a wealth of experience across many different types of business dispute and an eye for detail. He brings to the table an understanding not just of litigation and negotiation processes, but of the tactics and motives that underpin them, acquired through having “been there and done that”. He understands that every case is different and does not process cases according to a rigid template, but assists clients to achieve their commercial goals in an approachable and pragmatic way.

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