China's Bilateral Investment Treaties with EU Member States: Gaining a Competitive Advantage Through Investment Protection

An investor-state arbitration clause is extremely important for EU investors in China, because only the investors that can invoke a full scope arbitration clause can realize the entire potential of the substantive protections granted in BITs. Fully protected investors have a significant advantage over their unprotected competitors, and we explore the options available to extend the full protection available under the 'new generation' treaties to otherwise unprotected investors.

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China's bilateral investment treaties (BITs), which include several treaties with EU member states, traditionally did not provide for an investor-state arbitration clause. In the past, China's lack of an investor-state arbitration clause made investment arbitration subject to a subsequent agreement to arbitrate, or restricted the scope of the arbitration clause to the determination of compensation for expropriation.[1] In 1998, China's policy changed.[2] Most BITs that have been signed since 1998, again including several treaties with EU member states, have provided for an unrestricted investor-state arbitration clause that permits an efficient enforcement of all substantive protections.[3] Some post-1998 BITs have not yet entered into force.[4]

INVESTOR-STATE ARBITRATION CLAUSES

Investors cannot realize the tremendous potential of substantive protections granted under BITs without an enforcement mechanism. The only autonomous and efficient enforcement mechanism is investment arbitration. Contrary to common belief, investment arbitration is not necessarily an unpredictable and costly option.

Substantive Protections

The substantive protections granted in BITs between China and EU member states are not uniform. A comprehensive set of protections would include:

- Prohibition of expropriation without prompt, adequate and effective compensation – probably the best known and the most intuitive protection that, less intuitively, also applies to the host state's conduct that deprives the investor of the value of its investment even if the title is not formally expropriated;[5]
- Fair and equitable treatment—a requirement that the host country treat the investment in a manner that appears, from the perspective of the international community, fair and equitable under the circumstances of each case; the standard has been interpreted as a guarantee providing positive incentives to foreign investors that reflects both the investor's legitimate expectations and an absolute minimum fairness and equity required under international law regardless of the level of fairness and equity granted under the host state's domestic law;[6]
- Protection and security for the investment – the host country's commitment to protect the investment against interference by third persons;[7]
- National treatment – the host state's commitment not to treat the investors less well than its own nationals;
- Most-favored nation clause – the host state's commitment not to treat the investors less well than investors from third countries; and
- Umbrella clause – the host country's commitment to comply with specific commitments to the investor; such commitments may typically be found in investment agreements, concessions or any other instruments entered into by and between the host state and the investor.

Unexpected Benefits

Three aspects of BITs are of particular interest because they offer benefits that are not available in a purely domestic setting and may even escape the protected investor's attention.

First, the host state's commitments – and their violations – are primarily governed by the investment treaty and the principles of international public law.[8] This may make the investor's claims easier and more likely to succeed than under any national law. The reasons are numerous: Investment treaties only impose obligations on the host country, which creates a 'climate' favorable to the investor. A conduct that is perfectly legal under the state's domestic law may constitute a breach of international law. The host state's liability under international law is significantly broader; the state is liable for, among others, the conduct of municipal or regional authorities or the conduct of an official in an excess of power that would not necessarily be attributable to the state under its domestic law.[9]

Second, the prevailing interpretation of the required standard of fair and equitable treatment is relatively stringent on the host country. It has been interpreted to protect investors against unjustified or unpredictable adverse changes in regulatory rules, non-transparent or inconsistent decision-making in administrative procedures, the government's failure to negotiate in good faith,[10] or gross deficiencies in the host country's judicial system.[11] Such conduct may violate the standard even if it is not motivated by a specific discriminatory or any other malevolent intent. The possibility to invoke protection under fair and equitable treatment is thus extremely important, not only for regulated industries, in case of any interference by the host government.

Third, the umbrella clauses may be interpreted, even though such interpretation is not always accepted, to transform breaches of a specific agreement between the investor and the home country, into a breach of international law.[12] Besides the advantages described above, the transformation of a contractual claim into a treaty claim may provide the advantage of a more efficient dispute-resolution mechanism.

Enforcement Options

Investor-state arbitration is not the only means to enforce the host state's obligations under a BIT. Investors may ask their home government to exercise diplomatic protection and claim remedy on the investors' behalf.[13] Investors may also be able to raise their treaty claims in litigation before the host country's courts.[14]

Those generally available alternatives, however, are significantly inferior to investor-state arbitration. The home government may refuse to advance the aggrieved investor's claim for a number of reasons, such as unwillingness to risk worsening of its broader diplomatic relations with the host country or reluctance to espouse a pro-investor interpretation of the investment treaty. Litigation before the host country's courts may raise concerns regarding their potential 'patriotic' bias or reluctance to apply international rather than domestic law.

In contrast, the investor-state arbitration gives the investor a unique opportunity to enforce its claims on an even playing field in a perfect autonomy from both the host and the home government and their domestic and international political agendas.

Predictability

Nonetheless, investors are sometimes hesitant to engage in investor-state arbitration because they doubt its predictability. Such doubt is neither surprising, nor unfounded. The true development of international investment law only started with the boom of investor-state arbitration at the very beginning of the new millennium and the interpretation of several important concepts remains unsettled. Arbitral tribunals are not in an agreement on a number of key issues such as the umbrella clause[15] or the applicability of the most-favored nation clause to procedural issues.[16]

The apparent unpredictability can be significantly reduced. First, it is important to bear in mind that the unsettled issues tend to be procedural rather than substantive. They may be avoided by a careful investment protection strategy before the dispute ever arises. A careful investor will not need to claim the benefit of the most-favored nation clause because it will have structured its investment so that it is directly protected by the most favorable treaty. Second, the investor may simply select an arbitrator known for advocating the preferable interpretation. A counsel specialized in investment arbitration will be able to propose several suitable candidates.

Costs

Many, especially smaller, investors believe that investment arbitration is prohibitively costly. That is not always correct. The costs obviously depend on the number, complexity and scope of the investor's claims. Therefore, the investor's realistic choice of asserted claims and the conciseness and clarity of their formulation may help to keep litigations costs under control. In addition, smaller claims may be decided by a sole arbitrator rather than a panel of three.[17] There is no clear precedent regarding the allocation of costs. The costs either follow the event or both sides bear their own costs irrespective of the outcome of the proceedings.

GETTING FULL PROTECTION

'New generation' investment treaties with a full range of substantive protections give the protected investor a significant competitive advantage. Therefore, all EU investors in China should seek protection under one of such 'new generation' treaties. The most-favored nation clause in the 'old generation' treaties is not a reliable way to obtain such benefit. Investors should rather channel the investment through an EU member state that is a signatory to a 'new generation' treaty. Such restructuring, however, must be made before the dispute arises.

Competitive Advantages

An investor that can benefit from a full range of substantive protections described above, and can enforce all of them in an investment arbitration, enjoys a significant competitive advantage over unprotected competitors. The relative immunity from potential dysfunctions of the host state's administration or unpredictable regulatory framework may be of particular interest, both ex-ante and ex-post. Fully enforceable investment treaties reduce the investor's legal and political risk. While its unprotected competitors may rightly believe that the host country or an industry entails an excessive political and legal risk, the protected investor may rely on the investment treaty, as a kind of insurance against such risk. If the risk materializes, the protected investor may seek compensation from the host state, to a certain extent similarly as it would seek compensation from an insurer.. Consequently, the protected investor may be justified to invest into projects that would be too risky for its unprotected competitors.

Protected Investors

Nationals of EU member states with 'new generation' treaties with China that grant a full range of substantive protections are already fully protected, provided that the BIT has entered into force.

Nationals of other EU member states should seek to obtain similar protections in an alternative way. The nationals of EU member states with 'old generation' treaties providing for the most-favored nation clause have the choice between invoking that clause and channeling their investment through a country with a 'new generation' BIT. Nationals of other EU member states only have the option of channeling their investment through a country with a 'new generation' BIT.

Most-Favored Nation Clause

Nationals of EU member states that have signed an 'old generation' treaty with China may attempt to get protected under a 'new generation' treaty by virtue of the most-favored nation clause in the applicable 'old generation' treaty. Such investors would need to claim that the most-favored nation clause entitles the investors protected under an 'old generation' treaty to rely on all more advantageous provisions of the 'new generation' treaties, including the full scope investor-state arbitration clause.

Such option, however, is very unreliable. While arbitrators advocating the broad interpretation of the most-favored nation clause might support such argument, it would be squarely rejected by arbitrators advocating the narrow interpretation.[18] As a result, investors may prefer alternative options because the outcome of an arbitration based on such argument is unpredictable.

Investment Structures

The only alternative option for insufficiently protected EU investors in China is to channel the investment through an EU member state that has signed a 'new generation' treaty with China granting a full range of substantive protections. The investor needs to hold the investment through a special purpose vehicle (SPV) incorporated in such EU member state. If an investment dispute arises, the claimant will be the SPV rather than the ultimate investor. Nonetheless, the use of such structure is subject to certain caveats:

- The investment treaty applicable to the SPV should not deny its benefits to companies controlled by the nationals of third countries;
- The structure may not constitute an abuse of personality or a fraud;[19]
- The structure should be set before the dispute arises.[20]

CONCLUSION

The fact that EU investors in China enjoy dramatically different levels of effective protection under China's investment treaties with their home countries exposes the insufficiently protected investors to a greater political and legal risk and thus constitutes a competitive disadvantage. Despite China's undeniable success in making its regulatory and administrative framework more and more investor-friendly, obtaining the maximum protection still merits careful consideration.

Endnotes

1 As of June 1 2006, China had had 'old generation' treaties with the following EU member states: Austria, Bulgaria (not in the EU as of June 1 2006), Denmark, Estonia, France, Greece, Hungary, Italy, Lithuania, Poland, Romania (not in the EU as of June 1 2006), Slovenia, and UK. See the website of the United Nations Conference on Trade and Development, www.unctad.org.

2 That turn in China's policy coincided with an unprecedented increase in Chinese investment abroad. The first 'new generation' treaty was the BIT between China and Barbados.

3 As of June 1 2006, China had signed 'new generation' treaties with the following EU member states: Belgium, Cyprus, Czech Republic, Finland, Germany, Latvia, Portugal, Slovakia, Spain and Sweden. See the website of the United Nations Conference on Trade and Development, www.unctad.org.

4 As of June 1 2006, 'new generation' treaties with the following countries had not entered into force: Belgium, Czech Republic, Finland, Luxemburg, Portugal, Slovakia, Spain and Sweden. See the website of the United Nations Conference on Trade and Development, www.unctad.org. Several of these BITs have entered into force since June 1 2006, e.g. the BIT with the Czech Republic.

5 See *Starret Housing Corp. v. Iran*, 4 Iran-United States Cl. Trib. Rep. 122, 154 (1983).

6 See *Saluka v. The Czech Republic*, Partial Award of March 17 2006, ¶ 291 et seq., available at http://www.investmentclaims.com/decisions/Saluka-CzechRep-Partial_Award.pdf.

7 See *Wena Hotels Ltd. v. Egypt*, ICSID Case No. ARB/98/4, Final Award of December 8 2000, ¶ 84 et seq., available at http://www.investmentclaims.com/decisions/Wena-Egypt-FinalAward-8Dec2000.pdf.

8 See *ADC v. Hungary*, ICSID Case No. ARB/03/16, Award of October 4 2006, ¶ 288 et seq., available at http://www.investmentclaims.com/decisions/ARB0316_ADCvHungary_AwardOctober2_2006.pdf.

9 See International Law Commission, *Articles on State Responsibility for Internationally Wrongful Acts*, (2001), available at http://untreaty.un.org/ilc/texts/instruments/english/draft%20articles/9_6_2001.pdf.

10 See *Saluka v. The Czech Republic*, Partial Award of March 17 2006, ¶

11 See *Loewen v. USA*, ICSID Case No. ARB(AF)/98/3, Award of June 26 2003, available at http://www.investmentclaims.com/decisions/Loewen-US-Award-26Jun2003.pdf.

12 See *SGS v. Philippines*, ICSID Case No. ARB/02/6, Decision on Objection to Jurisdiction of 29 January 2004, available at http://www.investmentclaims.com/decisions/SGS-Philippines-Jurisdiction-29Jan2004.pdf.

13 See International Law Commission, *Draft Articles on Diplomatic Protection*, (2006), available at http://untreaty.un.org/ilc/texts/instruments/english/draft%20articles/9_8_2006.pdf

14 Certain BITs enable investors to submit the dispute to domestic courts rather than international arbitration. The courts would then be required to apply the provisions of the BIT.

15 The line of arbitral awards advocating a narrow interpretation of the umbrella clause, that not all contractual may transform into breaches of the BIT, can be traced back to *SGS v. Philippines* (cited in footnote 12). The line of arbitral awards advocating a broad interpretation, that there is no such restriction, can be traced back to *SGS v. Pakistan*, ICSID Case No ARB/01/13, Decision on Jurisdiction of August 6 2003, 18 ICSID rev- F.I.L.J. 307 (2003), also available at http://www.investmentclaims.com/decisions/SGS-Pakistan-Jurisdiction-6Aug2003.pdf.

16 Again, two lines of contradictory interpretations exist. The broad interpretation, that the most-favored nation clause also applies to procedural rights, can be traced back to *Maffezini v. Spain*, ICSID Case No. ARB/97/7, Decision on Objections to Jurisdiction of January 25 2000, available at http://www.investmentclaims.com/decisions/Maffezini-Spain-Jurisdiction-25Jan2000-Eng.pdf. The narrow interpretation, that the most-favored nation clause does not apply to procedural rights, can be traced back to *Plama v. Bulgaria*, ICSID Case No. ARB/03/24, Decision on Jurisdiction, February 8 2005.

17 See, e.g. *Malaysian Historical Salvors SDN, BHD v. Malaysia*, ICSID Case No. ARB/05/10, Award of May 17 2007, available at http://www.investmentclaims.com/decisions/MHS-Malaysia-Award.pdf.

18 See the brief presentation of the two interpretations in footnote 16.

19 See *Saluka v. The Czech Republic*, Partial Award of March 17 2006, ¶ 230.

20 See *Tokios Tokeles v. Ukraine*, ICSID Case No. ARB/02/18, Decision on Jurisdiction of April 29 2004, ¶ 56, available at http://www.investmentclaims.com/decisions/Tokios-Ukraine-Jurisdiction-29Apr2004.pdf.