

# Policy Analysis

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## *Liberalization or Litigation? Time to Rethink the International Investment Regime*

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### Executive Summary

Private investment is the great driver of economic growth. Despite this positive economic impact, however, there are sometimes objections to investment when it comes from foreign sources. These objections are misguided. Aside from occasional national security concerns, foreign investment offers all the same benefits as investment from domestic sources. A liberal and open policy toward foreign investment is clearly the optimal one. Governments should allow foreign companies to invest in the domestic market and should also allow domestic companies to invest abroad.

The United States has used international trade and investment agreements to promote foreign investment. However, if we examine the actual obligations in these agreements, we find the rules are not always about liberalization as it is usually understood. Rather than simply encouraging and welcoming foreign investment,

and treating it like domestic investment, many of the rules are designed to give special legal protections to American companies that invest abroad.

The United States is in the process of negotiating investment rules in several of its trade initiatives and is also considering new investment treaties. This recent activity in the area of investment rules provides an opportunity for reevaluation.

The current rules are not well calibrated to liberalizing foreign investment. Instead of offering a simple and direct policy of liberalization, they incorporate vague legal principles that provide numerous opportunities for litigation, and in doing so they undermine the more basic principle of treating foreign and domestic investment equally. If international rules are to be used at all in this area, a focus on nondiscrimination, and a more flexible legal framework, would be preferable to the existing system.

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## **Introduction**

Private investment is the great driver of economic growth. When companies build new factories, offer new services, and develop new technologies, the benefits spread throughout the economy. Despite the economic benefits, foreign-sourced investment is sometimes viewed with suspicion or doubt. These misgivings are misguided. Foreign investment provides economic stimulus in precisely the same manner and through the same channels as domestic investment, and it should only be opposed in the rare circumstance where national security can reasonably be considered imperiled. A liberal and open policy toward foreign investment—both inbound and outbound investment—should be the rule.

In recent decades, the United States has used the rules of international trade and investment agreements to promote foreign investment. Examining the obligations in those agreements reveals that the rules are not always about liberalization as the term is generally understood. Rather than simply encouraging and welcoming foreign investment, and treating it like domestic investment, many of the rules are designed to give special legal protections to American companies that invest abroad, allowing them to sue foreign governments directly in an international tribunal through a mechanism referred to as “investor-state dispute settlement” (and providing the same rights to foreign companies who invest in the United States). The connection between these special protections and liberalization is sometimes tenuous.

Currently, the United States is in the process of negotiating investment rules in several of its trade initiatives and is also considering new investment treaties. In the Trans Pacific Partnership, a proposed economic pact with 10 other nations in the Pacific region, negotiations on an investment chapter are well underway. More recently, the framework documents for talks on a U.S.-EU trade and investment pact have emphasized the importance of investment rules. And there have

been calls for investment treaties with China and India. All of this activity in the area of investment rules illustrates the importance of this issue and provides an opportunity to evaluate the costs and benefits of these rules.

This paper analyzes these international agreements and makes specific proposals for refocusing them on a policy of liberalizing foreign investment. It first considers the origins of the international investment system and the history and development of the U.S. investment treaty program and offers a general overview of the disputes under these international agreements. Next, it evaluates whether these rules, developed a long time ago, match up with the current state of international investment flows. Finally, it suggests a better model for foreign investment policy. In this regard, the paper argues that the existing rules are not well calibrated to liberalizing foreign investment. Instead of offering a simple and direct policy of liberalization, they incorporate vague legal principles that provide numerous opportunities for litigation, and in doing so they undermine the more basic principle of treating foreign and domestic investment equally. If international rules are to be used at all in this area, a focus on nondiscrimination and a more flexible legal framework would be preferable to the existing system.

## **The Origins of International Investment Obligations**

Protection of foreign investments through treaties has a long history, but the broad coverage treaties with effective enforcement that exist today can be traced to efforts by several European organizations in the late 1950s/early 1960s. This was a time of increased assertiveness by less-developed countries (LDCs) over their natural resources, resulting in the nationalization of a number of foreign operations, along with various other kinds of interference with, and bad treatment of, foreign companies. To deal with this issue, various attempts were made to design treaties

that provided effective recourse to a reliable adjudicatory system.

As discussed below, a key feature of today's investment treaties is that investors can file claims directly against foreign governments before an international tribunal, rather than rely on local courts or on their own government to bring a complaint on their behalf. This is referred to as the "investor-state" dispute settlement mechanism, as investors can sue states directly. The origins of investor-state come from a draft convention on foreign investment developed jointly by an English lawyer, Hartley Shawcross (a director of Royal Dutch Shell), and a German businessman, Hermann Abs (chairman of the Deutsche Bank).<sup>1</sup> The Abs-Shawcross convention was published in April 1959 as the "Draft Convention on Investments Abroad."<sup>2</sup> It marked the first tentative step toward the widely adopted, binding set of international investment rules we see today.

The Abs-Shawcross convention was seen as a "means of protecting the private foreign investments of Western capital-exporting nations."<sup>3</sup> A number of insights can be drawn from this characterization. First, the idea was not so much to push a free market approach to investment flows, under which countries would open their markets to investment because that was good policy. Rather, it was to provide additional legal protection to the investments of Western companies in developing countries. Second, and along the same lines, the agreements were fairly one-sided, in the sense that the protections were thought to be for Western countries only. This was a period where the Soviet bloc was presenting itself as a competitive threat, and the less developed world was trying to modernize and industrialize. These treaties were not thought of as a general policy tool to promote the free flow of investment, but rather as a competitive tool to help Western business.

With regard to the substance, many of the provisions of this Draft Convention have parallels to the later U.S. Bilateral Investment Treaties (BITs), described below. Article I required that "fair and equitable treatment" be

given to the property of foreign nationals. It also stated that "[s]uch property shall be accorded the most constant protection and security within the territories of the other Parties" and "the management, use, and enjoyment thereof shall not in any way be impaired by unreasonable or discriminatory measures." Article II provided that any "undertakings" (i.e., contracts) related to foreign investments must be observed. And Article III dealt with direct or indirect "deprivation" of property, and required "just and effective compensation" when that occurred. These provisions have evolved over time in the international investment system, and new provisions have been added, but this initial core is similar to what exists today.

Moving beyond the substance, of particular importance was the innovative dispute procedure in Article VII:2, under which investors could bring complaints against foreign governments directly, with the claim to be heard by an international tribunal. As provided for in the Draft Convention, this precursor to the modern investor-state procedure was only a tentative step, as investors first needed the consent of the foreign government in order to gain access to the tribunal. Presumably this approval would have been hard to obtain in many cases. But nevertheless the inclusion of the provision here laid the groundwork for the current system.

The drafters tried to present the investor-state procedure as something familiar. They emphasized that providing for individual access to an international tribunal was not new, citing the examples of the Central American Court of Justice and various European courts. They also noted that the procedure could only be used if the host government consented.<sup>4</sup>

After the Draft Convention was published, it was the subject of criticism that was similar to much of what can be seen with today's international investment obligations. Stanley Metzger, a Georgetown law professor and former State Department official, expressed concern that the regulatory space of countries who signed such treaties would

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be impaired, particularly in relation to development in poor countries, and also more generally related to economic policy in rich countries.<sup>5</sup> It was also suggested that these rules were being pushed by “business interests,” such as “banking and oil.”<sup>6</sup> Along these same lines, the Convention was criticized as being “one-sided,” focusing only on the “protection of the rights of the investor.”<sup>7</sup> As to investor-state in particular, there were concerns about “frivolous claims” in the absence of some government filter on complaints.<sup>8</sup> Finally, critics suggested buying insurance to mitigate against political risks as an alternative to what they saw as an overreaching of international investment obligations.<sup>9</sup> All of these points have also been made in relation to today’s international investment rules.

Investment treaties with investor-state dispute settlement were not negotiated immediately after the publication of the Abs-Shawcross convention, but they did begin to “emerge” during the 1960s,<sup>10</sup> eventually becoming stronger and more effective. As noted, the Abs-Shawcross provision on investor-state indicates that the foreign government who is being sued must give consent before arbitration is commenced. As of the early 1970s, most BITs had only weak investor-state clauses of this sort.<sup>11</sup> By the 1990s, however, the majority of BITs had provisions under which states gave advance consent to arbitration, meaning that direct complaints by investors could not be avoided. The development of strong investor-state protections coincided with the creation of the U.S. BIT program, as the United States, a latecomer to the practice, pushed for this.

## **The U.S. Bilateral Investment Treaty Program**

The United States has used international legal obligations to protect the rights of its foreign investors abroad for a long time, but it was only in recent decades that strong and effective obligations were developed. Spurred on in part by similar treaties negotiated by European countries, in the early 1980s the

United States began its Bilateral Investment Treaty program.<sup>12</sup> Treaties signed under this program imposed obligations on signatory governments with regard to the treatment of foreign investment and investors. Some of the key obligations in these treaties were as follows:

- Nondiscrimination, in the form of National Treatment and Most Favored Nation (MFN) obligations. In essence, this principle requires equal treatment for investors of different nationalities. These rules have counterparts in international trade law and operate in a similar manner, although some distinctions do exist.<sup>13</sup>
- A “minimum standard of treatment,” involving obligations such as “fair and equitable treatment” and “full protection and security.” Provisions of this kind are potentially very broad, and could include general principles such as reasonableness, nondiscrimination, consistency, transparency, due process, and good faith.<sup>14</sup>
- Rules on expropriation of assets, including both actual and regulatory expropriation, and compensation thereof. Such rules are similar to U.S. constitutional takings law.<sup>15</sup>

Beyond these substantive obligations, of great importance is the “investor-state” dispute settlement mechanism, under which foreign investors can sue host governments directly. This procedure is in contrast with dispute settlement under most treaties, where only governments can bring complaints against each other.

Initially, these treaties mostly protected the foreign investments made by U.S. corporations abroad. The first treaties were with developing countries such as Turkey, Senegal, and Egypt, and there was little chance that U.S. government actions toward inward investment from investors of these countries would be affected. While in theory the U.S.–Senegal BIT was available to Senegalese

investment in the U.S., such investment was minimal, and there was not much chance of litigation. It was U.S. investment abroad that was being protected. Also, the amount of U.S. investment in these countries was small, so there was no great fear of lost U.S. jobs as companies moved abroad—unlike with some later treaties. As a result, early treaties were fairly uncontroversial. There was little objection to treaties that helped an important constituency (U.S.-based multinational corporations) and caused no major concerns.

The dynamics changed significantly with the North American Free Trade Agreement (NAFTA) in 1994. While NAFTA was mostly about trade, it also incorporated the investment treaty rules of the time in a separate chapter (the NAFTA investment rules are now generally referred to as “Chapter 11”). The result was that these investment obligations now applied to two rich countries, Canada and the United States, with lots of cross-border investment and, just as importantly, clever lawyers who saw an opportunity to make creative claims against various government actions affecting those investments.

It also meant that a nearby, low-wage country, Mexico, was available as an export platform for U.S. companies. This caused concern about multinational corporations moving abroad to take advantage of weaker labor and environment rules.

As discussed further below, cases had been slow to appear under investor-state arbitration. However, NAFTA triggered a number of legal claims against the U.S. government. In response to these concerns, some minor tweaks were made to the substantive obligations over the years,<sup>16</sup> but they remained essentially the same. Then, during the 2008 presidential election, candidate Barack Obama indicated on several occasions that he supported changes to these rules.<sup>17</sup> After his election, his administration initiated a review of the “model” BIT that provides the basis for negotiating specific agreements.<sup>18</sup> On April 20, 2012, that review was finally completed, and the U.S. government announced a new model BIT.<sup>19</sup>

Again there were minor tweaks, including some steps to bring labor and environmental standards into BITs, but the substance remained mostly the same.<sup>20</sup>

This model serves as the basis for future U.S. negotiations of stand-alone investment treaties and investment chapters of trade agreements. With the substantive issues now resolved by the review, investment treaty negotiations with specific countries can go forward. After the announcement of the new model BIT, several news organizations reported that the completion of the BIT review could pave the way for a BIT with China (and Russia and India),<sup>21</sup> and one congressman specifically called for this to happen.<sup>22</sup> Along the same lines, an investment chapter is being discussed in the context of the Trans Pacific Partnership (TPP)<sup>23</sup> and is likely to be part of the recently announced U.S.–EU Trade and Investment Partnership.<sup>24</sup>

## The Investor-State Complaints

As noted, cases were slow to appear under investor-state arbitration. The first was recorded under the arbitral proceedings of the International Center for the Settlement of Investment Disputes (ICSID) in 1987, and only 14 had been brought through April 1998. But since then, investor-state cases have grown considerably. According to figures from the United Nations Conference on Trade and Development, there have been at least 30 new cases filed each year since 2003, with a record 62 initiated in 2012.<sup>25</sup>

In the United States, NAFTA triggered the first legal claims, as the cross-border investment between Canada, Mexico, and the United States far surpassed the investment covered by earlier treaties. These cases put a spotlight on how investment rules might affect domestic policymaking. It is beyond the scope of this paper to delve too deeply into the many investor-state cases that have been brought. However, examining just a few of the NAFTA complaints makes it clear that

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the issues go well beyond “border” restrictions on inflows of foreign investment, and instead focus largely on “domestic” issues. Complaints have dealt with policies such as regulations requiring backfilling and grading for mining operations in the vicinity of Native American sacred sites; the 1998 settlement agreement between various state attorneys general and the major tobacco companies; and a California Executive Order and regulations banning gasoline additive methyl tert-butyl ether (also known as MTBE).<sup>26</sup>

In terms of the impact of these cases on domestic regulation, some critics have expressed concern that the mere possibility of these claims leads to “regulatory chill,” where governments are discouraged from regulating due to the fear of being sued.<sup>27</sup> It is not clear that governments will always regulate *less* due to these rules, although that may be the case in some instances. More generally, the rules could affect *how* governments act, shaping their approach to regulating specific policy issues. Thus, regardless of the results of the actual complaints, the mere existence of the rules has an impact on policymakers.

As to the actual results of the complaints, legal scholar Susan Franck has examined the results of all investor-state cases worldwide. Through 2007, she has calculated that investors have won and the tribunal awarded damages in 38.5 percent of the cases; governments have won and paid nothing in 57.7 percent of the cases; and 3.85 percent were settled. She found that there were fifty-two cases in which tribunals made awards resulting in a damages determination. Of these cases, there were 31 instances in which investors were awarded nothing. In the remaining 21 instances, tribunals awarded damages, with the average amount of damages being approximately US\$10.4 million. The highest award was \$269 million.<sup>28</sup>

The data on these cases undermine some of the more hyperbolic claims of the critics regarding the impact of international investment rules. Investors do not win every claim, and the actual awards are much lower

than the amounts claimed by investors in their pleadings. However, it is not the win-loss record of investors that is important for judging the system. It is the structure of the system, and the ability of investors to bring claims directly under vague legal provisions, that are the sources of the problem. The existence of any legal victories under these provisions helps demonstrate that investors can and have used the rules to influence how governments regulate.

## **The Changing World of International Investment Flows**

International investment obligations have their origins in agreements that were conceived over 50 years ago. Although they have been refined over the years, they retain much of their original character. Yet during this period, foreign investment itself has changed significantly. It is therefore worth asking whether current obligations correspond with today's world of foreign investment.

The specific impetus for the early international investment rules was the end of colonialism, which resulted in the emergence of many new nations. These countries were the recipients of a great deal of investment from large Western companies and were wary of losing control of their natural resources. The result was a one-time surge in expropriation that is not likely to be repeated. Data on expropriations of foreign direct investment show a proliferation of such acts in the 1960s and 1970s, slowing to a trickle thereafter. There were 136 expropriation acts in the 1960s and 423 in the 1970s; but then only 17 in the 1980s, 22 in the 1990s, and 27 from 2000 to 2006.<sup>29</sup> Rather than rejecting foreign investment as an affront to sovereignty, most countries now welcome and encourage it (in fact, they often subsidize it, with tax breaks and other incentives). By the time most of these treaties were in place, foreign investment had already become far

more secure. Thus, to a great extent, investment treaties deal with a problem that has mostly disappeared.

Along the same lines, the spread of investment treaties beyond the original target countries calls into question the original purpose. Investment treaties now apply between wealthy democracies, whose behavior does not normally give rise to such concern.

Furthermore, the modern global economy looks different from this older period. Today's foreign investment flows in much more varied ways. It is not just Western companies investing in the developing world. It is a wide range of companies of many nationalities, investing all over the world and creating global supply chains and operations. Companies might have their headquarters in one country, develop technology in another, and produce in several other countries. And the nationality of the owners might not match up with any of these countries.

In this context, the notions of "foreign" and "domestic" investment have much less meaning. Should we think about investors as having a particular nationality, as "American" or "Korean" or "Mexican"? While particular companies may have a majority of shareholders who are citizens of a country, or may have their headquarters in a particular jurisdiction, transnational corporations are fundamentally "citizens of the world." Their owners can and do move production or other operations to wherever is the best location. As a result, a policy under which the U.S. government protects the rights of "American" investors abroad seems questionable.

To take some examples from the auto industry, in the practice of U.S. trade and investment policy, Ford is considered an "American" company, and the U.S. government often negotiates on its behalf in trade and investment agreements. But does it make sense to think of Ford this way? Total U.S. employment for Ford in the manufacturing sector is about 43,000, but Ford employs 123,000 people worldwide in 51 differ-

ent production facilities. Ford has factories in North America, Africa, South America, Australia, Europe, and Asia. In South America (26,000 employees), production is centered in Brazil and Argentina. Within Europe (38,000 employees), production is concentrated in Belgium, Germany, Romania, and Spain. And in Asia (45,000 employees), Ford plants are located in China, India, Thailand, and Turkey.<sup>30</sup>

In contrast, Toyota is thought of a "Japanese" company. While there are 16 Japanese production facilities and about 70,000 Japanese employees, Toyota has overseas employment of about 166,000. It has factories in North America, Latin America, Europe, Africa, Asia, Australia, and the Middle East. Within the United States, manufacturing employment is concentrated in Kentucky, Indiana, and Texas. In Europe, manufacturing employment is in the Czech Republic, France, Turkey, and the United Kingdom. And in Asia, manufacturing is concentrated in China, Taiwan, India, Indonesia, and Thailand.<sup>31</sup>

Clearly, both of these companies operate globally. Should the historical origin or shareholder nationality really play such a role in the legal treatment of these companies under international investment law? Why should the U.S. government push for protections for Ford abroad but not Toyota abroad? The nationality-based approach to the protections offered under these treaties does not reflect the way many companies operate in today's investment world.

Looking at another major American carmaker, it used to be said that "what is good for General Motors is good for America." That may or may not have been true then, but these days it is increasingly less true as companies have become globally integrated, and the connection between country and company is greatly weakened. What is good for America (and any other country) is finding the policies that best attract human and physical capital and make America (or other countries) an appealing place for companies—whether "foreign" or "domestic"—to invest.

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## **Evaluating the International Investment System: A Critique of the Current Rules**

Based on these changes to the nature of foreign investment flows, it is not clear whether the system as it has evolved makes sense today. In this regard, the formal statements of its purpose often focus on the “protection” of foreign investments, generally from bad treatment by foreign governments.<sup>32</sup> But is “protection” still such a vital goal? The number of rogue governments who treat foreign investment badly has fallen considerably, and thus this aim seems less important. And if “protection” is needed, what is the protection from? Discrimination, or something broader?

Instead of “protection,” a better focus for these rules may be on the increasing irrelevance of the nationality of companies. As noted above, Ford is not an “American” company in the same way it once was. Any rules on international investment should reflect that. Thus the rules could emphasize the equality of all companies, regardless of the owner’s nationality or the various jurisdictions where the company operates, by relying on the nondiscrimination principle as the core obligation.

Some might argue that nondiscrimination does not go far enough. One positive contribution of investment treaties, they might say, is that these treaties serve as an extra check on domestic regulation. At all levels of government, investors may be treated badly in some way. This includes discrimination, but also nondiscriminatory treatment that is, in some general sense, unfair, or burdensome. To the extent that the current rules constrain bad behavior by governments and offer a meaningful avenue through which such actions can be challenged, they may serve a useful function.

In response to this point, it is certainly possible that foreign entities get treated badly in domestic political and legal sys-

tems. But the existence of widespread problems of this kind in most countries, requiring international adjudication to resolve, has not been shown. Furthermore, it is not clear that there is much bad treatment that goes beyond nationality-based discrimination, and if there is a problem with discrimination, this is addressed as a specific obligation under investment treaties, making the obligations that go beyond discrimination look superfluous.

Moreover, as discussed above, “foreign”-owned companies are not “foreign” the way they once were, and domestic courts may not see them that way. If Hyundai opens a factory in Alabama, employs lots of people, and behaves as a good corporate citizen, U.S. courts are likely to treat Hyundai’s U.S. subsidiary as a domestic actor. And for all intents and purposes, Hyundai’s Alabama operations are domestic. Thus, even the suggestions of discrimination against foreign companies may be exaggerated.

There are a number of other objections to the current system as well. First, the broad and vague legal obligations that have been included offer many opportunities for enterprising investors (and their attorneys) to come up with novel legal theories in support of their claims. For example, tribunals have had a difficult time coming up with a coherent explanation of “fair and equitable” treatment, opening the door to creative legal arguments.<sup>33</sup> When these claims begin to affect domestic laws and regulations that are not protectionist, they reduce the policy autonomy of governments and thus infringe upon national sovereignty. It may be that the policies governments pursue are sometimes ineffective or misguided, but if all such policies potentially violated international investment rules, the ability of governments to fulfill legitimate functions would be reduced considerably.

Second, the investment treaty system socializes the risks of investment to some degree. Investment is an inherently risky decision, and investors know this. Risk exists regardless of whether the investment is “for-

eign” or “domestic,” and it varies depending on all the circumstances of the investment. However, there is no market failure in the area of foreign investment that needs government action. Investors can buy insurance if they want to mitigate risk, or they can sign specific arbitration contracts when they make their investment. When governments step in to promote the interests of domestic companies who invest abroad, by pushing for special protection, they are taking on some of the costs that would otherwise be paid by the investor. Instead of governments pushing economic partners on other issues (e.g., lowering tariffs) that will benefit a broader segment of the population, political capital is spent on convincing them to consent to favorable litigation procedures for foreign investors.

Third, there is an imbalance in the system, as only particular foreign investors can make use of it. A company can only bring a case if it is a legal entity of a country that has a treaty with the host country. This creates an incentive to be the right kind of “foreign” (i.e., to be from a country that has signed an investment treaty with the host), which is not the best way for companies to make decisions about corporate structure.

In this regard, there have been recent allegations that companies abuse this process by adjusting their corporate structure so as to make investment claims possible. In a complaint by cigarette maker Philip Morris against the Government of Australia under a Hong Kong–Australia BIT, Australia argued that after it committed to introduce plain packaging legislation for cigarettes in 2010, Philip Morris International adjusted its corporate structure for this purpose. In particular, the Hong Kong subsidiary Philip Morris Asia Limited acquired shares in related company Philip Morris Australia in 2011, so as to have an “investment” in Australia and be able to invoke the BIT.<sup>34</sup>

To further illustrate the complexity of this issue, assume that GM and Hyundai each open a new factory in Alabama. Under the Korea–U.S. FTA, if Hyundai feels badly treated by the local, state, or federal govern-

ment, it can file a complaint with an international tribunal based on the substantive obligations described above. Or it can use the U.S. domestic legal system for the same purpose. By contrast, GM can only use the U.S. system. Similarly, if this new factory were in Korea, GM could use the international tribunal system or the domestic courts to assert rights related to an investment, but Hyundai could only go the domestic route. Now imagine if GM buys Hyundai. Has GM become a foreign investor in Alabama by virtue of its Hyundai factory? Is GM still a foreign investor in Korea, or does its ownership of the Hyundai factory mean it is effectively a domestic company? Depending on the corporate structure that emerges, these questions may be answered in different ways by investment tribunals. This different treatment of companies based on the nationality of the ownership makes little sense and leads to distortions to normal business decisions, with companies setting up ownership in a way that is not based on market factors, but on where they can get the best access to these international tribunals.

And finally, investor-state dispute settlement leads to frivolous cases, or at least cases with a limited chance of success. Such cases push the boundaries of the rules and create doubts about the merits of the system. With most international legal obligations, only states can bring complaints. This serves as a filter to make sure that the cases that are brought can be handled successfully. Without this filter, companies and their lawyers can shape global governance, in the form of these binding international obligations, in uncertain ways. International law does not have the credibility of most domestic legal systems, and pushing controversial issues into the international legal system can be dangerous.

These concerns have led some countries to reject the current system. Importantly, it is not just authoritarian nations such as Venezuela who have pushed back. South Africa has suggested that it will phase out some of its BITs and focus instead on strengthening “its domestic legislation in respect of the

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protection offered to foreign investors by, amongst other things, codifying typical BIT provisions into domestic law.”<sup>35</sup> And based on a report from its Productivity Commission, Australia announced that it will no longer pursue investment obligations that rely on investor-state.<sup>36</sup> To some extent, then, there is an emerging movement to rethink the current system.

## **A Better Model for a Liberal Foreign Investment Policy**

In an ideal world, the U.S. government and others would recognize the benefits of foreign investment, and they would welcome and encourage it. Reasonable restrictions on the basis of security and other public policy considerations may be justifiable, but the overall climate would be one in which foreign investors were treated just like domestic investors, in both the pre- and post-establishment phases. Investment is good, regardless of the source.

In practice, of course, governments sometimes act out of nationalist interests, ignoring sound economics. This might mean discouraging foreign companies from investing domestically, or domestic companies from investing abroad. As a result, international rules related to foreign investment have the potential to be beneficial, in order to set the proper tone and promote good domestic policies.

However, a rationale for the current set of international investment rules is difficult to articulate. In the early years, they seemed to be mainly about providing international legal protection to rich country companies operating in poor countries in the post-colonial era, as these companies were often subject to the whims of unstable and unpredictable governments. But as these obligations have begun to include developed country governments with reliable judicial systems, the purpose has become less clear. What is the goal, for example, of a U.S. investment agreement with New Zealand, one of the parties to the Trans Pacific Partnership agreement that is

currently being negotiated? In what way are U.S. companies operating there in need of special protection? And why do New Zealand companies operating in the United States need these protections? It is understandable that businesses want these rules in place, as it gives them additional leverage over host governments. It is less clear, however, that the policies underlying the current system make sense in terms of allowing investment to flow freely.

While current international investment rules may provide some benefits, there are aspects of the rules which perhaps cause unnecessary controversy. First of all, the investor-state mechanism leads to many cases being filed that cause concerns about the impact on domestic sovereignty. Second, some of the rules that go beyond nondiscrimination are of uncertain scope and potentially quite broad. For example, the “minimum standard of treatment” targets bad behavior by governments. It can be analogized to a due process requirement, and it is not very precise about what behavior is covered. In addition, the rules on regulatory expropriation, which are similar to those under the U.S. Constitution’s takings clause, offer another very general rule that can be used to challenge a wide range of government actions.

Beyond these issues of the substantive scope of the agreements, a problem with these rules as *bilateral* treaties, or as part of *bilateral/regional* trade agreements, is that they may divert investment from its best use. Thus, if there is an investment treaty with Korea but not Japan, U.S. companies might invest in Korea to take advantage of the protections rather than for the merits of the investment.

Based on these critiques of the existing regime, this paper suggests several components for a possible alternative.

First, there should be a *multilateral* set of investment rules, applying to as many countries as possible. As noted, rules that apply bilaterally or regionally distort the market incentives that guide investment choices, favoring certain countries over others based solely on the existence of a treaty. Such rules

can also lead to complex, overlapping obligations, and may even come into conflict with each other.

Second, the core principle should be *nondiscrimination*, with some of the broader principles currently in effect taken out. The point of constraints on discrimination is to establish a policy of openness toward foreign investment, so as to encourage capital to flow to its most productive use, at home or abroad.<sup>37</sup> An anti-discrimination rule also prevents an escalating, back-and-forth economic competition between nations in the field of investment policy, where tit-for-tat retaliation against foreign investment may become a problem. One nation excludes its rival's foreign investors; the rival then retaliates with a similar exclusion. In contrast, government actions that are not discriminatory can have an impact on investment, but not in the same way. Experiencing the incidental effects of domestic regulation usually does not lead to the same reaction as with intentional discrimination. While broader principles such as "fair and equitable" treatment or "indirect expropriation" sound reasonable in a general sense, and are part of many countries' domestic legal systems, including them as part of the international investment regime pushes the regime into areas that bring great controversy, without addressing the core problem of promoting good economic relations through equal treatment for investors of all nationalities.

And third, the system should filter out frivolous complaints by using *state-state dispute settlement*. Investor-state dispute settlement can lead to creative and far-fetched complaints that bring unwelcome controversy to the trade and investment system, even if they are later rejected. Generally speaking, international law is about relations between nations, and a private right of action is rare. In the related field of international trade law, state-state dispute settlement at the World Trade Organization has worked very well. A similar system for investment disputes seems appropriate.

International rules, when limited in

terms of the substance and procedures, can provide benefits in terms of preventing backsliding by governments that have committed to allowing foreign investment but may have second thoughts later in the face of domestic political pressure. At the same time, though, while these limited rules may be helpful, companies need to do more on their own to address the risks of investing in countries with unreliable political and legal systems. For example, political risk insurance can be used to deal with issues of bad treatment that go beyond discrimination, such as expropriation. And companies that invest in these countries can demand special arbitration clauses as part of their investment. In essence, businesses must conduct an assessment of the risks for any investment, and act accordingly. The earlier post-colonial wave of nationalizations has dissipated; the risks are more manageable now. Governments do not need to go to bat for "domestic" companies by pushing for treaties with such broad and vague obligations.

Beyond the narrow universe of countries with these kinds of risks, local courts should be sufficient to deal with such problems. Local courts are the only option for domestic companies. Providing an additional option for foreign investors discriminates in *favor of* these investors, which makes little sense.

This proposal is a significant departure from the existing regime. However, the regime seems to have outlived its original purpose. It is now experiencing growing pains, and this may be a good time to reflect on its current functioning and evaluate its possible future. It is clear that some of the issues currently covered by international investment agreements which go beyond non-discrimination are important subjects that could benefit from international cooperation. For example, expropriation and "due process" type requirements reflect principles that, at the domestic level, often find a place in constitutional law. These issues are worth talking about at an international level, to compare and contrast how various countries operate, and perhaps search for

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common ground. However, binding international rules as they exist now may be offering something beyond what is politically feasible.

In terms of prospects for reform, the political status of international investment obligations is a bit uncertain. Have they become permanently entrenched, with the existing regime set in stone for decades? Or are they at a crossroads, with the future uncertain? There is evidence on both sides. Within Europe, the European Commission has now taken over jurisdiction of these issues from European Union (EU) member states<sup>38</sup> and is pushing forward just as hard as individual EU member states did previously. In the United States, the major review of U.S. policy in this area concluded last year with few substantive changes. At the same time, as noted above, Australia has changed course. In the TPP talks, Australia appears to be opting out of the investor-state provisions.<sup>39</sup> And Canada and the EU have had trouble reaching agreement on investment issues in the context of their trade negotiations,<sup>40</sup> suggesting that there is still disagreement among major trading countries.

The United States and the EU are now about to embark on negotiations in this area in the context of their proposed “Transatlantic Trade and Investment Partnership.” The working group report that provides the framework for these talks says, “a comprehensive U.S.-EU trade agreement should include investment liberalization and protection provisions based on the highest levels of liberalization and highest standards of protection that both sides have negotiated to date.”<sup>41</sup> The U.S.-EU talks may provide a good opportunity to rethink the proper scope of international investment rules. The United States has revised its approach to investment obligations over the years and now offers more limited protections in some areas than does the European Union. Thus, the United States and the EU will have to sort out their differences. And with EU investment in the United States over seven times the amount of Canadian investment,<sup>42</sup> there

is the potential for a large number of complaints. In the face of this prospect, the parties may want to consider why democracies with sophisticated legal systems need such rules.

## **Conclusion**

If the major economic powers that have pushed for the current international investment system were to re-evaluate these issues, they might consider the following. Many of the rules in the existing regime seem positive in and of themselves. A wide range of countries have domestic laws that deal with expropriation and regulatory expropriation. And due process-type requirements are also common. Taking these domestic principles and elevating them to international legal status is not inherently objectionable.

But there are important implications from doing so, as these rules have a real impact on domestic policymaking. To some extent, these implications are obscured when the principles are made part of an international investment regime. It makes the rules seem limited to “foreign investment” matters, whereas in reality they are much broader. This is domestic law being pushed to the international level. If this is going to be done, it should be discussed more explicitly. A global agreement on rules for expropriation, in which governments gather with the explicit task of developing common rules on compensation for expropriation, would be one thing. Applying these principles only to foreign investors, and doing so as part of what is characterized as an investment treaty, is another thing entirely.

The current set of international investment rules was created to deal with problems faced by Western companies investing in the developing world decades ago. But what rules are appropriate in today’s more balanced world of investment, where companies with multiple national affiliations invest in multitudes of countries around the world? What rules are appropriate in a

world where the nationality of companies is increasingly irrelevant, as companies operate globally and have little allegiance to particular governments? Liberalizing foreign investment is an important goal. But we need to make sure that any international rules in this area take on this task in an appropriate way, and it is worth examining how the existing system is performing. In this regard, this paper has proposed the following reforms to the system: any rules in this area should be *multilateral*, not bilateral or regional; the core principle should be *nondiscrimination*, with some of the broader principles currently in effect taken out; and *state-state dispute settlement* should be used, rather than investor-state. Rules along these lines would better reflect the current state of foreign investment flows, promote foreign investment, and maintain domestic regulatory autonomy.

## Notes

1. Andrew Newcombe, *Law and Practice of Investment Treaties* (London: Kluwer Law International, 2009), p. 22.
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3. Introduction by the editors to round table on “The Proposed Convention to Protect Private Foreign Investments.” The authors themselves referred to the “security of investment.” “Comment on the Draft Convention by its Authors,” *Journal of Public Law* 9 (1960): 119.
4. *Ibid.*
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6. Georg Schwarzenberger, “The Abs-Shawcross Draft Convention on Investments Abroad: A Critical Commentary,” *Journal of Public Law* 9 (1960): 148; Metzger, p. 133; Paul Proehl, “Private Investments Abroad,” *Journal of Public Law* 9 (1960): 362.
7. Arthur Larson, “Recipients’ Rights under an International Investment Code,” *Journal of Public Law* 9 (1960): 172–73; see also Proehl, pp. 363, 366.
8. Schwarzenberger, pp. 162–63.

9. Metzger, p. 146.
10. United Nations Centre on Transnational Corporations and International Chamber of Commerce, “Bilateral Investment Treaties 1959–1991,” pp. 11–12 (1992).
11. José Alvarez, “The Once and Future Foreign Investment Regime,” in *Looking to the Future: Essays on International Law in Honor of W. Michael Reisman*, ed. Mahnoush H. Arsanjani et al., pp. 614–15, citing Jason Webb Yackee, “Bilateral Investment Treaties, Credible Commitment, and the Rule of (International) Law: Do BITs Promote Foreign Direct Investment?” *Law & Society Review* 42 (2008): 805, 815.
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On the fair and equitable treatment (FET) clause, decisions rendered in 2011 highlight the potential unpredictability of the standard as tribunals continued to emphasize its flexible nature and coverage of a number of elements. Citing the Rumeli award, the tribunal in *Pausbok v. Mongolia* noted that the FET standard includes the following elements: transparency, good faith, conduct that cannot be arbitrary, grossly unfair, unjust, idiosyncratic, discriminatory, lacking in due process or procedural propriety and respect of the investor’s reasonable and legitimate expectations.

United Nations Conference on Trade and Development, “Latest Developments in Investor-State Dispute Settlement,” *IIA Issues Note* no. 1 (April 2012), p. 7, [http://unctad.org/en/PublicationsLibrary/webdiaeia2012d10\\_en.pdf](http://unctad.org/en/PublicationsLibrary/webdiaeia2012d10_en.pdf).

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26. The brief summaries of these cases are taken from the U.S. State Department's website for NAFTA Investor-State arbitration, <http://www.state.gov/s/l/c3439.htm>.
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31. See [http://www.toyota-global.com/company/profile/facilities/worldwide\\_operations.html](http://www.toyota-global.com/company/profile/facilities/worldwide_operations.html); [http://www.toyota-global.com/company/profile/facilities/japanese\\_production\\_site.html](http://www.toyota-global.com/company/profile/facilities/japanese_production_site.html).
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