Class 6

Defences in International Investment Law: State Regulatory Space

Mesrop Manukyan

SOVEREIGNTY

What is sovereignty? How is it expressed?

Investment law an exception of sovereignty?

Sovereignty is based in customary international law and NOT investment law-specific

What about investment treaties?

TREATY AND CUSTOM

How can customary law and treaties interact with each other?

1. Interpretation VCLT
2. Governing norms superseding treaty provisions lex superior
3. Governing norms supplementing the treaty questions not covered by treaty, e.g. IMS

DEFENSES

Investment arbitration is very one-sided. How?

The state can bring certain arguments as defenses for its actions, and in many cases those arguments justify the actions of the state.

Examples?

There can be **(1)** defenses based on customary international law and **(2)** defenses based on the treaty

TREATY BASED CONCEPTS

1. Police powers doctrine
2. Deference
3. Good faith
4. Transnational public policy
5. Circumstances precluding wrongfulness

POLICE POWERS DOCTRINE

Definition?

Methanex v United States:

"...as a matter of general international law, a **non-discriminatory** regulation **for a public purpose**, which is **enacted in accordance with due process** and, which affects, inter alios, a foreign investor or investment is not deemed expropriatory and compensable **unless specific commitments had been given by the regulating government** to the then putative foreign investor contemplating investment that the government would refrain from such regulation."

POLICE POWERS DOCTRINE

Police powers is based on international law, and thus will be present, unless expressly excluded by the parties to the treaty autonomous concept

Suez v Argentina:

This case relates to the refusal of Argentinian authorities to revise water tariffs in the context of a water concession in Buenos Aires**. The tribunal stated that the police powers concept only applied in connection with breaches of the expropriatio**n clause and not other investment discipline.

Problems?

POLICE POWERS DOCTRINE

1) If the police powers doctrine is characterized as a component of expropriation clauses or as operational only in the context of an expropriation, it is no longer possible to consider it as a customary autonomous concept expressing the inherent right and duty of states to regulate.

2) Such a characterization amounts to a license for claimants to neutralize the police powers doctrine (a major avenue for expression of sovereignty) simply by bringing claims for breach of investment disciplines other than expropriation.

POLICE POWERS DOCTRINE

The Government enacts a decree that investor A's license shall terminate because the latter's operation is harmful for the environment. Police power doctrine?

Chemtura v. Canada concerned a ban on pesticides that contained the substance 'lindane' and the import of products containing such substances. The claimant was a producer of such pesticides. The Canadian Pest Management Regulatory Agency (PMRA) launched a 'Special Review' that would investigate the use of lindane, which lasted 2 years and reached the final conclusion that the ban on the products was justified, due to the ***health risks*** on the workers handling lindane-containing products. Tribunal in ***Chemtura*** recognized and applied this concept to shield a targeted measure, i.e. the suspension and later cancellation of some authorizations to produce and commercialize pesticides.

POLICE POWERS DOCTRINE

Burden of proof?

the question is no longer which party has to prove a ‘defense’ or an ‘exception’ but rather who has the burden of proving that a measure has a public purpose, that it amounts to discrimination, that it was enacted without respect for due process, that it has had certain effects, and so on.

In practice, both parties may want to address these issues in their submissions, but the burden of proving, for example, discrimination, lack of due process, and the specific effects of the measure lie clearly with the claimant.

POLICE POWERS DOCTRINE

The Government enacts a decree that investor A's license shall terminate because the latter's operation is harmful for the environment. The government assured the investor before that it would not terminate the license. Police power doctrine?

Methanex v US - **conditioned the operation of the police powers doctrine on the absence of *'specific commitments***…*given by the regulating government to the then putative foreign investor contemplating investment that the government would refrain from such regulation'*.

Prior assurances are one of the factors in considering reasonableness of state conduct?

DEFERENCE

Definition?

1. Deference can refer to the idea that international courts and tribunals have to respect the treaty-making power of states, including authoritative interpretations by contracting parties, and that **tribunals should not rewrite treaty-obligations they disagree with for policy reasons**. (***Waguih Elie George Siag and Clorinda Vecchi v Republic of Egypt***)

2. Deference can refer to an interpretive principle for interpreting international treaties, including investment treaties, in a state-friendly (or sovereignty-friendly) manner (in dubio mitius-principle) (*SGS v Pakistan*).

3. Deference is used to designate a margin of appreciation, a space for maneuver, within which host state conduct is exempt from fully fledged review by an international court or tribunal ***(SD Myers).***

DEFERENCE

2 approaches:

1. Presumption of Deference: **an underlying principle of international dispute settlement.** In such a case deference involves the respect an arbitral tribunal need to pay to the determination of facts by a domestic agency or a domestic court, to the state's substantive policy choices.

S.D. Myers v. Canada:

"investment treaty tribunals "do not have an open-ended mandate to second-guess government decision-making". If governments made mistakes in their policies or decisions, "the ordinary remedy, if there were one, for errors in modern governments is through internal political and legal processes, including elections."

DEFERENCE

2 approaches:

2. No presumption of deference, and the approach should be more differentiated.

Chevron vs Ecuador - distinguished in a case dealing with denial of justice for undue delay and manifestly unjust judgments of domestic courts as follows:

"[...] the uncertainty involved in the litigation process [...] is taken into account in determining the standard of review. [...] if the alleged breach were based on a manifestly unjust judgment rendered by the Ecuadorian court, the Tribunal might apply deference to the court's decision and evaluate it in terms of what is 'juridically possible' in the Ecuadorian legal system. However, in the context of other standards such as undue delay [...] no such deference is owed."

GOOD FAITH

The principle of good faith is stipulated in major international instruments such as Article 2(2) of UN Charter (1945). Article 26 VCLT expressly states: *"Every treaty in force is binding upon the parties to it and must be performed by them in good faith."*

It has to be noted that the customary requirement of good faith is twofold:

(a) it can be invoked by an investor when the state did not act with good faith: *'a requirement of good faith that permeates the whole approach to the protection granted under treaties and contracts'* (***Sempra v Argentina***) OR

(b) the principle of good faith can be **invoked by the state** (relevant for the purposes of this part) by allegation that the investor failed to act according to the principle of good faith and thus it cannot seek protection under the investment treaty (see below).

GOOD FAITH

Phoenix v. Czech Republic – The claim in Phoenix arose out of an Israeli company's acquisition of two metal Czech companies, Benet Praha (BP) and Benet Group (BG). BG and BP were controlled by the same person, Czech citizen Vladimir Beno. BP and BG became involved in proceedings before Czech courts, BG in relation to the ownership of three other Czech companies (one of which was insolvent); and BP in a public prosecution for tax and custom duty evasions in which assets of BP had been frozen and seized. Mr Beno sold BP and BG to Phoenix Action Ltd (Phoenix), a company incorporated under the laws of Israel and controlled by other members of Mr Beno's family. Two months later, Phoenix gave its host state notice of the existence of an investment dispute. Eleven months after giving notice of dispute, in February 2004, Phoenix commenced arbitration against the Czech Republic under the Israel-Czech Republic BIT (1997), alleging that the Czech courts' failure to resolve promptly the actions involving BP and BG was a measure equivalent to expropriation of Phoenix's assets, and a breach of the Fair & Equitable Treatment (FET) and Full Protection & Security (FPS) standards of the BIT.

GOOD FAITH

The Tribunal concluded that because the 'investment' was made without a ***bonda fide*** **intention to engage in economic transactions**, and it was made for the sole purpose of bringing international litigation against the Czech Republic, **the transaction is not a bone fide transaction and cannot be a protected investment under the ICSID system** (under the BIT and Article 25 of ICSID Convention) ... All elements analyzed lead to the same conclusion of an abuse of rights. The abuse here could be called a 'détournement de procedure', consisting in the Claimant's creation of a legal fiction in order to gain access to an international arbitration procedure to which it was not entitled. On these grounds, the Tribunal determined that it lacked jurisdiction to hear the merits of Phoenix's BIT claim.

TRANSNATIONAL PUBLIC POLICY

Definition?

TPP includes elements borrowed from a variety of sources, such as public international law "(…) the terminology used in arbitral awards, where it is not always easy to distinguish what really belongs to the concept of transnational public policy and what "merely" relates to general principles, common or fundamental principles of the law of international trade, of the lex mercatoria, of an emerging "transnational law" or also of an "international law of contracts"

TRANSNATIONAL PUBLIC POLICY

World Duty Free v Kenya

The case involved a state contract between a company form the UK and the Government of Kenya governing the former's investment in an airport duty free store. In proceedings Kenya submitted that the contract which had been obtained by corruption, did not have any force of law and thus is contrary to transnational public policy. The Tribunal considered that:

"the concept of public policy ('ordre public') is rooted in most, if not all, legal systems. Violation of the enforcing State's public policy is grounds for refusing recognition and enforcement of foreign judgments and awards. **In this respect, a number of legislatures and courts have decided that a narrow concept of public policy should apply to foreign awards. This narrow concept is often referred as 'international public policy' ('ordre public international')**. Although this name suggests that it is in some way a supra-national principle, it is in fact no more than domestic public policy applied to foreign awards and its content and application remains subjective to each State. **The term 'international public policy,' however, is sometimes used with another meaning, signifying an international consensus as to universal standards and accepted norms of conduct that must be applied in all fora**". The tribunal concluded that the contract at issue was contrary to IPP because it had been secured through bribery.

TRANSNATIONAL PUBLIC POLICY

Legality clause?

Legality of investment made under domestic law

Hamester v Ghana - *"The Tribunal considers, as was stated for example in* ***Phoenix v. Czech Republic****, that: 'States cannot be deemed to offer access to the ICSID dispute settlement mechanism to investments not made in good faith'.* ***An investment will not be protected if it has been created in violation of national or international principles of good faith; by way of corruption, fraud, or deceitful conduct; or if its creation itself constitutes a misuse of the system of international investment protection under the ICSID Convention. It will also not be protected if it is made in violation of the host State's law (as elaborated****, e.g., by the tribunal in Phoenix) [...].* ***These are general principles that exist independently of specific language to this effect in the Treaty***"

The ***Hamester*** tribunal, thus, expressly confirmed that such principles operate autonomously, irrespective of their incorporation into a treaty clause → they operate **independently from the treaty clause**.

NECESSITY

Definition?

The customary defence of necessity involved voluntary action on the part of the state in breaching its international obligation(s) for a 'higher' essential interest.

DARSIWA Article 25 provides:

1. Necessity may not be invoked by a State as a ground for precluding the wrongfulness of an act not in conformity with an international obligation of that State unless the act:

*a) is the **only means** for the State to **safeguard an essential interest against** a **grave and imminent peril**; and*

*(b) does not seriously **impair an essential interest** of the State or States towards which the obligation exists, or of the international community as a whole.*

2. In any case, necessity may not be invoked by a State as a ground for precluding wrongfulness if:

(a) the international obligation in question excludes the possibility of invoking necessity; or

(b) the State has contributed to the situation of necessity.

Because necessity can be characterized as customary 'exception', the burden of proof is on the state to show that the actions met the requirements of Article 25.

NECESSITY

Operation of necessity:

1. The affirmative requirements in 25(1) have to be cumulatively met
2. The exceptions in 25(2) must not preclude the use of defence

NECESSITY

ICJ *Gabčíkovo-Nagymaros Project* is a landmark decision in this case, despite the fact that it was taken just before the final text of then Article 33 (now 25). It is a guide to the article in its current form.

Hungary and Slovakia concluded a treaty for construction and operation of a system of lock on the River Danube, forming the border between the countries. Slovakia had completed much of the work for which it was responsible by 1989, while Hungary suspended and later abandoned much of its share of the work. Hungary and Slovakia submitted the dispute to the International Court of Justice. Hungary claimed that it was justified in suspending performance under the treaty by a 'state of ecological necessity'. The Gabčikovo portion of the project called for the construction of a large reservoir to hold sufficient water to satisfy the hydroelectric plant's operation during periods of peak demand. Hungary claimed, *inter alia*, that this large reservoir would cause unacceptable ecological risks, including artificial floods, a decrease in groundwater levels, a diminution in the quality of water, sand-choked stretches of hitherto navigable arms of the Danube, and the extinction of various flora and fauna.

NECESSITY

1. The defence should protect the essential interest

CMS v Argentina **(economic necessity) -** The Tribunal acknowledged that in certain circumstances a fiscal crisis, and the accompanying 'need to prevent a major breakdown, with all its social and political implications, might have entailed an essential interest of the State'. The Tribunal concluded, that '*the relative effect that can be reasonably attributed to the crisis does not allow for a finding on preclusion of wrongfulness*'. **The Tribunal thus found that an essential interest was affected in that the economic crisis was insufficiently catastrophic to warrant the response taken**. ***Sempra and Enron*** followed ***CMS***.

2. The interest should be against a grave and imminent peril

In **Gabčíkovo- Nagymaros Project** the court noted that (a) the 'peril' had to be established **objectively** and (b) the peril had to be **'imminent'**. The Court (ICJ) declared that "imminence" is synonymous with "immediacy" or "proximity" and goes far beyond the concept of "possibility"'

NECESSITY

3. Only means

In ***Gabčíkovo*** ICJ noted that **Hungary could have 'resorted to other means** in order to respond to the dangers that it apprehended' than the suspension and abandonment of its obligations under the treaty.

4. The invocation of defense does NOT impair an essential interest

According to **Professor Crawford**, this means that 'the interest relied on must outweigh all other considerations, not merely from the point of view of the acting State but on a reasonable assessment of the competing interests, whether these are individual or collective'.

NECESSITY: EXCEPTIONS

1. The international obligation in question precludes the use of the defense

As shown below in **C,** the parties would retain the right to raise the defenses even though there were no treaty provisions to that effect → in case of presence the treaty provision should be assessed first and if it does not fully displace customary international law as ***lex specialis***, then customary international law comes into play (***CMS Annulment Committee***).

2. The state has contributed to the situation of necessity

According to the commentary to Article 25, **the contribution must be 'sufficiently substantial and not merely incidental or peripheral'**.

Gabčíkovo-Nagymaros: the ICJ determined that Hungary had itself contributed to the situation of necessity. Hungary, with full knowledge that the Danube River project would have certain environmental consequences, had entered into the treaty it later sought to abrogate. Similar decision were reached by ***CMS and Enron***. HOWEVER, ***LG&E*** reached the opposite conclusion.

3. Jus cogens

Professor Ago's report noted that the wrongfulness of instances of aggression that are prohibited by *jus cogens* will not be precluded by necessity.

NECESSITY AND TREATY PROVISIONS

CMS v Argentina

Argentina argued that the measures challenged by the investor were covered by both the customary necessity defence and Article XI of Argentina-US BIT (an emergency clause). The tribunal discussed the customary necessity defence first, concluding that it was not available in this case. It then **moved to the analysis of the emergency clause in the treaty equating the conditions for its availability with those required by the customary defence**. The basis for reasoning of the tribunal is seen in the following passage, where it stated that it had to:

"examine whether the state of necessity or emergency meets the conditions laid down by customary international law and the treaty provisions and whether it thus is or is not able to preclude wrongfulness".

By way of illustration, the tribunal notes that it "must determine whether, as discussed in the context of DARSIWA Article 25, the act in question does not seriously impair an essential interest of the State or States towards which the obligation exists" → customary international law.

NECESSITY AND TREATY PROVISIONS

CMS v Argentina

The Ad Hoc Committee severely criticised the reasoning of the Tribunal. On the question of relations between treaty and custom the Committee rightly observed: "the requirements under **[emergency clause]** are not the same as those under customary international law as codified by Article 25, as the Parties in fact recognized during the hearing before the Committee. On that point, the **Tribunal made a manifest error of law**".

If the body of investment treaties form indeed a so-called "self-contained regime" and displace custom with accordance to the ***lex specialis*** principle, **this reasoning should operate not only to constrain the scope of State sovereignty but also to preserve it when a treaty clause has been expressly included for that purpose**.

FORCE MAJEURE

Definition?

Force majeure is a customary defence which involves and unforeseen and unavoidable external occurrence, and constitutes a circumstance precluding wrongfulness, because the state is physically unable to comply with the obligation → **the breach of international obligation is involuntary**.

DARSIWA Article 23:

1. The wrongfulness of an act of a State not in conformity with an international obligation of that State is precluded if the act is due to **force majeure**, that is the **occurrence of an irresistible force or of an unforeseen event, beyond the control of the State, making it materially impossible in the circumstances to perform the obligation**.

2. Paragraph 1 does not apply if: (a) The situation of force majeure is due, either alone or in combination with other factors, to the **conduct of the State invoking it**; or (b) The State has **assumed the risk** of that situation occurring.

FORCE MAJEURE

This defence is rarely invoked due to the difficulty of proving it. The state invoking the defence must meet the following requirements of Article 23:

1. The occurrence of irresistible force or an unforeseen event - there must be a constraint which the State was unable to avoid or oppose by its own means.

2. Beyond the control of the sate – such acts or omissions cannot be attributed to him as a result of his own wilful behaviour.

3. Material impossibility of performance – material and NOT absolute impossibility.

Similar to necessity, the defence is not available if (a) the situation of force majeure is attributable to the state invoking it or (b) the state has assumed the risk of this situation occurring.

TREATY: EXCEPTIONS

There is a **distinction between treaty-based exceptions and treaty-based carve-out**. What is the difference?

In case of the former the state is in breach of its obligation, which however is considered as 'excused'. In case of the latter the conduct of the state is not even covered by the treaty. Depending on the wording a certain 'type' of clause can be either a carve-out or an exception but not both.

It is also useful to note that in case of exceptions the **burden of proof** is on the state to show that the breach is justified according to the relevant clause of the treaty, whereas in case of carve-outs the burden is on the claimant to show that the conduct is covered and is in breach of the treaty.

CARVE OUTS

1. Carve-outs due to the fact that the conduct is simply not covered by the scope of the treaty due to lack of (a) consent, (b) *ratione personae*, (c) *ratione materiae* or (d) *ratione temporis*. Therefore, the carve-out is not due to a presence of some clause in the treaty, but rather due to limitations of the treaty on the above-mentioned grounds.

2. Carve-out due to a specific clause in the treaty, also referred to as NPM clauses. The application of the clause means that in certain cases and/or certain matters are excluded from the scope of the treaty.

CARVE OUTS

(a) Please of illegality

It is an established practice in the case-law of tribunals that the lawfulness of the acquisition of the investment is a condition precedent for the investment treaty's conferral of adjudicative power upon tribunal.

The consent of the host state to arbitral jurisdiction does not extend to disputes relating to investments that have been acquired by the claimant's violation of the host state's own law by virtue of an express provision of the investment treaty (**legality clause**) or by implication (***Hamester v Ghana***)

CARVE OUTS

(b) Legality clauses

Vannessa Ventures v Venezuela

The case concerned a situation where CVG, a state agency, cited a number of contractual violations, moved to rescind the work contract and concessions attached to a mine. After a set of legal proceedings in Venezuelan courts, Vannessa lodged a claim at ICSID for breaches of the Canada-Venezuela BIT in 2004. The treaty contained a clause similar to the one mentioned above containing the phrase ***'in accordance with the host state's law'***.

The respondent argued that the legality clause should be interpreted in accordance with the good faith interpretation requirement, and that the legality clause requires a conduct in good faith both under host state law and as a principle governing contractual obligations. More importantly, **the respondent argued that the expression 'laws of [the host state]' is not restricted to the type of legal rules formally defined as law but includes also contractual obligations**.

By referring to the ordinary meaning of the legality clause the Tribunal state that it does not cover contractual obligation but only extends to **'laws and regulations'**. However, the tribunal accepted the clause as being a legality requirement.

NPM CLAUSES

Non-precluded measures clauses (NPM) are so-called treaty-based necessity or emergency clauses, which act as carve-outs to set certain acts of the state outside of the scope of the treaty because they follow certain objectives

The **permissible objectives** mentioned above may include security, international peace and security, public order, public health, public morality, etc.

THANK YOU