1 The Investment Treaty Regime in Context

Introduction

Few people had heard of investment treaties until very recently. Most of these treaties had been negotiated by mid-level government officials and with little public awareness. Parliaments and the media rarely paid much attention as compared to other globalization instruments, such as preferential trade agreements (PTAs) (Figure 1.1). Until a few years ago, investment treaties and investment treaty arbitration were examples of 'supranational governance activities that [went] virtually unnoticed' (Esty quoted in Montt 2009, 143).

Lawyers and legal scholars have appreciated the importance of investment treaties for some time. However, unlike in the international trade regime, where legal scholars have a long history of engagement with political scientists and economists (e.g. Hoekman and Kostecki 1995; Trebilcock and Howse 2005), lawyers have been slow to integrate insights about the political and economic foundations of the investment treaty regime.

This is not surprising, as there has been very little engagement with investment treaties in scholarship from politics, economics, and business. Introductions to the field of international political economy barely mention investment treaties (e.g. Gilpin 2001, 300; Oatley 2010, 205–12; Ravenhill 2011, ch. 11).[1] And while political scientists increasingly write about the investment treaty regime, the literature is still in its infancy compared with the more advanced scholarship on the trade regime. Economists have almost entirely ignored the regime—even in texts devoted to foreign investment (Navaretti, Venables, and Frank 2006, 252, 269–70)—and scholarship on international business management also tends to ignore investment treaties (for an exception, see Moran 2007). This lack of engagement leaves major gaps in our understanding of the micro- and macroeconomic underpinnings of investment treaty arbitration, as well as the practical implications of the regime for international business management and politics.

[1] Before the rise of investment treaty arbitration, even the main textbook on international investment policy spent less than ten pages on BITs (Brewer and Young 2000, 74–8). Cohn (2011) includes two pages on BITs.

4 Standards of Investment Protection

Introduction

This chapter introduces the substantive obligations in investment treaties. Although the treaties differ, most offer a common core of six substantive protections to foreign investors: most-favoured nation treatment (MFN); national treatment (NT); fair and equitable treatment (FET); a guarantee of compensation for expropriation; an umbrella clause; and a free transfer of funds clause. While investment treaties contain other substantive protections—such as the guarantee of full protection and security—many of these provide overlapping protection from host state conduct that would also breach one of the six core standards. Table 4.1 shows how common the main provisions are in investment treaties.[1]

In any given investment treaty arbitration, investors typically claim that the host state breached two or more substantive protections of the investment treaty. At the heart of most arbitrations are three so-called 'absolute' standards of protection: expropriation, the umbrella clause, and FET—standards that have no analogue in the international trade regime (Kurtz 2016, 79). The application of these three standards is normally decisive for outcomes in investment treaty arbitration, with FET playing a particularly important role. Table 4.2 shows how often investors have alleged breaches of substantive protections, how often investment tribunals have upheld each type of claim, and the success rate for each.

This chapter proceeds as follows. The first section examines MFN and NT, two 'relative' standards of protection. As described in Chapter 1, they are relative standards in the sense that their application requires a comparison of the way a state treats one foreign investment with the way it treats one (or more) other investments. The second section turns to four 'absolute' standards of protection: expropriation, FET, umbrella clauses, and free transfer of funds. They are 'absolute' in the sense that they require host states to guarantee foreign investors certain standards of treatment, regardless of how they treat

[1] We cross-checked the percentages by hand-coding a representative sample of 400 of the treaties used in Table 4.1. The percentages are similar to other studies. For example, Pohl, Mashigo, and Nohen (2012) find that only 6.5 per cent out of 1660 investment treaties do not include investor–state arbitration.

Table 4.1 Frequency of investment treaty provisions

	Investment treaties containing provision (%)
Most-favoured-nation treatment	95%
Expropriation	95%
Investor–state dispute settlement	90%
Fair and equitable treatment	90%
Free transfer of funds	80%
Full protection and security	70%
Losses sustained due to insurrection, war	70%
National treatment	60%
Arbitrary, unreasonable, and/or discriminatory treatment	45%
Umbrella clause	45%
Exceptions	10%
Performance requirements	5%

Source: Author compilation from 1602 investment treaties from UNCTAD's International Investment Agreements Navigator, last updated by UNCTAD in July 2016.

Table 4.2 Breaches of investment treaty provisions alleged and found in known investment treaty arbitrations

	Alleged/share of 739 arbitrations	Breach found	Success rate
Fair and equitable treatment	368/50%	93	36%
Indirect expropriation	331/45%	47	20%
Full protection and security	197/27%	19	13%
Arbitrary, unreasonable, and/or discriminatory treatment	163/22%	24	19%
Umbrella clause	107/14%	13	17%
National treatment	106/14%	8	13%
Most-favoured-nation treatment	84/11%	0/21	0%/41%
Direct expropriation	81/11%	19	42%
Other	50/7%	9	22%
Free transfer of funds	27/4%	2	10%
Performance requirements	12/2%	3	30%

Note: In the 'found' column for MFN, the '0' relates to better treatment granted to the investor/investments of a third nationality other than by virtue of another investment treaty; '21' refers to better treatment based on a third investment treaty where investors used the MFN clause as a stepping stone to another substantive guarantee (on this distinction, see the following text). Success rates are calculated as a percentage of decided cases (not shown). These rates exclude settled, pending and discontinued cases, which column 1 includes.

Source: Author compilation from 739 known investment treaty arbitrations in UNCTAD's Investment Dispute Settlement Navigator, with a few corrections of the coding by the authors. Last updated by UNCTAD in September 2016.

other investments. As investment treaty protections are often formulated in vague, imprecise terms, arbitral tribunals have a great degree of discretion in their interpretation and application. Consequently, each section considers how arbitral tribunals have interpreted and applied the six core treaty provisions in practice.

The third section examines carve-outs that remove certain state measures from the scope of application of investment treaties, defences that can justify

or excuse breaches of investment treaty protections, and the standard of review that tribunals apply when examining host state conduct. Together, these three issues have a significant impact on the scope of a host state's obligations under investment treaties. The fourth and final section discusses the calculation of compensation or damages if host states have breached investment treaties.

Relative standards of protection: MFN and NT

This first section introduces the two relative standards: MFN and NT. MFN and NT protect foreign investors from discrimination based on the nationality of the investor. With the exception of using MFN to import provisions from *other* investment treaties (see Table 4.2), MFN and NT have only played a peripheral role in the investment treaty regime. This is in contrast with the international trade regime, where relative standards of treatment are the core, and is arguably for three reasons. First, with respect to national treatment, Chapter 1 described that the trend in investment policy since the 1990s has been for states to provide established foreign investors with equal treatment, and, in some cases, better treatment than domestic investors. Second, the narrow prohibition of discrimination on grounds of nationality leaves host states leeway to distinguish between investors based on other criteria supported by legitimate policy objectives—for example, imposing more stringent environmental requirements on investment in sectors that have greater environmental impacts. Third, the MFN and NT provisions of most investment treaties apply only after an investment has been made in the host state ('post-establishment'). This leaves host states free to impose discriminatory requirements on the admission and establishment of new foreign investment ('pre-establishment').

This section begins by examining the application of these twin non-discrimination standards to investments that host states have already admitted, before turning to the more recent extension of NT and MFN obligations to the pre-establishment phase. This shift has major policy implications and promises a greater role for NT and MFN in the future (see further Chapter 6).

POST-ESTABLISHMENT MFN AND NT

NT and MFN clauses bar host states from drawing nationality-based distinctions among investors. MFN prevents host countries from treating foreign investors of one nationality better than foreign investors of another nationality. NT prevents host states from treating its own investors better than foreign investors. Both clauses are typically broadly formulated, and traditionally

apply to all state conduct affecting foreign investment. They are not normally subject to significant exceptions.

Both clauses prohibit *de jure* and *de facto* discrimination. *De jure* discrimination refers to the situation when a legal instrument—for example, a law of the host state or another investment treaty (see the following text)—provides less favourable 'treatment' to foreign investors on grounds of nationality. *De jure* discrimination is simple to identify, as it arises from explicit nationality-based distinctions contained in legal texts (Schill 2009, 218–21)—for example, a law that explicitly imposes more onerous regulatory requirements on investors of one nationality than investors of another nationality. In claims for *de jure* discrimination, the main issue has been the types of 'treatment' that fall within the scope of the relevant treaty provision.

By contrast, *de facto* discrimination refers to the factually disparate treatment of investors/investments of different foreign nationalities in cases where relevant laws and policies do not expressly discriminate between investors by nationality. As the burden of complying with laws that are not explicitly discriminatory often falls more heavily on some investors than others, identifying *de facto* discrimination raises more complex and controversial questions than *de jure* discrimination. A particular source of controversy has been whether a law that purports to address a legitimate policy aim, such as the protection of the environment or public health, amounts to *de facto* discrimination because the burden of complying with that law falls more heavily on foreign investors than domestic investors. The following section discusses these issues.

POST-ESTABLISHMENT MFN

MFN clauses appeared in the earliest investment treaties (e.g. the Germany–Pakistan BIT of 1959), and more than 90 per cent of investment treaties contain them (Table 4.1).[2] To illustrate the implications of the MFN provision, consider the following combined MFN/NT clause in the Austria–Kazakhstan BIT (2010).[3]

> Each Contracting Party shall accord to investors of the other Contracting Party and their investments or returns treatment no less favourable than it accords to its own investors and their investments [NT] or to investors of any third country and their investments or returns [MFN] with respect to the management, operation, maintenance, use, enjoyment, sale and liquidation as well as dispute settlement of their investments or returns, whichever is more favourable to the investor.

[2] An exception to this trend is the Japan–Singapore FTA (Brown 2013, 360).

[3] In early investment treaties, both MFN and NT are frequently combined in a single provision. More recent investment treaties tend to contain separate and more detailed clauses, including exceptions—for example, Articles 3 and 4, US Model BIT 2012.

Under this MFN clause, Kazakhstan agrees to treat Austrian investors and investments at least as well as investors and investments from third countries. Austria made a reciprocal MFN commitment to Kazak investors. As such, Austria could not give more favourable treatment to US investors in an investment treaty or in an Austrian law than it gives to Kazakh investors. For example, if an Austrian law granted subsidies to established US investors in a particular sector, *established* Kazakh investors in that sector would be entitled to the same subsidy on account of the MFN provision of the Austria–Kazakhstan BIT. Crucially, for *de jure* discrimination, it is enough that a *hypothetical* investor in like circumstances be entitled to better treatment as a matter of law (Schill 2009, 519). A Kazakh investor would not need to identify a US investor operating in Austria that actually benefits from the subsidy.

There are at least three points of contrast between MFN obligations in the trade and investment treaty regimes.[4] First, in the investment regime, MFN obligations are bilateral, owed only to investors with the nationality of the other treaty party (here, by Austria to Kazakh investors and vice versa). In contrast, in the trade regime, MFN obligations are multilateral, owed by each WTO member to all 163 other WTO members (WTO 2016). Second, the scope of the MFN obligation in the trade regime operates 'within the relatively confined framework of the WTO covered agreements' (McRae 2012, 19). For example, the GATS allowed WTO members to provide for MFN exemptions on accession. Third, built-in exceptions to MFN in investment treaties are rare, unlike in trade agreements. For example, Article XXIV of the GATT carves out FTAs and custom unions from the operation of the MFN clause to the extent necessary for their formation (Bhagwati 2008)—a very significant limitation of MFN, given the proliferation of FTAs.[5]

Whereas MFN has played an important role in the trade regime (Kurtz 2016), its role in the practice of investment treaty arbitration has been limited. To date, no investment tribunal in a publicly available award has found that a host state breached MFN by treating a foreign investment from one state worse than a foreign investor from a third state (see Table 4.2, cf. also Caron and Shirlow 2015, 400). Thus far, MFN has exclusively functioned as an enabling device to import more favourable provisions from another investment treaty. This is by far the most important practical effect of MFN provisions in the modern investment treaty regime, and therefore the focus of the paragraphs in the following text.

[4] The comparison in this paragraph is between the WTO and investment treaties, leaving aside the MFN provisions of trade in goods and trade in services chapters of PTAs. Note that few disputes under PTAs are resolved in formal dispute settlement, with the exception of NAFTA and Mercosur (Davey 2007). See generally Allee and Elsig (2015).

[5] Similar carve-outs are found in some investment treaties—for example, those based on Singapore's de facto model BIT (Ho 2013, 637)—but are surprisingly uncommon.

Although most investment treaties share a common core of substantive protections, there is a degree of variation in such provisions between treaties. This heterogeneity of obligations, coupled with the reference to all 'treatment' in typical MFN clauses, has opened up space for arguments that the (higher) level of protection promised to foreign investors of a third state by an investment treaty between the host state and a third state qualifies as 'treatment' under MFN clauses. Under this interpretation of MFN, host states are bound to extend the most advantageous protections granted to the foreign investors of *any* of its treaty partners to a foreign investor that is covered by an investment treaty containing an MFN clause. Accordingly, some tribunals have allowed foreign investors covered by one investment treaty to invoke more generous substantive and procedural obligations contained in a host state's other investment treaties.

In this way, MFN clauses serve to 'multilateralize' substantive and potentially procedural guarantees across the investment treaty network (Schill 2009). The effect is to harmonize upwards states' obligations to foreign investors to the highest level of protection provided in *any* treaty of the host state. As a result, a state may owe foreign investors in its territory a combination of obligations that are more onerous than those found in any one investment treaty (considered individually) to which it is a party. Despite being made up of bilateral treaties, MFN provisions thereby give the investment treaty regime a multilateral flavour. Apart from the practical implications, this is also important for how empirical researchers test the effects of investment treaties, something we return to in Chapter 6.

One of the known investment treaty arbitrations in which the investor successfully relied on the MFN to import substantive protections from another investment treaty is *White Industries v. India* (2011). An Australian investor in India sought compensation under the Australia–India BIT for the Indian court system's 8-year delay in enforcing a commercial arbitration award against an Indian state-owned company. The Australia–India BIT did not contain any provisions explicitly dealing with judicial processes; however, it did contain a standard post-establishment MFN provision. The tribunal accepted the investor's argument that the investor was entitled to use this MFN provision to rely on a provision of the Kuwait–India BIT, in which India guaranteed to provide Kuwaiti investors with an 'effective means of asserting claims and enforcing rights with respect to investments'. The tribunal held that India breached this standard.

This importation of substantive provisions from other investment treaties contrasts with how MFN provisions work in the trade regime. Even more controversial, however, is whether MFN clauses allow investors to invoke more favourable *procedural* dispute settlement guarantees in other treaties (Banifatemi 2009; Douglas 2010; Maupin 2011). The answer again turns on

the range of 'treatment' that the MFN provision in question covers, and, more precisely, whether MFN clauses cover variations of arbitral procedure, and the extension of subject matter and temporal jurisdiction. As most MFN provisions do not specify whether 'treatment' includes procedural rights conferred by other treaties, it has fallen to arbitral tribunals to resolve this matter.

As Table 4.3 shows, arbitral tribunals are divided on whether MFN can be used to invoke more favourable dispute settlement procedures in other investment treaties. For example, in the case of *Maffezini v. Spain* (2000), a foreign investor successfully used an MFN provision in the Argentina–Spain BIT to circumvent a procedural requirement in that BIT to exhaust local remedies—that is, to litigate first in the Spanish domestic courts—before commencing arbitration. Another Spanish BIT did not contain this procedural requirement. The tribunal's rationale was that such procedural advantages under this second BIT were 'essential for the adequate protection of the [substantive] rights they sought to guarantee' and, therefore, fell within the range of 'treatment' covered by an MFN clause of the Argentina–Spain BIT (para. 55). Other tribunals have disagreed with this reasoning, however, and stressed the undesirability of displacing specifically negotiated procedures between the two state parties (*Plama v. Bulgaria* 2005).

Table 4.3 Use of MFN to import different types of provisions

	MFN invocation successful?		
Type of MFN question	Yes	No	Dissent
Change arbitral procedure	11	3	4
Extend temporal scope	0	2	0
Expand subject matter scope	1	11	3
Import substantive obligations	9	1	0
Better treatment	0	13	0
Totals	21	30	7

Note: *Change in arbitral procedure*: investor attempts to invoke more favourable dispute settlement procedures in another investment treaty. *Extend temporal scope*: investor attempts to invoke the broader temporal coverage of another investment treaty. *Expand subject matter scope*: investor attempts to invoke the broader range of 'investments' or government measures covered by another investment treaty. *Import substantive obligations*: investor attempts to invoke substantive protections contained in other investment treaties. *Better treatment*: the investor alleges that the host state offered better treatment—other than in a third investment treaty—to investments/investors of a third nationality. The table is limited to decided cases that are publicly available (a significant number of pending and settled cases in which investors invoked the MFN clause but no further information is available is left out). For the last two categories—the importation of substantive obligations and better treatment—the table only includes cases where the tribunal reached a finding on the investor's MFN claim (i.e. it excludes cases in which the tribunal declined jurisdiction and also cases such as *Bilcon v. Canada* (2015) in which the tribunal did not decide the MFN claim). In addition, in four cases in the fourth category, tribunals did not allow the investor to bypass exceptions based on the MFN clause, or found that the investor failed to show that another BIT was more favourable. In another dozen cases, tribunals did not decide the claim that investors could use the MFN clauses to import substantive provisions.

Source: Authors' coding of arbitral awards. The first three rows draw on Box 2 in Maupin (2011, 172), extended and updated by the authors.

Foreign investors have also attempted to use MFN provisions to expand the coverage of an investment treaty to include types of disputes and investments that fall outside the coverage of the treaty in question, but within the broader jurisdictional parameters of another of the host state's investment treaties. There is virtually no support among tribunals for the use of MFN clauses to expand an investment treaty's jurisdictional scope in this way. This is because an investor is only able to benefit from the MFN provision of an investment treaty if it first establishes that it falls within the scope of that treaty's coverage. An investor that falls outside the coverage of an investment treaty is simply not entitled to the benefit of that treaty's MFN provision, meaning that it has no entitlement to demand more favourable treatment of any sort provided by a host state's other investment treaties.

The extent to which MFN provisions allow investors covered by one investment treaty to benefit from the more favourable substantive and procedural provisions of other investment treaties has been controversial. In response, some states have begun to draft MFN provisions in new investment treaties more precisely.[6] For example, the Austria–Kazakhstan BIT cited in the preceding text expressly extends MFN to dispute settlement—a reaction to arbitral awards that excluded procedural matters from MFN clauses. Conversely, the MFN provisions of other new investment treaties, such as the TPP, explicitly prevent the importation of procedural provisions from other investment treaties.[7] Some new treaties, such as CETA, go even further and prevent the importation of *both* substantive and procedural treaty provisions.[8] Such limits on importation of terms from other investment treaties are essential if a state wishes to enter into new investment treaties that grant lower levels of protection than its existing treaties. Moreover, the approach in CETA is similar to how MFN clauses operate in the trade regime. If CETA is ratified and future investment treaties were to follow this approach, the operation of MFN clauses in the trade and investment regime could converge (see Kurtz 2016).

POST-ESTABLISHMENT NATIONAL TREATMENT

Although a standard provision in modern investment treaties, NT was less commonly included in investment treaties in the early years of the regime than

[6] In Chapter 9, we return to *greater precision* as one technique by which states have reasserted control over the investment treaty regime.

[7] Article 9.5 (3) TPP 2016.

[8] Article X.7 CETA 2016: 'For greater certainty, the "treatment" referred to in Paragraph 1 and 2 does not include investor-to-state dispute settlement procedures provided for in other international investment treaties and other trade agreements. Substantive obligations in other international investment treaties and other trade agreements do not in themselves constitute "treatment", and thus cannot give rise to a breach of this article, absent measures adopted by a Party pursuant to such obligations'.

MFN (see Table 4.1). Some countries—such as China—still subject NT provisions to qualification or limitation (Gallagher and Shan 2013, 160). The purpose of NT provisions is to ensure a 'level playing field' between domestic and foreign investors (Dolzer and Schreuer 2012, 198). The metaphor of a *playing field*—also influential in the international trade regime—invokes a relationship between competitors. Notwithstanding the widespread acceptance of the *playing field* metaphor, economic ideas about the nature and extent of competitive interactions among various investors and investments have played a surprisingly limited role in how arbitral tribunals interpret and apply investment treaties' NT provisions.[9]

NT has only played a minor role in the practice of the investment treaty regime to date. Insofar as NT claims have been brought to arbitration, most involve allegations of *de facto* discrimination (Bjorklund 2010, 411; Henckels 2015, 78). Among known cases, only eight tribunals have decided NT claims in favour of investors (see Table 4.2). All were under investment treaties that extend NT to the pre-establishment phase. And, with one exception, all were concerned with *general* measures affecting the *importation* of foreign-produced goods such as discriminatory taxes or quantitative restrictions—the traditional domain of trade law.[10]

Foreign investors need to meet two conditions to succeed in claims of *de facto* discrimination in breach of a guarantee of NT. They have to show that their investment has (i) been treated less favourably; than (ii) a comparable domestic investment. With respect to element (ii), the central question is whether particular domestic investments can reasonably be compared to the foreign investment in question. In answering this question, arbitral tribunals have also considered whether there is a reasonable justification for treating the foreign investment less favourably. For example, if a host state imposes more onerous environmental conditions on a foreign-owned gold mine than it imposes on a domestic-owned gold mine, this would normally breach NT. However, if the differences in environmental conditions resulted from a more polluting extraction technique used by the foreign-owned firm, or because the foreign-owned mine operated in a more ecologically sensitive area, an arbitral tribunal might regard these investments as not comparable. On this basis, a tribunal might regard any difference in treatment of the two mines as justified and, therefore, not a breach of NT.

[9] We examine the implications of economic ideas for the interpretation and application of NT provisions in Chapter 5.

[10] The only exception thus far is the arbitration *Bilcon v. Canada* (2015). It concerned a Canadian environmental review panel's rejection of a foreign investor's proposal for a new mining project. The NT claims at issue did not unequivocally concern post-establishment protection. Six of the NT claims were under the NAFTA and two under US investment treaties (both of which extend NT to the pre-establishment phase). We return to the distinction between general and specific measures in Chapter 9.

Arbitral tribunals have differed on the choice of comparator in NT claims. For example, in *Methanex v. US* (2005), the tribunal held that the treatment of a foreign investor should be compared to the treatment of domestic investors in the most similar situation. As such, it compared the treatment of a Canadian methanol producer to US-owned methanol producers and found no breach of NT. In reaching this conclusion, the tribunal held that the more beneficial treatment given to US *ethanol* producers was not relevant as a comparator. In contrast, in *Cargill v. Mexico* (2009), the tribunal found that Mexican producers of cane sugar were relevant comparators when considering the treatment of US-owned producers of high-fructose corn syrup operating in Mexico. (Both cane sugar and high-fructose corn syrup are used to sweeten soft drinks.) On this basis, a tax that applied to high-fructose corn syrup—but did not apply to cane sugar—breached NT. The tribunal in *Occidental v. Ecuador I* (2004) took an even broader approach to the choice of comparator in NT claims. It held that Ecuador's imposition of value-added tax on oil exports—but not on the export of other products—breached NT, even though the tax applied equally to oil exports by both foreign and Ecuadorian-owned companies. This is because the tribunal found that Ecuadorian companies in the mining, seafood, and cut flowers sectors were relevant comparators in assessing the treatment of a foreign investor in the oil sector, because all were involved in producing goods for export.[11]

Differences in treaty language are relevant in clarifying the basis for comparison in NT claims. As is typical of European BITs, the non-discrimination provision in the Austria–Kazakhstan BIT in the preceding text does not provide any guidance on the choice of comparator in NT, leaving the question entirely to the tribunal. NAFTA states that a foreign investor/investment should be compared to a domestic investor/investment 'in like circumstances', but leaves it up to the tribunal to determine when investors are 'in like circumstances'.[12] The TPP, which was signed but had not entered into force at the time of publication,[13] contains the further clarification that a determination of whether investors/investments are in like circumstances 'depends on the totality of the circumstances, including whether the relevant treatment distinguishes between investors or investments on the basis of legitimate public welfare objectives'.[14] This clarification directs tribunals to consider the justifications for any differences in treatment—for example, that the more onerous environmental conditions imposed on a particular foreign investment may be justified by its more serious environmental impacts.

[11] Other tribunals consider the extent to which the firms compete with one another—for example the *SD Myers v. Canada* case examined in Chapter 5.

[12] Articles 1103 and 1104 NAFTA 1992.

[13] As mentioned in Chapter 1, the TPP's prospects were uncertain at the time of writing, following President Trump's withdrawal of the US signature on 23 January 2017.

[14] Footnote 14 to Article 9.4 TPP 2016.

INVESTMENT LIBERALIZATION: NT AND MFN IN THE PRE-ESTABLISHMENT PHASE

As noted in Chapter 1, investment treaties historically did not limit states' ability to restrict or prohibit new foreign investment. While many older investment treaties require host states to 'encourage and admit' new foreign investment, these provisions are expressly subordinated to the host state's law, and toothless in practice.[15] Even today, about 90 per cent of investment treaties, including virtually all European BITs and the Energy Charter Treaty, do not contain binding provisions governing the admission of new foreign investment (UNCTAD 2015b, 3).

However, investment treaties increasingly do extend guarantees of NT and MFN to the entry and establishment of foreign investment. Such provisions are standard in recent Canadian, US, and Japanese BITs (Joubin-Bret 2008, 11). They are also an increasingly common feature of multilateral investment treaties[16] and the investment chapters of multi-issue preferential trade agreements (PTAs) (see Table 4.2).[17] Under this approach, non-discrimination extends to the 'admission', 'establishment,' and 'acquisition' of investments, as opposed to only applying to the 'management', 'conduct,' and 'operation' of investments (post-establishment). For example, NAFTA Article 1102 states that each state 'shall accord NT with respect to the *establishment*, *acquisition*, expansion, management, conduct, operation, and sale or other disposition of investments'.

The application of NT and MFN provisions to the pre-establishment phase is sometimes described as creating 'market access' obligations (e.g. Sacerdoti 1997, 321–31; DiMascio and Pauwelyn 2008, 56). However, the use of the term 'market access' in this context is confusing. Provisions such as NAFTA Article 1102 do not prevent states from placing restrictions and conditions on the admission and establishment of new investment in their territory, so long as such restrictions and conditions do not discriminate by nationality.[18]

Nevertheless, the application of NT to the pre-establishment phase potentially prohibits the use of restrictions on new foreign investment in the pursuit of other policy objectives. For example, many states limit foreign investment in strategic industries on national security grounds; regulate foreign investment in the media sector to ensure plurality; limit the ability of foreign

[15] For example, Article 3, French Model BIT 2006: 'Each of the Contracting Parties encourages and admits, *in accordance with its legislation* and the provisions of the present Agreement, investments . . . '.

[16] For example, Article 5, ASEAN Comprehensive Investment Agreement, 2009.

[17] For example, Articles 9.4 and 9.5, TPP 2016; Article X.4, CETA 2016.

[18] Moreover, the term 'market access' in trade treaties refers to a specific set of obligations concerned with the elimination of quantitative restrictions (e.g. Article XVI, GATS; Chapter 10, Article X.4, CETA). 'Market access' provisions in this specific sense of the term differ from pre-establishment MFN and NT.

nationals to own land; impose joint venture requirements on foreign investment in particular sectors to encourage technology transfer to local firms; and place restrictions and conditions on foreign investment to protect local firms from foreign competition. Absent relevant exceptions, such measures breach NT in the pre-establishment phase.[19] For instance, Singapore applies an additional buyer's stamp duty of 15 per cent to foreign nationals buying land.[20] As a result of the unqualified NT obligation in the Singapore–US FTA 2001, US citizens are entitled to the same treatment as Singaporeans, and, consequently, do not need to pay the higher rate of tax (unlike, for example, Chinese, Indonesian, or Malay citizens purchasing property in Singapore) (Vaughan 2013).

Pre-establishment NT and MFN obligations have played no role in investment treaty arbitration to date. Time will tell whether they acquire greater importance. Yet, even in the absence of claims brought to arbitration, the extension of MFN/NT obligations to the pre-establishment phase could have powerful behind-the-border effects in requiring host states to remove or amend discriminatory restrictions on foreign investment. We return to the issue of the impact of investment treaties on state decision-making in Chapters 5, 6, and 9—an important area for further research.

Absolute standards of protection

We now turn to four 'absolute' standards of protection: expropriation, FET, umbrella clauses, and free transfer of funds. These standards of protection are 'absolute' in the sense that they require host states to guarantee certain standards of treatment to foreign investors and investments covered by the treaty, regardless of how other investors and investment are treated. We focus on these four absolute standards, as they typically capture breaches of other substantive protections as well—such as the prohibition of arbitrary, unreasonable, or discriminatory measures, which overlaps significantly with FET and NT.

NO EXPROPRIATION WITHOUT COMPENSATION

Expropriation refers to state conduct that deprives investors of title to property, or otherwise substantially deprives investors of their investments.[21] Investment treaties allow states to expropriate foreign investments, but this right is subject to the payment of compensation (see again the discussion of

[19] Figure 8.4 shows exceptions to pre-establishment national treatment in selected US treaties.
[20] Inland Revenue Authority of Singapore (2016).
[21] We use the terms 'nationalization' and 'taking' as synonyms for 'expropriation'.

'liability rules' in Chapter 1). Recall from Chapter 2 that most investment treaties cover a broad range of investments, including intangible rights (e.g. intellectual property rights) and financial instruments (e.g. bonds and hedging contracts). As such, the application of investment treaties' expropriation provisions extends beyond the expropriation of physical assets such as factories and mines.

The legal principles governing expropriation of foreign investment are rooted in customary international law. Customary international law acknowledges a state's right to expropriate foreign-owned property subject to three conditions: the expropriation must (i) serve a public purpose; (ii) be carried out with due process of law; and, most importantly, (iii) be accompanied by 'full' compensation—a standard understood to refer to an investment's fair market value (see section on 'Compensation and Damages' in the following text). The duty to pay compensation is by far the most important condition in practice; although many expropriations comply with conditions (i) and (ii), investors frequently contend that host states fail to pay full compensation.

These standard conditions are also found in most investment treaties. For example, Article 5 of the 2008 UK Model Investment Treaty provides:

> Investments of nationals or companies of either Contracting party shall not be nationalized, expropriated or subjected to measures having effect equivalent to nationalization or expropriation in the territory of the other Contracting Party except for a public purpose related to the internal needs of that Party on a non-discriminatory basis and against prompt, adequate and effective compensation.

As with almost all investment treaties, Article 5 distinguishes between direct expropriations ('investments . . . shall not be nationalized [or] expropriated') and indirect expropriations ('or subjected to measures having effect equivalent to nationalization or expropriation'). Both are equally compensable.

Direct expropriation involves a transfer of title or physical seizure of an investment. The expropriation comes about in a single act, and is usually easy to identify. As direct expropriations without compensation are becoming rare (see Chapter 1), only about one in ten of the more than 700 known investment treaty arbitrations have alleged a violation of this provision (Table 4.2). Instead, the more important question in arbitral practice is how to identify *indirect* expropriation. Investors have alleged indirect expropriation in 45 per cent of all known investment treaty arbitrations (Table 4.2),[22] and the subject has proven highly controversial (Fortier and Drymer 2004; Ratner 2008, 229, 482–4; Schneiderman 2008, 75; Shirlow 2014). Several considerations are important for this distinction, which we review in the following text.

[22] The 2008 UK Model BIT, Article 5, for instance, describes indirect expropriation as 'measures having effect equivalent to nationalization or expropriation'.

As a starting point, it is important to clarify that mere reductions in the profitability of an investment are insufficient for an indirect expropriation to have occurred; what is needed is a loss of such magnitude that it very substantially lowers the value of an investment. For example, in one recent case, a tribunal concluded that significant reductions in the feed-in tariffs that Spain paid to foreign-owned solar plants did not amount to expropriation (*Charanne v. Spain* 2016).[23] Equally, even though Argentina's modification of gas distribution licenses in the early 2000s in the aftermath of its financial crisis had a negative impact on the businesses of foreign investors, a tribunal found that the impact was not severe enough, nor sufficiently permanent in duration, to amount to indirect expropriation (*LG&E v. Argentina* 2006, para. 200). Similarly, host states can significantly increase levels of taxation without the resulting tax burden amounting to an indirect expropriation (*Paushok v. Mongolia*, para. 332).

While arbitral practice unanimously supports the view that state conduct can only amount to indirect expropriation if it results in a substantial deprivation of the investor's investment, there is an ongoing controversy about how to draw the line between indirect expropriation and a state's non-compensable exercise of regulatory powers to meet public policy objectives. There are many cases in which state conduct has a substantial negative impact on an investor's business but in which the state asserts a justification for such interference on public policy grounds. Examples from previous arbitrations include a host state cancelling an investor's operating license citing the failure of the investor to meet mandatory environmental standards (e.g. *Tecmed v. Mexico* 2003), and a state banning the sale of an investor's product citing public health risks (e.g. *Chemtura v. Canada* 2010). Some tribunals have articulated implicit exceptions to the concept of indirect expropriation—namely, that non-discriminatory regulatory measures in pursuit of legitimate policies *never* amount to indirect expropriation regardless of the magnitude of loss, or interference with, an investment (e.g. *Methanex v. US* 2005, Part IV, Chapter D, para. 7).

More generally, there are two stylized approaches in determining whether a measure affecting a foreign investment amounts to indirect expropriation and, therefore, obliges the host state to compensate the investor. The first approach looks exclusively to the *effect* of the state conduct on the investment, including the degree of economic loss that the conduct causes to investors and the extent to which it interferes with the investor's legal rights to use and enjoy the property (Schreuer 2006; Hoffmann 2008). This view accepts that state conduct must have created a 'persistent or irreparable obstacle' to the operation of the investment (*Generation Ukraine* 2003, para. 20.32), but permits little or no

[23] At the time of writing, more than 30 similar arbitrations were pending against Spain concerning its modifications of feed-in tariffs for solar energy.

consideration of the state's regulatory purpose. This 'effects' approach was particularly influential in early investment treaty arbitral decisions. For example, in *Metalclad v. Mexico* (2000), the tribunal held that a local government's refusal to issue a construction permit to a landfill that had been approved by all other levels of the Mexican government amounted to an indirect expropriation. In the words of the tribunal, the local government's inaction was a 'covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host State' (para. 103).

A second approach adopts a narrower view of indirect expropriation, granting states greater latitude to regulate foreign investment for legitimate public purposes. Alongside the intensity of interference with the property of the investor, this approach considers the *purpose* and *characteristics* of host state measures. For example, in another case against Mexico, the tribunal considered Mexico's decision to discontinue its practice of granting tax rebates on cigarette exports to a foreign investor. In addition to noting that the measure had not deprived the investor of control over its investment, the tribunal observed that the change in practice affected *all* cigarette resellers and was justified by the purpose of discouraging tobacco smuggling (*Feldman v. Mexico* paras. 112–16, 136–7). Taken together, these factors meant that Mexico's measure did not amount to indirect expropriation.

The 'effects' approach to indirect expropriation has been especially controversial, as critics argue that it provides greater protection to foreign investors than is provided to private property rights in most developed legal systems (Montt 2009). In response to these, and other, criticisms, a newer generation of investment treaties define the concept of 'indirect expropriation' more precisely, thereby reducing arbitral tribunals' interpretative discretion (Nikièma 2012; Moloo and Jacinto 2013). The first and most influential clarification was a new annex to the 2004 US Model BIT, which clarifies that non-discriminatory regulatory measures will only amount to indirect expropriation 'in rare circumstances'.[24] It also directs arbitral tribunals to distinguish between indirect expropriation and legitimate, non-compensable regulation based on three factors:

(1) the degree of interference with property rights;
(2) the character of the government measure—that is, its purpose and context; and
(3) the interference of the measure with reasonable and investment-backed expectations—notably, expectations related to the use of the investment.

[24] Annex B on Expropriation, US Model BIT 2004. Canadian investment treaties follow a similar approach.

These three factors are adapted from the US Supreme Court's jurisprudence on indirect expropriation, notably the decision in *Penn Central Transportation Co. v. New York City' (1978)* (Sanders 2010). The US government's decision to define 'indirect expropriation' based on the way that concept is understood in US law followed a Congressional direction to the US Executive in 2002 that US investment treaties should not provide protection to foreign investment beyond that found in US law (Gagné and Morin 2006). The annex on indirect expropriation has been included in all subsequent US investment treaties. It has also diffused into the treaty practice of other states. Similar text clarifying the meaning of indirect expropriation is now found in investment treaties as diverse as the ASEAN Comprehensive Investment Agreement (ACIA), the Comprehensive Economic and Trade Agreement (CETA) between Canada and the EU, the China–Japan–Korea trilateral investment treaty, and the TPP.[25]

FAIR AND EQUITABLE TREATMENT

We turn now to the most important substantive protection in the investment treaty regime, FET. Consider the following sample clause:

'Each Contracting State shall in its territory in every case accord investments by investors of the other Contracting State fair and equitable treatment'.[26]

As with most FET clauses, this short and open-ended formulation provides broad interpretive discretion to investment tribunals. Whereas the outcome in early investment treaty arbitrations often turned on the application of indirect expropriation, the interpretation and application of FET provisions has been decisive in most disputes since 2000. (This is an important point for empirical scholarship on investment treaty arbitration, some of which still focuses primarily on indirect expropriation; e.g. Pelc 2016). Investors have invoked the FET standard to challenge the entire gamut of state conduct, including changes to legislation of general application, decisions of executive agencies of the host state specifically addressed to the investor in question, and the actions of the host state's judiciary.

One important point of contrast between FET and the concept of indirect expropriation is that host states may breach FET even if the impact of state conduct on the foreign investor falls short of a 'substantial deprivation' of an investment necessary for expropriation. Moreover, in contrast to NT and MFN, a host state's action may breach FET even if it is non-discriminatory. Investment tribunals 'regularly apply [FET] in a broad manner, using it as a yardstick for the conduct of the national legislator, of domestic administrations, and of domestic courts' (Schill 2009, 79). For this

[25] Annex 2, ASEAN Comprehensive Investment Agreement 2009; Annex 8-A, CETA 2016; protocol to the China–Japan–Korea trilateral investment treaty 2012; Annex 9-B, TPP 2016.

[26] Article 2(2), German Model BIT 2009.

reason, the FET standard has begun to eclipse the operation of other substantive protections.

The meaning of FET is the subject of disagreement between arbitral tribunals, states, and academics. In practice, arbitral tribunals have played a major role in elaborating the meaning of FET through the interpretation and application of FET in individual disputes (on the 'law-making' functions of tribunals, see Chapter 9). Tribunals have considered a range of factors in determining whether host states have breached FET, including: (i) the extent to which state conduct interferes with or alters a foreign investor's legal rights under domestic law; (ii) the extent to which state conduct breaches promises made to foreign investors; (iii) the extent to which state conduct is consistent with standards of procedural fairness and due process; (iv) the extent to which state conduct pursues a legitimate policy objective; and (v) the likely effectiveness of the state conduct in achieving its intended policy objective.

Given these interlocking factors, the exposition of the FET standard in legal texts is almost always organized around a discussion of the different 'elements' of FET—that is, more specific legal principles that apply to particular categories of cases. However, no two academic commentators propose the same taxonomy of 'elements' (cf. Newcombe and Paradell 2009, 275; Dolzer and Schreuer 2012, 145; Vandevelde 2012, 190; Paparinskis 2013, 239; Salacuse 2013, 388; Bonnitcha 2014a, 161). In this section, we organize discussion of the FET standard under the following three headings: (i) denial of justice and due process, (ii) arbitrary or unreasonable conduct, and (iii) legitimate expectations.

Denial of justice and due process

This first dimension of the FET standard refers to requirements of procedural fairness in administrative and judicial proceedings. It includes procedural requirements such as investors' rights to make submissions to decision-making processes affecting their interests, to unbiased and impartial decision-making, and to knowing the basis and reasons for state decisions so that investors can challenge them (Schill 2010, 158). Arbitral consideration of whether a state has breached this element of the FET standard looks to the *process*, as opposed to the outcome, of proceedings affecting the foreign investor.

Take the example of *Loewen v. United States* (2003), described in Chapter 3. Here, Loewen argued that its treatment in the Mississippi court system amounted to a breach of FET by the United States. For unrelated reasons, the arbitral tribunal found that it lacked jurisdiction over this claim. However, it explained that, if it had had jurisdiction over the dispute, it would have found that the serious procedural irregularities in Mississippi state court's conduct amounted to a denial of justice in breach of the FET provision of the investment treaty (para. 137; see also Paulsson 2005, 186).

Arbitrary or unreasonable conduct

A second dimension of FET is the prohibition on 'arbitrary' or 'unreasonable' state conduct that interferes with a foreign investor's investment. Although they are not always consistent, arbitral tribunals normally use the term 'arbitrariness' to mean a lack of a rational policy justification for measures adversely affecting a foreign investor (e.g. *Noble v. Romania* 2005, para. 177; Paparinskis 2013, 241).[27] Used in the sense of lack of rationality, 'arbitrariness' overlaps with concepts such as 'reasonableness' and 'proportionality', which also direct a tribunal's attention to the strength of a state's policy justifications for conduct affecting foreign investors. These issues also overlap with the degree of deference that arbitral tribunals should show to states' policy judgments, an issue that we consider in more detail in the next section.

Tribunals have taken radically different views about the extent to which FET entitles a tribunal to evaluate the strength of policy justification for measures that affect foreign investors. The tribunal in *SD Myers v. Canada* (2000) took the view that tribunals applying the FET standard do not have:

> ... an open-ended mandate to second-guess government decision-making. Governments have to make many potentially controversial choices. In doing so, they may appear to have made mistakes, to have misjudged the facts, proceeded on the basis of a misguided economic or sociological theory, placed too much emphasis on some social values over others and adopted solutions that are ultimately ineffective or counterproductive (para. 261).

In contrast, other arbitral tribunals have taken a more active role in evaluating the justifications for state conduct under challenge. For example, in *Occidental II*, the tribunal engaged in detailed scrutiny of whether Ecuador was justified in terminating a concession contract in response to Occidental's prior breach of that contract. It concluded that Ecuador's decision to terminate was disproportionate, because Ecuador could have responded to Occidental's breach of contract in ways that were less damaging to Occidental's interests (*Occidental v. Ecuador II* 2012, para. 452). The extent to which arbitral tribunals should use the FET standard as a tool to review the policy justifications for state conduct remains a controversial issue.

[27] In contrast to this usage, the arbitral tribunal in *Bilcon v. Canada* concluded that the conduct of a Canadian environmental review panel breached the FET standard because it was 'arbitrary'. However, the tribunal used the term 'arbitrary' to refer to *procedural* failures relating to the way Canada carried out the review. The tribunal said that it was not expressing an opinion on whether a decision to approve or not approve the project was justified (paras. 602–3).

Legitimate expectations and stability of the legal framework

A third dimension of FET is the protection of investors' 'legitimate expectations'. Investment tribunals differ in the weight they give to legitimate expectations under FET, and in how to distinguish those expectations protected by investment treaties from those that are not. Among tribunals that see an important role for legitimate expectations under FET, most recognize that there are two significant limitations: (i) that the investor's expectations must be based on a *specific* commitment made by the host state to the investor; and (ii) that these expectations must be *reasonable* in light of the circumstances.

A comparison of the various arbitral awards arising out of the Argentine financial crisis of 2001 illustrates the first requirement of a specific commitment. Prior to the crisis, the Argentine peso had been pegged to the US dollar, and a range of investment contracts were denominated in dollars. When Argentina dismantled the currency convertibility regime, it modified the terms of gas distribution licenses of foreign investors. The licenses had specifically guaranteed the payment of gas tariffs to investors in US dollars and indexed to the US gas market. In a series of cases, the foreign license holders successfully argued that Argentina's actions had breached their legitimate expectations by violating these specific commitments (e.g. *LG&E v. Argentina* 2007, para. 134).

Continental Casualty, a US insurance company operating in Argentina, also challenged the dismantling of the currency convertibility regime and the forced pesification of dollar-denominated contracts and debt. It argued that it had a legitimate expectation that the regime would remain in place, and that this expectation was derived from Argentinian legislation establishing the currency convertibility regime and ministerial pronouncements (*Continental Casualty v. Argentina* 2008, para. 252). However, the tribunal held that, in the absence of a specific commitment addressed directly to the claimant that the regime would be maintained, the claimant could not have any legitimate expectation that the regime would continue in force. Similarly, in *Charanne v. Spain* (2016), the arbitral tribunal found that the Spanish legislative framework for investment in the solar sector, though aimed only at a limited number of investors, did not create specific commitments vis-à-vis each solar investor, and therefore could not create a legitimate expectation of a stable legal framework. In the tribunal's view, any other conclusion would have unduly constrained the host state's right to regulate (paras. 493).[28] At the time of writing, several dozen pending solar arbitrations turn on whether other tribunals reach the same conclusion.

[28] See Chapter 9 for further discussion on the impact of investment treaties on host states' exercise of regulatory power in practice.

Second, representations by themselves are insufficient—they must also generate *reasonable* expectations. A good example of unreasonable expectations is *Thunderbird v. Mexico* (2006). The US company Thunderbird asked the Mexican Interior Ministry whether its gaming machines were lawful under Mexican law. Based on Thunderbird's description of its machines, the ministry informed Thunderbird that its business venture would be lawful. However, Thunderbird had not accurately described its machines, and Mexico subsequently closed down the company's gaming facilities. In light of Thunderbird's misrepresentation, the tribunal concluded that Thunderbird had no legitimate expectation that it could operate gaming facilities in Mexico.

Finally, related to legitimate expectations is the controversial notion that major changes to the legal framework of a host state made after a foreign investment was established could violate FET. The legal issue here is whether foreign investors have a 'legitimate expectation' of a stable regulatory environment, even absent expectations based on specific commitments. In one view, the host state's legal framework as such is an important source of expectations on the part of the investor (Dolzer and Schreuer 2012, 115). This has some support among arbitral tribunals (e.g. *Occidental v. Ecuador* 2004), but it remains an outlying view. Several investment tribunals have criticized the view that FET entails a general guarantee of stability of the legal environment (*LG&E v. Argentina* 2007, paras. 66–7; *Suez v. Argentina* 2010, para. 224).[29]

The broad range of protections that FET confers on foreign investors, coupled with a success rate of 37 per cent for investors, has made this open-ended standard the most important, albeit controversial, substantive guarantee in the modern investment treaty regime. It allows for compensation even in disputes where no expropriation, discrimination, or denial of justice has taken place. To its champions, the quasi-constitutional standard of FET embodies the rule of law in the investment treaty regime (Schill 2009, 333–8), whereas to critics it has 'disempower[ed] governments from modifying their laws, even in reaction to new threats to the public welfare' (Alvarez 2011a, 248).

State responses to concerns about FET

States have been slow to respond to developments in arbitral jurisprudence in ways that clarify the meaning of FET (cf. Alschner 2016). An exception is the authoritative interpretation issued by the three NAFTA state parties in July 2001 (NAFTA Notes of Interpretation 2001). It stated that FET does not go

[29] As Chapter 5 shows, stringent guarantees of a stable and predictable legal framework are problematic from an economic perspective.

beyond the requirements of customary international law. This joint intervention by Canada, Mexico, and the United States was a response to the expansive interpretation of FET by the arbitral tribunal in *Pope & Talbot v. Canada* in June 2001. However, this joint interpretation did not clarify the standard of protection required by customary international law, which is itself a subject of disagreement and uncertainty, and has done little to resolve the debate.

Against this background, a new trend of defining FET more precisely within the text of investment treaties is beginning to emerge. For example, Article X.9 of CETA contains the following exhaustive list of the 'elements' of FET:

(i) denial of justice;
(ii) fundamental breach of due process, including a fundamental breach of transparency;
(iii) manifest arbitrariness;
(iv) targeted discrimination on manifestly wrongful grounds, such as gender, race, or religious belief; and
(v) abusive treatment of investors, such as coercion, duress, and harassment.

These 'elements' overlap with those considered in this chapter, except that a breach of legitimate expectations is not recognized as a freestanding ground for violation of the FET standard.[30] If and when CETA enters into force, it will be important to examine whether these clarifications narrow tribunals' application and interpretation of the FET provision, or whether the specific introduction of a term such as 'manifest arbitrariness' broadens the scope of the provision in some cases.[31]

UMBRELLA CLAUSES

The fifth substantive protection we consider is the umbrella clause, included in roughly half of all investment treaties (Table 4.1; UNCTAD 2007, 73; Sinclair 2013).[32] A typical umbrella clause can be found in the Switzerland–Pakistan BIT

[30] A subsequent paragraph of CETA explains that a tribunal may consider whether a state's action has breached legitimate expectations, but only as part of an inquiry into whether one of the five specifically enumerated elements of FET has been breached.

[31] The EU Commission's proposal for the investment chapter in TTIP follows the same model—see Article 3, European Commission (2015b).

[32] The model BITs of Austria, Canada, China, Colombia, Germany, Italy, Korea, Latvia, Russia, Singapore, and the United States do not contain umbrella clauses, whereas the Japanese, Dutch, Swiss, UK, and French models do. However, the majority of US investment treaties contain umbrella clauses even though the US model treaty does not. The first group accounts for circa 1000 investment treaties, and the second for circa 600.

[E]ither 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.[33]

This clause spans a protective 'umbrella' over the 'commitments' or 'obligations' that host states have assumed with regard to foreign investments. In doing so, it functions as a type of 'catch-all' provision, potentially requiring host states to comply with a myriad of obligations beyond those set out in the investment treaty itself—most notably, obligations contained in investor–state contracts.[34] However, as is the case with FET, the precise effect of umbrella clauses is much contested (Crawford 2008; Sinclair 2013).

The practical significance of debates about the effect of the umbrella clause is best illustrated with an example. Country A signs a contract with foreign investor B to build a power plant in A. This contract is governed by the law of A. Country A alleges that B did not build the power plant to the contractually agreed specification, and refuses to pay the final instalment for construction of the plant. As a result, either A or B—or both—may be in breach of the investment contract and may pursue contractual remedies in the forum that they agreed to use for the resolution of contractual disputes. This forum could be domestic courts or contractual arbitration, but, whichever forum is chosen, the court or tribunal would have to resolve the dispute on the basis of the rights and obligations in the *contract*. Umbrella clauses may change this situation in two respects: first, with respect to the forum in which disputes are resolved; and, second, with respect to the applicable law.

The first controversy is whether umbrella clauses override an express agreement between A and B to resolve contractual disputes in another forum. In one view, an umbrella clause allows a foreign investor to commence investment treaty arbitration in respect of obligations in an investment contract, even if that contract contains an express agreement between the investor and the host state to resolve contractual disputes in a different forum (e.g. *Eureko v. Poland* 2005, paras. 93, 246). The effect of this interpretation is to give investor B a better deal than it bargained for in the investor–state contract, because B is allowed to enforce some obligations contained in its investment contract while avoiding the effect of other obligations contained in the contract—namely, the obligation to submit disputes to an agreed forum. However, on a second, narrower interpretation, the parties' *exclusive* choice of forum in an investment contract remains binding (e.g. *SGS v. Philippines* 2008). The effect of this interpretation is that B cannot turn to investment treaty arbitration insofar as contractual breaches are concerned. (B retains the right to bring claims that

[33] Switzerland–Pakistan BIT 1995, Article 11. The dispute in *SGS v. Paraguay* (2012) was based on this umbrella clause.

[34] We do not examine the extent to which umbrella clauses allow foreign investors to invoke a host state's non-contractual obligations that they have expressly assumed—for example, a host state's obligations to foreign investors arising from human rights treaties that the state has entered into.

A has breached other investment treaty provisions—e.g. claims of compensation for expropriation—to investment treaty arbitration). Insofar as claims for breach of contractual obligations are concerned, B is limited to the forum it agreed to with A.

A second controversial issue is the extent to which umbrella clauses alter the content of the underlying obligations contained in investment contracts. On an expansive first view, umbrella clauses 'internationalize' investment contracts, so that the governing law is no longer the domestic law originally chosen by the parties in their contract (*Noble v. Romania* 2005). One practical implication of this interpretation is to prevent A from relying on defences to claims of breach of contract recognized in the chosen domestic law—for example, a defence available under the law of A that A's non-payment of investor B is justified by B's failure to build the power plant to agreed specification. Critics of this expansive interpretation argue that its effect is to 'transform the obligation which is relied on into something else' (*CMS v. Argentina, Annulment* para. 95). An alternative, narrower view is that umbrella clauses do not alter the governing law of a contract (*SGS v. Philippines* 2004). According to this view, the question of whether an investment contract was breached depends on the chosen domestic law; but the effect of the umbrella clause is to give the authority to decide this question to an arbitral tribunal established under an investment treaty.

Arbitral tribunals have adopted diverging interpretations of these clauses, and the issues remain unsettled. Whether they adopt the narrow or the expansive approach has significant implications; the expansive view greatly limits the ability of host countries to renegotiate, unilaterally modify, or cancel investment contracts, including in response to breaches of investment contracts by foreign investors.

FREE TRANSFER CLAUSES

We now turn to the last of the six core provisions discussed in this chapter. Free transfer of funds clauses guarantee foreign investors that they can carry out all transfers related to investments freely and without delay. They were at the heart of the investment treaty regime when states created it in the 1960s and 1970s, and were of major importance to foreign investors, given how widespread capital controls were at the time (Paparinskis, Poulsen, and Waibel 2017). Uniquely among the core substantive standards in investment treaties, free transfer clauses are not primarily about protecting investment, but about *liberalizing* inward and outward transfers. As states have largely refrained from imposing new restrictions on the transfer of funds since the 1990s (Eichengreen 1998; Simmons 2000; Abdelal 2007; Henry 2007; Mukherjee and Singer 2010), foreign investors have rarely invoked free transfer provisions in arbitrations (see Table 4.2). Only two tribunals have found that

host states breached the free transfer clause.[35] Nevertheless, the provision is potentially crucial as investors consistently rate the ability to transfer funds freely as a high priority when making international investments (Drake and Nicolaïdis 1992; Freeman 1999; Sauvé and Steinfatt 2001; US Chamber of Commerce 2011).

Consider the following free transfer clause from the Ecuador–US BIT:

> Each Party shall permit all transfers related to an investment to be made freely and without delay into and out of its territory.

Subsequent sections of the article clarify that the term 'all transfers' covers current payments, profits, and repatriation of capital. The broad scope of this obligation contrasts with the more limited obligations of states under the multilateral IMF Articles of Agreement.[36] Whereas the IMF Articles of Agreement require IMF Member States to allow free transfers in relation to current transactions (Article VIII(2))—for example, a foreign investor's transfer funds out of the host state to pay for imported inputs used in their operations in the host state—the IMF Articles permit states to restrict inflows and outflows that pertain to the host country's capital account (Article VI (3)). As such, the main effect of free transfer clauses in investment treaties is to constrain host states from using capital controls that are permissible under the IMF Articles. For this reason, investment treaties arguably liberalize the capital account by the backdoor (Waibel 2010b; Siegel 2013), and could chill the use of capital controls in times of crisis. This is an example of a potential negative 'spillover' from the investment treaty regime to other parts of the investment regime complex (see Chapter 9).

Capital controls have long formed part of a state's macro-prudential regulatory toolkit to maintain financial stability (Kant 1996; Ostry et al. 2010; Korinek 2011; Broner and Ventura 2016). Yet, only around 10 per cent of investment treaties create exceptions for restrictions on the transfer of funds during balance-of-payments crises or other macroeconomic emergencies.[37] By contrast, the vast majority of investment treaties do not contain any exceptions for balance-of-payments crises or other macroeconomic emergencies (UNCTAD 2007, 62; Poulsen 2011b, 196). The issue came to a head in the drafting of the US Model BIT 2012, with input from an advisory panel. Notwithstanding a call by more

[35] *Achmea v. Slovakia* (2012) and *Pezold v. Zimbabwe* (2015). In *Achmae*, however, this breach was subsumed within FET (para. 286).

[36] The IMF is the major international organization in the monetary sphere. It has 189 member states. Virtually all states are members, with Cuba and North Korea being the only notable exceptions.

[37] See Table 4.2. Canadian, French, and UK investment treaties often include a balance-of-payments exception. Cf. Article 6 of the French 2006 Model BIT provides: 'When, in exceptional circumstances, capital movements from or to third countries cause or threaten to cause a serious disequilibrium to its balance of payments, each Contracting Party may temporarily apply safeguard measures to the transfers, provided that these measures shall be strictly necessary, would be imposed in an equitable, non-discriminatory and in good faith basis and shall not exceed in any case a six months period'.

than 250 economists to strike a better balance between investor protection and financial stability in future US investment treaties (Hausmann et al. 2011), the US Treasury took the view—without explanation—that US treaties already provided sufficient flexibility for host states to manage risks associated with rapid reversals in capital flows (Geithner 2011).

Carve-outs, defences, and the standard of review

No discussion of international investment law would be complete without consideration of carve-outs, defences, and the applicable standard of review. *Carve-outs* refer to matters that are expressly excluded from the scope of an investment treaty's application, whereas *defences* refer to treaty provisions and legal principles that justify or excuse state conduct that would otherwise amount to a breach of substantive investment treaty law. The *standard of review* refers to the extent to which tribunals reconsider factual and policy judgments by host states while determining whether a host state's conduct breaches investment treaties. As will become clear, the role of all three legal features in balancing host state regulatory autonomy with investment protection is much in flux.

CARVE-OUTS

Carve-outs are the simplest and most direct way in which host states can limit the applicability of substantive treaty obligations or, more rarely, the availability of dispute resolution (Russo 2015). These provisions may exclude certain economic *sectors* from the scope of treaty obligations, or they may exclude certain types of *state measures* from the scope of treaty obligation. Carve-outs have not been a standard feature of the investment treaty regime and were entirely absent from early investment treaties. When included, the most common carve-out concerns taxation measures. For example, Article 21 of the US Model BIT 2012 exempts taxation measures, except for the obligation to provide compensation in the event of expropriation. Other carve-outs are rare.[38] In recent years, some countries have specifically carved out tobacco control measures in response to Philip Morris' challenge of Australia's and Uruguay's plain packaging legislation.[39] Yet, the vast majority of investment

[38] Article 1108(7)(a) NAFTA ('Reservations and Exceptions') and Article 14(5)(a) 2012 US Model BIT ('Non-Conforming Measures') carve out procurement from MFN and NT, but not the other substantive protections; Annex 10-B, Chile–US Free Trade Agreement, 6 June 2003, and Annex X, CETA, provide that *only* MFN and NT apply to the restructuring of sovereign debt—see further Waibel (2007a).

[39] Examples include Article 29.5 TPP and the 2016 Amendment of the 2003 Singapore–Australia PTA, Article 22.