

International Investment Agreements: Are their policy aims served by their broad definitions of covered “investors” and “investments”?

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With negotiation of “mega-treaties” such as the 12-country Trans-Pacific Partnership (TPP) and investment treaties between the EU and other large economies such as Canada and the United States, international investment agreements (IIAs) are gaining fame and raising a host of important policy questions. Among those questions are who/what the treaties benefit and at what cost.

Throughout their history, which is often said to have begun with the signing of the first bilateral investment treaty between Germany and Pakistan in 1959, IIAs have been focused on safeguarding foreign investors and their investments from harms suffered as a result of conduct by their “host” states. IIAs give covered foreign investors a set of international law protections similar to those provided by political risk insurance, and if there is a breach, allow investors to bring claims directly against the host state via arbitration proceedings that are decided by a panel of (typically) three arbitrators appointed on an ad hoc basis by the disputing parties. The theory is that once investors are invested in the host country, they become subject to the host country’s whims and laws, and can face discrimination, expropriation and other abuses but can find it difficult to protect against or recover compensation for those harms. The direct benefits of the treaties thus flow to investors and investments whose international business activities become less risky when an international layer of investment protection is placed over the host state’s legal framework. And presumably the states signing the treaties and providing these enhanced rights and protections— both the home state of the investor and the host state

of the investment – do so on the basis that direct benefits given to investors and investments will produce indirect benefits within their jurisdictions.

Those indirect benefits into the host state can include the benefits often cited as arising from foreign direct investment (FDI) – namely creation of jobs, infusion of capital, and transfer of technology, skills and knowhow from the firm into the host country. Impacts on the home country have been less studied and so are less known. Nevertheless, to the extent FDI increases the competitiveness and profitability of the home-country-based firm, then those advantages gained by the firm can potentially translate into advantages in the home country through a strengthened domestic economy and tax base.

But, as is well known, not all FDI produces those positive benefits for the host and home country. (Sauvant et al. 2014). And, as explained below, tribunals have largely eschewed interpretations of the investment treaties that would make investment protection contingent on whether FDI actually has any economic benefit in the host economy or is tied in any meaningful way to the home country. Moreover, investment treaties cover much more than FDI.

The types of assets that tribunals have deemed covered by “investment” treaties include such things as portfolio investments, contracts for cross-border sales of goods or services, hedging contracts, and securities traded on international markets. Consequently, through investment treaties and the free political risk insurance they provide companies, both home and host states may be facilitating and encouraging certain transactions and activities that have no real or lasting presence in or indirect benefits for their economies.

(I)rrelevance of benefits for host economy

In terms of the relevance – or lack thereof – of benefits to the host country when determining whether any given asset is a covered “investment”, a few tribunals have required satisfaction of the so-called “*Salini*” test. That test, which is based on the premise international investment protection regime² and its system of investor-state arbitration was designed to promote international investment that advanced economic development in the host country, requires³ investments to have four characteristics:

- (1) entail a substantial commitment or contribution into the host state;
- (2) be of a certain duration;
- (3) involve an element of risk; and
- (4) contribute to the host state’s economic development.⁴

That test, first suggested in *Fedax v. Venezuela*⁵ and then described in *Salini v. Morocco*, has since been followed in other cases including *Joy Mining v. Egypt*,⁶ *Jan de Nul v. Egypt*,⁷ and *Bayindir v. Pakistan*.⁸ The

² When applied, this test is used to identify whether there is an investment under the “ICSID Convention”, the 1965 Convention on the Settlement of Investment Disputes between States and Nationals of Other States. Not all investor-state arbitrations under IIAs, however, are conducted under the ICSID Convention. For those that are not, the ICSID Convention’s test on whether something is a covered “investment” is not relevant.

³ Some tribunals have suggested that the *Salini* test sets forth required elements, while others note that they are indicative or hallmarks of investments, but not necessarily indispensable. See discussion in *Malaysian Historical Salvors v. Malaysia*.

⁴ *Salini Costruttori SpA v. Kingdom of Morocco*, ICSID Case No. ARB/00/4, Decision on Jurisdiction, July 23, 2001, paras. 51-52. Some also describe the test as including a requirement of profit or return.

⁵ *Fedax N.V. v. Republic of Venezuela*, ICSID Case No. ARB/96/3, Decision of the Tribunal on Objections to Jurisdiction, July 11, 1997.

⁶ *Joy Mining v. Egypt*, ICSID Case No. ARB/03/11, Decision on Jurisdiction, August 6, 2004, para. 53.

⁷ *Jan de Nul N.V. Dredging International N.V. v. Egypt* (ICSID Case No. ARB/04/13).

tribunal in *Phoenix Action v. Czech Republic* further elaborated on the criteria, stating that they require consideration of various potentially overlapping elements, which are similar but not identical to the *Salini* test: “a contribution in money or other assets;” “a certain duration;” “an element risk;” “an operation made in order to develop an economic activity in the host State;” “assets invested in accordance with the laws of the host State;” and “assets invested bona fide.”⁹

A number of tribunals applying these tests have taken a narrower approach than advanced in *Salini* or *Phoenix* by discarding certain criteria. The tribunal in *Metal-Tech v. Uzbekistan*, for example, rejected the *Phoenix* tribunal’s conclusion that good faith and compliance with the host state’s law are necessary.¹⁰ Other tribunals have taken issue with and declined to apply the “economic development” criterion.¹¹

Yet significantly, a large number of tribunals do not apply these tests at all. Rather, they simply look to see whether the “investment” at issue can fall within the IIA’s typically illustrative list of covered assets and, if so, look no further to its impacts. Moreover, absent particularly egregious circumstances such as fraud or corruption in the making of the investment, tribunals have generally even allowed illegally acquired or maintained assets to qualify as covered “investments”. (Johnson 2014). As highlighted recently by one arbitrator, under these approaches, “it is possible to conceive of an entity which is systematically earning its wealth at the expense of the development of the host State. However, much that may collide with a prospect of development of the host State, it

⁸ *Bayindir Insaat Turizm Ticaret Ve Senayi A.S. v. Pakistan*, ICSID Case No. ARB/03/29.

⁹ *Phoenix Action Ltd. v. Czech Republic*, ICSID Case No. ARB/06/5, Award, April 15, 2009, para. 114.

¹⁰ *Metal-Tech Ltd. v. Uzbekistan*, ICSID Case No. ARB/10/3, Award, October 4, 2013, para. 127.

¹¹ See, e.g., *Victor Pey Casado and President Allende Foundation v. Chile*, ICSID Case No. ARB/98/2, Award, May 8, 2008, para. 232.

would not breach a condition” of establishing that there is a covered “investment”.¹²

Paradoxically, while many tribunals have declined to *narrow* the meaning of covered “investments” by applying an “economic development” criterion, they have applied a “benefits” test in order to *broaden* the meaning of the term “investment”. More specifically, IIAs typically indicate that an “investment” must be “in the territory of” the host country in order to be satisfied. A small but apparently growing number of tribunals, however, have effectively discarded that “territoriality” element, concluding that the requirement that an investment be made “in” the host country is satisfied if the investment is made *for the benefit of* the host country.

The decision of the majority in *Abaclat v. Argentina*,¹³ and the subsequent decision of the majority in *Deutsche Bank v. Sri Lanka*,¹⁴ are two examples of how tribunals have applied this “benefit” test. In *Abaclat*, the claimants – who numbered over 180,000 at the time the case was initiated – were Italian individuals and entities who held security entitlements in international sovereign bonds issued by Argentina in the 1990s. The issue was whether those securities, which were purchased by retail investors on secondary markets, denominated in foreign currency, and governed by foreign law,¹⁵ constituted investments *in* Argentina. A majority of the tribunal determined that they did.

¹² Malaysian Historical Salvors v. Malaysia, Dissenting Opinion to Decision on Annulment, April 16, 2009, para. 22.

¹³ *Abaclat v. Argentina*, Decision on Jurisdiction and Admissibility, August 4, 2011, paras. 343-387.

¹⁴ *Deutsche Bank AG v. Democratic Socialist Republic of Sri Lanka*, ICSID Case No ARB/09/2, Award, Oct. 31, 2012.

¹⁵ Cf. *Grand River Enterprises Six Nations, Ltd. et al. v. United States*, Award, para. 88, citing *Bayview*, Award on Jurisdiction, paras. 98-99 (“[A] salient characteristic of an investment covered by the protection of NAFTA Chapter Eleven would be that the investment is primarily regulated by the law of a state other than the state of the investor’s nationality, and that this law is created and applied by that state which is not the state which is not the state of the investor’s nationality.”).

The majority reasoned that the test for whether financial instruments are “in” the host country was different from the territoriality test that applied to other types of investments:

With regard to an investment of a purely financial nature, the relevant criteria cannot be the same as those applying to an investment consisting of business operations and/or involving manpower and property. With respect to investments of a purely financial nature, the relevant criteria should be where and/or for the benefit of whom the funds are ultimately used, and not the place where the funds were paid out or transferred. Thus, the relevant question is where the investment funds ultimately made available [sic] to the Host State and did they support the latter’s economic development?¹⁶

The majority then proceeded to answer that question, stating:

There is no doubt that the funds generated through the bonds issuance process were ultimately made available to Argentina, and served to finance Argentina’s economic development. Whether the funds were actually used to repay pre-existing debts of Argentina or whether they were used in government spending is irrelevant. In both cases it was used by Argentina to manage its finances, and as such must be considered to have contributed to Argentina’s economic development and thus to have been made in Argentina.¹⁷

¹⁶ *Abaclat v. Argentina*, Decision on Jurisdiction and Admissibility, para. 374.

¹⁷ *Id.* at para. 378.

In *Deutsche Bank v. Sri Lanka*, the majority adopted the test developed by the *Abaclat* majority and determined that an oil price hedging contract between Sri Lanka's state-owned oil company and Deutsche Bank was an investment by Deutsche Bank in Sri Lanka, notwithstanding the fact that the contract had been predominantly prepared by branches of Deutsche Bank outside Sri Lanka, was governed by English law, and selected English courts as the proper forum for dispute resolution. The tribunal concluded:

In the present case, it is undisputed that the funds paid by Deutsche Bank in execution of the Hedging Agreement were made available to Sri Lanka, were linked to an activity taking place in Sri Lanka and served to finance its economy which is oil dependent. The Tribunal therefore decides that the condition of a territorial nexus with Sri Lanka is satisfied.¹⁸

In reaching that finding, the tribunal rejected Sri Lanka's argument that the "purpose of the BIT was not to provide a method of enforcement for transnational debt claims but to protect foreign investment, i.e., inward investment, from regulatory abuse."¹⁹

These approaches produce broad readings of covered "investments" while discounting any real or in-depth analysis of those investments' ties to or development impacts in the host country. As a result, free political risk insurance coverage offered by IIAs is relatively easy for investors to obtain, and the obligations and potential liability of host states expansive and difficult to limit or ascertain. Curiously, these approaches also contrast with home-state-supported political risk facilities – such as those provided by the United States' Overseas Private Investment Corporation – that expressly make political risk insurance contingent on the insured's

commitment to and compliance with various criteria designed to ensure that the investments do have positive development impacts in the host (and home) country. This raises the question of whether home states are crowding out their own performance-contingent and development-oriented insurance programs by providing investors with similar but no-cost and strings-free protection under an IIA.

(Ir)relevance of benefits or ties to the home economy

It is an underexplored question of whether and what benefits home states and their economies get from securing IIAs to protect their firms abroad. As noted above, some theoretical benefits are that IIAs can help protect the competitiveness and profitability of home country firms; another theoretical benefit that is often cited is that, by giving its investors private rights of action, the home country can free itself from having to use diplomatic capital to resolve its investors' complaints.

Complicating any effort to tally these home country benefits, however, is the fact that the *real* home and the *investment treaty home* often differ. It is increasingly common for a company with its headquarters and management in one country (Country A) to route an investment into the host country (Country C) through another country (Country B) in order to secure the benefits of an IIA between Country B and Country C. The investor may do this when there is no IIA between Country A and Country C, or when the IIA between Country B and Country C is seen as offering better protections than the IIA between Country A and Country C. (Figure 1).

Similarly, tribunals have also allowed beneficial owners in Country A, with investments in host Country C, to bring claims under the Country A-Country C treaty even though the investment was routed through a company or companies in Country B. (Figure 2).

¹⁸ *Deutsche Bank v. Sri Lanka*, para. 292.

¹⁹ *Deutsche Bank v. Sri Lanka*, para. 224.

Figure 1

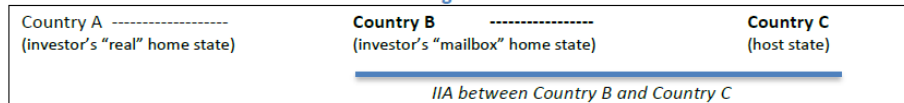
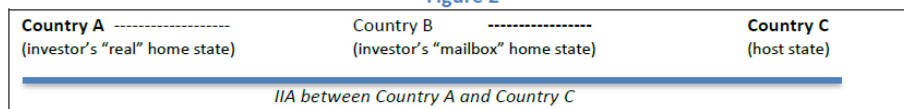


Figure 2



According to tribunals, there is no objection to companies using corporate form to engage in complex “treaty planning” similar to how they might engage in “tax planning”.²⁰ As the tribunal in *Sanum Investments Limited v. Laos* stated, for example, “The search for a convenient place of incorporation is common practice whether for fiscal reasons or for the network of investment treaties a country may have concluded. There is nothing wrong *per se* in this search.”²¹

Yet as a result of these practices, the benefits to the “real” home country become less clear: Because of the practice of treaty shopping, for example, the treaty network established by a home state likely loses relevance as a factor companies might consider when deciding whether to keep or locate their “real” activities in the home country’s territory. Another issue is that an investor aggrieved by the host country’s conduct can pursue an IIA claim as a “mailbox” national of one home country while still appealing to its “real” home country to place diplomatic pressure on the host country.²² In this sense, IIAs do not replace investor calls for diplomatic protection; they merely provide a

complementary avenue for relief. A third issue is that if an award against the host state is subsequently secured by the “mailbox” affiliate, it is unclear whether and what powers the “real” home country (or the host country) will have to tax that award and how those taxation issues affect the cost-benefit calculation.

A more nuanced assessment of costs and benefits of investment treaties

What these trends in interpretation and application of IIAs appear to evidence is a relatively blunt approach to considering what constitutes a protected “investment” – one which fails to take into account the varying characteristics and policy considerations tied to different types of assets and different ways of engaging in international business. As the debates heat up around what to do with existing IIAs, whether to conclude new ones, and what IIAs should ideally do with respect to governance of international investment, it is crucial that the discussion involve a more nuanced consideration of the types of investments and investors that are and should be covered by these instruments, and the rationales for giving them enhanced treaty protections.

References

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Sauvant, K. et al., 2014, Trends in FDI, Home Country Measures and Competitive Neutrality, Yearbook on International Investment Law & Policy, 2012-2013 (Oxford University Press): 3-108.

²⁰ Some states have begun expressly including language requiring that covered investors must have real and substantial business activities in the home country that is party to the IIA. Absent such language, however, tribunals have declined to interpret the treaties as including any such limits.

²¹ PCA Case No. 2013-13, Decision on Jurisdiction, December 13, 2013, p.ara. 309. The tribunal then added that an exception in which tribunals have considered such treaty shopping to be improper is when it is done after a dispute has arisen. *Id.* para. 311.

²² See, e.g., ADC Affiliate Ltd. v. Hungary, ICSID Case No. ARB/03/16, October 2, 2006.