International Legal Framework on Foreign Investment

Background Paper prepared
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The International Legal Framework on Foreign Investment

A. Introduction

This background note provides an overview of recent trends in the international legal framework on foreign investment. The body of international investment law has grown rapidly, promoting investment liberalization and providing extensive rights and privileges to investors. The current framework does not adequately address environmental and social aspects linked to foreign investment. It does not in any way strengthen corporate accountability and corporate governance. Certain gaps in the present framework could be addressed in instruments relating to corporate governance.

This note does not take position or go into detail on the benefits and detriments of binding instruments versus voluntary codes on corporate accountability. It should be pointed out, however, that the current foreign investment rules -- while subjecting host states to binding obligations and providing private rights to foreign investors -- do not subject the foreign investor to any obligations. Moreover, investment rules do not provide other private stakeholders with any rights concerning the conduct of the foreign investor or of the host state. Many of the current instruments also provide for binding dispute settlement which can be initiated by the investor. No private stakeholder other than the foreign investor can initiate dispute settlement proceedings.

The *Governance Principles on Foreign Direct Investment in Hazardous Activities* which will be presented at Kiev Ministerial Conference "Environment for Europe" in May 2003 must take into account the current state of international investment law in which multinational companies operate. Some specific recommendations are made below. Recommendations of more general nature are not made in this note. However, if the *Governance Principles* are to contribute to a more balanced and sustainable framework on foreign investment, they must, at a minimum, provide for strong and independent monitoring and provide sanctions for non-compliance.

B. Background

In the last two decades of the 20th century, great changes have taken place in policies and legal structures relating to foreign investment. The rapid changes in foreign investment have found their expression in numerous bilateral and multilateral investment treaties. The proliferation of such instruments has direct impacts on national sovereignty, federalism, and states' ability to regulate in areas such as environmental protection and human health.

In the past, foreign investment was largely regulated domestically. In general, the only international rules that applied to some aspects of foreign investment were rules of customary international law, and their application was purely exceptional. With the adoption of bilateral investment treaties beginning in the 1980s, an international legal framework started to emerge. Both developed and developing countries were eager to negotiate investment rules in order to further transnational investment. Because domestic laws and policies can be changed unilaterally, while bilateral and multilateral rights and obligations cannot, industrialized countries have preferred to rely on treaties as a more stable basis for their companies wishing to invest abroad. Developing and countries in transition on the other hand hope to attract foreign investment through the granting of extensive investor protection in treaties. They believe that the existence of an investment treaty will influence an investor in its choice whether or not to invest and that an increase in foreign investment will contribute to rapid economic development. Whether investment treaties actually benefit potential host states is debatable. A recent World Bank report refers to research which seriously questions the efficacy of existing bilateral investment treaties in assisting developing countries in attracting new investment flows. The report advises that 'unilateral reforms to liberalize foreign direct investment (FDI) are likely to have the greatest and most direct benefit for the reforming country'.[1] Investors have many other considerations for deciding whether or not to invest into a country, including political instability, infrastructure, labor costs or the presence of skilled labor.

C. Bilateral and Regional Investment Treaties

To date, over 2000 bilateral investment treaties (BITs) have been concluded across the globe. The number of investment treaties increased rapidly over the past 20 years, with an accelerating pace in the past five years[2]. In 2001 alone, figures show that some 158 new BITs were adopted.[3] In addition, the past decade has seen a rapid increase in regional investment agreements among more than two states. The North American Free Trade Agreement (NAFTA)[4], which includes a chapter on investment, and was negotiated between the United States, Canada and Mexico, is one such example. Others include the Colonia Protocol on the Reciprocal Promotion and Protection of Investments within Mercosur[5], the Buenos Aires Protocol on the Promotion and Protection of Investments Made by Countries That are not Parties to the Mercosur[6], the Treaty on Free Trade Between Colombia, Mexico and Venezuela[7], and the Energy Charter Treaty.[8] The Free Trade Agreement of the Americas (FTAA), which also includes an investment chapter in

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[1] *See* www.worldbank.org/prospects/gep2003/.
[2] For a list of bilateral investment treaties and related information, *see* http://www.worldbank.org/icisid/treaties/intro.htm.
[3] United Nations Conference on Trade and Development, *World Investment Report 2002: Transnational Corporations and Export Competitiveness, available at* www.unctad.org/wir/
[4] North American Free Trade Agreement, December 17, 1992, Can.-Mex.-U.S., Pub. L. No. 103-182, 107 Stat. 2047 (NAFTA), reprinted in 32 ILM 289, text is also available at http://www.nafta-sec-alena.org.
[5] The Colonia Protocol on the Reciprocal Promotion and Protection of Investments within Mercosur, signed on January 17, 1994 and the Buenos Aires Protocol on the Promotion and Protection of Investments Made by Countries That are not Parties to the Mercosur, signed on August 8, 1994. Both protocols were concluded under the Asuncion Treaty Establishing a Common Market Between Argentina, Brazil, Paraguay and Uruguay (Mercosur), signed on March 26, 1991.
[6] The Colonia Protocol on the Reciprocal Promotion and Protection of Investments within Mercosur, singed on January 17, 1994 and the Buenos Aires Protocol on the Promotion and Protection of Investments Made by Countries That are not Parties to the Mercosur, signed on August 8, 1994. Both protocols were concluded under the Asuncion Treaty Establishing a Common Market Between Argentina, Brazil, Paraguay and Uruguay (Mercosur), signed on March 26, 1991.
[7] Treaty on Free Trade Between Colombia, Mexico and Venezuela, singed on June 13, 1994.
[8] Energy Charter Treaty, reprinted in 34 ILM 381 (1995).

its current draft, is presently under negotiation among 34 countries. This is currently the most ambitious attempt to unify transnational investment rules. While all these multilateral agreements are limited to a specific region, no global investment agreement exists to date. Negotiations under the auspices of the Organization for Economic Cooperation and Development (OECD) to adopt a global agreement on investment were broken off in 1998 when countries realized that granting extensive investor protection could lead to serious problems for the host state to regulate in areas such as the environment and public health and that the negative effects of a far reaching investment agreement could outweigh the benefits of investment liberalization and investor protection.[9] In September 2003, Members of the World Trade Organization (WTO) will decide whether they will initiate negotiations for a global agreement on investment.

D. Substantive International Investment Law: Investment Liberalization and Investor Protection

Investment treaties, both bilateral and regional, usually incorporate two types of issues. One group of provisions concerns investment liberalization, the other covers investor protection. The former category is based on the idea that investment liberalization leads to higher economic efficiency. These provisions aim at a decrease or elimination of restrictions on the entry and operation of foreign investment in a host country. The second group of provisions concerns the protection of foreign investments against government action once established in the host country. Both groups of provisions are included in virtually all investment agreements in varying forms.

A brief overview of the substantive rules that are usually included in investment treaties and related concerns are described below:

National Treatment: Under most investment treaties, the host country must treat the foreign investor no less favorably than it treats domestic investors in like circumstances. While at first blush this requirement seems unobjectionable, in practice the national treatment obligation is problematic because it requires the comparison of activities that are not necessarily easy to compare. Recent cases under the NAFTA, for example, show that investment tribunals tend to rely primarily on business considerations when comparing domestic and foreign investments, rather than looking into the environmental and legal circumstances.[10] Thus, if a domestic company were to be treated differently from a foreign company because its production process was more environmentally sustainable, the host state could be sued for breach of the national treatment obligation -- hardly a result that supports sustainable development policies.

Minimum Standard of Treatment: Many investment treaties include a minimal treatment standard that requires that a host State treat the foreign investor in accordance

[9] Members of the Organization for Economic Cooperation and Development (OECD) decided to discontinue negotiations on the Multilateral Agreement on Investment (MAI), *see* UNCTAD, *Lessons from the Mai*, New York and Geneva, 1999.

[10] *See* S.D.Myers, Inc. v. Canada at http://www.appletonlaw.com/cases/Myers%20-%20Final%20Merits%20Award.pdf

with international minimum standards of fair and equitable treatment. Traditionally, this type of provision applied only to extreme cases of mistreatment, however, tribunals under NAFTA's investment chapter have interpreted this provision extremely broadly, finding that almost any behavior perceived as unfair by the investor could be in breach of the minimum standard. In response to this troubling expansion of the scope of this provision by arbitral panels, the trade ministers of the NAFTA parties issued an interpretive note in July 2001 attempting to curtail extensively broad interpretations. The exact scope and effect of both the interpretive note and the underlying obligation remain unclear.

Performance Requirements: Investment agreements prohibit the use of a number of "performance requirements," which have traditionally been used by developing countries to ensure that foreign investment furthered their developmental goals. Examples of performance requirements include technology transfer obligations, local hiring and training requirements, and domestic content rules. Being able to guide incoming investments so that they meet local and national priorities is critical to harness private investment to further environmentally and socially sustainable development. NAFTA, for example, disallows such controls 'in connection with the establishment, acquisition, expansion, management, conduct or operation of a foreign investment.'[11] The language makes clear that performance requirements are disallowed at every stage of the investment, thus significantly weakening the bargaining position of developing country governments to promote national environmental and social goals.

Expropriation: A central provision of investment agreements is a prohibition on uncompensated expropriation or taking of investors' assets. Early instruments dealing with foreign investment usually contained provisions regarding "nationalization" and/or "expropriation". These terms were understood to cover direct expropriations of property by the host state through legislative or administrative measures, which resulted in a compulsory transfer of property rights. More recent investment treaties expanded the scope of expropriation to include indirect expropriation. Indirect expropriation is also referred to as "disguised" or "creeping expropriation" and is the equivalent of a "regulatory taking" under U.S. law. In this context, the question arises whether an indirect expropriation also includes actions, which fall generally within the police powers of a state. International law and practice appear to exclude the normal exercise of sovereign regulatory powers from the obligation to compensate for expropriation. However, tribunals addressing this question have interpreted indirect expropriations to include regulations that aim to protect the environment and public health.[12]

As a consequence, public interest groups as well as governments have expressed concerns about the potential chilling effect of such provisions on the ability and willingness of governments to adopt and implement environmental and other public welfare regulations.

[11] NAFTA Article 1106.1.
[12] *See e..g.* Metalclad Corp. v. United Mexican States, Int'l Centre for the Settlement of Inv. Disputes, No. ARB(AF)/97/1 (2000).

E. Investor-to-State Dispute Settlement

In the past, disputes concerning the application of a treaty or the interpretation of its provisions were primarily resolved by state-to-state arbitration or adjudication before the International Court of Justice (ICJ). For example, in the post-World War II era, treaties of friendship, commerce and navigation to which the U.S. was a party usually included a state-to-state dispute settlement mechanism to resolve investment disputes. The negotiation of bilateral investment treaties in the early 1980s, however, brought a shift in the resolution of disputes and began to introduce investor-to-state arbitration rules.[13] It appears, though, that international arbitrations were initiated only rarely and that the main function of the treaties was to send positive and reassuring signals to investors.

Only in the past five years, has the use of investor-to-state dispute settlement to resolve disputes arising from investment agreements soared due to the increasingly aggressive approach by investors in initiating proceedings against host countries. Investor-to-state dispute settlement extends to investors the right to initiate international arbitration proceedings against the host state if the investor believes that one of the host state's obligations has been breached. In the past few years, investors have used this mechanism aggressively to push their agenda. While investment agreements were traditionally thought of 'as recourses of last resort, aimed at protecting an investor through extraordinary means in extraordinary circumstances',[14] investors have now begun using the tools offered under investment treaties to 'attack' rather than to gain protection. Moreover, threats to initiate arbitral proceedings are becoming routine lobbying instruments for transnational investors. For example, in one NAFTA investment case[15] the investor initiated proceedings while the environmental measure allegedly violating the NAFTA investor protection provisions was still being debated in the host state's parliament.

The dispute settlement provisions included in the various investment treaties usually refer to arbitration mechanisms, such as the International Center for the Settlement of Investment Disputes (ICSID), part of the World Bank Group, the arbitration facilities of the International Chamber of Commerce (ICC) in Paris, or the Stockholm Chamber of Commerce (SCC) among others. Some dispute settlement clauses do not refer to any particular arbitral institution but instead refer ad-hoc arbitration under UNCITRAL arbitration or other rules. While under ICSID rules cases launched are publicly registered and listed on ICSID's web site, other arbitration mechanisms do not publicize cases at all. No arbitration rules, including those under ICSID, require open hearings or public access to documents and decisions.

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[13] *See* Report of the United States General Accounting Office to the Chairman, Subcommittee on Trade, Committee on Ways and Means, House of Representatives, *NORTH AMERICAN FREE TRADE AGREEMENT, U.S. Experience With Environment, Labor, and Investment Dispute Settlement Cases* (July 2001), GAO-01-933, at page 33.

[14] *See* WWF and IISD, *Private Rights, Public Problems, A Guide to NAFTA's Controversial Chapter on Investor Rights*, at page 16.

[15] Ethyl Corp. v. Canada, Award on Jurisdiction.

The secrecy and absence of public knowledge about cases gives investors exclusive lobbying powers, especially at the beginning stages. Furthermore, the decisions issued by tribunals are binding and are not subject to appeal. Only very limited review is possible, for example, in cases of procedural deficiencies or where a decision has been made beyond the scope of submission to arbitration. Legal mistakes and misinterpretations of treaty provisions, however, cannot be reviewed and corrected. Investment treaties usually do not require the exhaustion of domestic remedies, something that is usually required under international law.

F. Concession Contracts

Concession contracts or so called host government agreements also constitute an important element of the international investment regime. They are entered into by governments and foreign investors to discipline their undertakings in investment projects. Through these concession contracts, foreign investors usually acquire rights to explore and exploit natural resources, including for example access to water, forests, minerals, fisheries, etc. In spite of the fact that access to natural resources raises important public-interest concerns, these contracts are negotiated behind closed doors, without public consultations. The covert character of these contracts greatly undermines the ability of civil society to raise public-interest concerns.

The host government agreements involved in the Baku-Tbilisi-Ceyhan (BTC) Crude Oil Pipeline Project, for example, involve various worrisome provisions. The standards of expropriation, for instance, go well beyond what is established in international law. Also, the stabilization clauses provide that the host government shall 'take all action available' (including exemptions from the law) to 'restore the economic equilibrium' that could be affected through any new health, environmental, tax, or labor legislation. As a consequence, it is likely that the host governments will be reluctant to adopt any new environmental or other legislation involving a reduction of expected profits for the investor.

Most host government agreements include a dispute settlement clause referring to international arbitration. Additionally, recent (March 2003) bilateral Free Trade Agreements concluded between the United States and Singapore and between the United States and Chile, provide that the breach of such agreements is a new and separate cause of action for investors against host governments before international arbitral tribunals. Thus, the non-transparent structure of the investment dispute-settlement system used in the context of international investment treaties described above, is also inherent to disputes arising from host government agreements.

G. Mechanisms for Advice, Monitoring and Public Participation

Different formulas for multi-stakeholder advisory or monitoring committees are starting to be crafted and used in the context of international trade and investment. British Petroleum, for example, set up an 'independent external advisory panel' to ensure that the Baku-Tbilisi-Ceyhan pipeline project 'sets new standards in responsible development'.

The panel commenced its work in early 2003 'and will provide objective advice to the company on the economic, social and environmental impacts in the three countries Azerbaidjan, Turkey and Georgia. The Panel is funded by BP and will have a secretariat. While this specific example has raised a host of concerns regarding the panel's independence and the procedures followed for the election of the panel members, specially created advisory mechanisms -- if well crafted -- could allow for more sustainable foreign investment and citizens' involvement.

Another example is the mechanism which was established under an environmental side agreement to the NAFTA, the North American Agreement on Environmental Cooperation (NAAEC). The main goal of the NAAEC is the promotion of effective enforcement by the Parties of their domestic environmental legislation. Under the NAAEC's Articles 14 and 15, anyone living in any of the three NAFTA countries can submit a claim to the Commission for Environmental Cooperation (CEC) (a commission established pursuant to the NAAEC), alleging that a government appears to be failing to enforce its environmental laws effectively. Following a review of the submission, the CEC may investigate the matter and publish a factual record of its findings, subject to approval by the CEC Council, which consists of the environmental ministers of the three NAFTA parties.

These two types of mechanisms offer two different ways how environmental concerns and public participation might be structured. While the former mechanism focuses on a specific project and is privately funded, the latter involves governments and has a more general focus on environmental law enforcement. In the context of foreign investment it appears useful to establish an institutionalized body which can receive citizens' submissions and/or has the power to make factual findings regarding the implementation of a host state's environmental laws.

H. Recommendations for the Governance Principles

Recommendation 1: Arbitral proceedings lack transparency and are inaccessible to the public. When foreign companies engage in potentially harmful activities, public access to information is of particular importance. The public has the right to know about the foreign investor's activities, especially where issues of public interest, such as environmental protection and health, are concerned. In the context of the existing international legal framework on foreign investment, and particularly in the context of investor-to-state dispute settlement, it would thus be useful to complement the *Governance Principles for Foreign Direct Investment in Hazardous Activities* with a paragraph requiring that investors agree that any arbitration between the investor and the host state be made public, including the intent to arbitrate, the notice of arbitration, submissions to the tribunal, and decisions of the tribunal. Hearings should also be open to the public. Finally, investors involved in an investor-to-state dispute should specifically agree to allow amicus submissions by affected communities.

Recommendation 2: Host government agreements typically involve issues of public interest, such as environmental and social concerns. Thus, it is essential that the public have access to all relevant documents and be consulted at an early stage of the negotiations. *The Draft Governance Principles* should explicitly address this need.

Recommendation 3: The OECD Guidelines for Multinational Enterprises state that 'enterprises should refrain from seeking or accepting exemptions not contemplated in the statutory or regulatory framework related to environmental, health, safety, labour, taxation, financial incentives, or other issues.' The types of host government agreements that are currently being negotiated by multinational enterprises are clearly not in line with this OECD principle. The *Draft Governance Principles* already refer to the OECD Guidelines. However, the *Governance Principles* should elaborate on the OECD principle to more clearly reflect the need for companies to abide by existing laws as well as subsequent changes in laws. Even where environmental or health standards and regulations affect expected profits, companies should not seek exemption from such legislation through host government agreements or other instruments. Moreover, investors should refrain from discouraging the adoption or seeking the repeal of new environmental and health legislation.

Recommendation 4: Different models of multi-stakeholder advisory or monitoring committees for foreign investment projects should be explored. When different models are assessed, it should be kept in mind that especially models involving private advisory or supervisory panels should be crafted carefully and in a transparent manner to ensure independence**.**