The Crucial Question of Future Investment Treaties: Balancing Investors' Rights and Regulatory Interests of Host States

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Introduction

When the Lisbon Treaty entered into force on December 1, 2009, competence over foreign direct investment passed to the European Union (EU).[1] Whether this gives the EU exclusive competence for the conclusion of future international investment agreements (IIAs) has yet to be clarified.[2] However, now more than ever the question arises of how protection of investors should be harmonized with the regulatory interests of the EU and its Member States. Pursuant to Article 205 TFEU and Article 21 EU Treaty, the principles and objectives encompassing the promotion of human rights, sustainable development, and the protection of the environment will have to be taken into account as part of the EU's Common Commercial Policy[3] and will influence the negotiation of future IIAs. Along with the intense debate as to whether the EU should retain investor–state dispute settlement provisions in future IIAs, the balance between investors' rights and

[1]Article 206 and Article 207(1) Treaty on the Functioning of the European Union (TFEU), OJEU, May 9, 2008, C115/47.

[2]See, e.g., Tietje, Die Außenwirtschaftsverfassung der EU nach dem Vertrag von Lissabon, Beiträge zum Transnationalen Wirtschaftsrecht (2009), Heft 83 p. 16, http://www.wirtschaftsrecht.uni-halle.de/Heft83.pdf.

[3]Bungenberg, Going Global? The EU Common Commercial Policy After Lisbon, in: Herrmann/Terhechte (eds.), *European Yearbook of International Economic Law 2010*, pp. 123 et seq. (128); Tietje, Die Außenwirtschaftsverfassung der EU nach dem Vertrag von Lissabon, Beiträge zum Transnationalen Wirtschaftsrecht (2009), Heft 83, p. 19, http://www.wirtschaftsrecht.uni-halle.de/Heft83.pdf. For possible implications, see Bungenberg, The Politics of the European Union's Investment Treaty Making, in: Broude/Porges (eds.), *The Politics of International Economic Law*, forthcoming 2010.

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state regulatory interests will surely constitute one of the crucial questions in the drafting of future IIAs.

This question is not easy to answer since the necessary balance of interests poses one of the classic dilemmas in international investment law. On the one hand, the investor desires legal certainty, the protection of its investment, and the realization of profit. This coincides to a large extent with the interests of the contracting states to an IIA in promoting foreign investment and depoliticizing potential investment disputes. On the other hand, the "host states" of the investments generally seek to retain the greatest regulatory flexibility in order to react to national or global challenges by means of appropriate state measures – an aim that falls under the slogan "sovereign freedom of action." Although IIAs do not legally limit such freedom of action, they contain obligations to pay compensation or damages in the case of a violation of the IIA. Thus, freedom of action and the right to regulate will come at a dissuasive cost, also called "regulatory chill."

This article intends to introduce some ideas on how the conflicting interests between investors' rights and regulatory freedom could be harmonized. Nowadays, it is no longer sufficient to insist that IIAs were created for the very purpose of preventing states from interfering with investments.[4] Many states have begun to realize that IIAs entail significant obligations[5] and that these obligations can be effectively enforced by investors through investor–state dispute settlement mechanisms. This has led to public criticism and backlashes[6] ranging from the lowering of protection standards[7] to the termination of IIAs[8] or membership of the ICSID

[4]See, e.g., ICSID, Case No. ARB/01/3, *Enron Corporation Ponderosa Assets L.P./Argentine Republic*, Award (May 22, 2007), para. 331. This and all subsequent decisions are available at http://ita.law.uvic.ca or http://www.investmentclaims.com, as long as no other source is indicated.

[5]This was recently admitted by the South African government in a policy paper: "*Prior to 1994, the RSA [Republic of South Africa] had no history of negotiating BITs and the risks posed by such treaties were not fully appreciated at that time. The Executive had not been fully apprised of all the possible consequences of BITs. While it was understood that the democratically elected government of the time had to demonstrate that the RSA was an investment friendly destination, the impact of BITs on future policies were not critically evaluated. As a result the Executive entered into agreements that were heavily stacked in favour of investors without the necessary safeguards to preserve flexibility in a number of critical policy areas*." Bilateral Investment Treaty Policy Framework Review, 2009, p. 5, www.thedti.gov.za/ads/bi-lateral_policy.pdf.

[6]See C.H. Brower II, Obstacles and Pathways to Consideration of the Public Interest in Investment Treaty Disputes, in: Sauvant (ed.), *Yearbook on International Investment Law & Policy 2008-2009*, 2009, pp. 347 et seq. (357); Sornarajah, The Retreat of Neo-Liberalism in Investment Treaty Arbitration, in: Rogers/Alford (eds.), The Future of Investment Arbitration, 2009, pp. 273 et seq. (291).

[7]This tendency is apparent in the USA, see Schwebel, The United States 2004 Model Bilateral Investment Treaty: An Exercise in the Regressive Development of International Law, in: Aksen/Böckstiegel/Mustill/Patocchi/Whitesell (eds.), *Liber Amicorum Rober Briner*, 2005, pp. 815 et seq. (823); Alvarez, The Evolving BIT, TDM 7 (2010) 1, p. 8.

[8]Ecuador, e.g., terminated nine of its bilateral investment treaties (BITs) in 2008, Perkams/Secomb, Der Schutz deutscher Auslandsinvestitionen in Lateinamerika, WiVerw (2009) 1, pp. 31 et seq. (32); Cabrera Diaz, Ecuador Continues Exit from ICSID, Investment Treaty News (June 8, 2009),

Convention.[9] Interestingly, this tendency is not limited to a few Latin American states rediscovering the *Calvo* Doctrine. It can also be detected in various capital-exporting states and has influenced former "pioneers of investment protection" such as the USA.[10] The reactions are to some extent the result of the growing view that investment arbitral tribunals have not yet sufficiently taken into account states' regulatory interests.[11] This is attributed in part to the inconsistency of the arbitral awards dealing with regulatory interests,[12] and in part to a perceived bias in favor of the interests of investors.[13]

If states are to be prevented from weakening or completely abandoning the system of investment protection in the future, it will become necessary to find a balance between investors' rights and state regulatory interests. In undertaking this task, this article will first set out to delimit the regulatory interests that will be the focus of this study. In a second step, different ways of balancing investors' rights and state regulatory interests shall be examined. In so doing, a focus will be placed on the inclusion of the right to regulate in provisions of IIAs and possible issues associated with it. Finally, the question must be asked whether the inclusion of the right to regulate in provisions of IIAs can effectively establish an adequate balance between the interests of investors and those of host states.

Types of Regulatory Interests

The current uncertainty of how an adequate balance between investors' rights and regulatory interests of host states should be established might be due to the fact that the latter can be asserted in a multitude of ways. Depending on the factual and legal circumstances, regulatory interests do not necessarily belong to one and the same legal category.

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http://www.investmenttreatynews.org/cms/news/archive/2009/06/05/ecuador-continues-exit-from-icsid.aspx.

[9]Bolivia declared its termination on May 2, 2007, whereas Ecuador declared its termination on July 5, 2009, http://icsid.worldbank.org/ICSID/ICSID/ViewNewsReleases.jsp.

[10]Alvarez, The Evolving BIT, TDM 7 (2010) 1, p. 14; Vandvelde, A Comparison of the 2004 and 1994 U.S. Model BITs, Rebalancing Investor and Host Country Interests, in: Sauvant (ed.), *Yearbook on International Investment Law & Policy 2008-2009*, 2009, pp. 283 et seq. (288).

[11]C.H. Brower II, Obstacles and Pathways to Consideration of the Public Interest in Investment Treaty Disputes, in: Sauvant (ed.), *Yearbook on International Investment Law & Policy 2008-2009*, 2009, pp. 347 et seq. (361).

[12]Kalderimis, Investment Treaties and Public Goods, TDM 7 (2010) 1, p. 10; Muchlinski, Trends in International Investment Agreements, Balancing Investor Rights and the Right to Regulate. The Issue of National Security, in: Sauvant (ed.), *Yearbook on International Investment Law & Policy 2008-2009*, 2009, pp. 35 et seq. (53).

[13]Kalderimis, Investment Treaties and Public Goods, TDM 7 (2010) 1, pp. 15, 18.

Case law and the legal literature seem to use the term "regulatory interests" in connection with the state of necessity,[14] measures for the protection of national security and public order,[15] environmental protection,[16] protection of health[17] and of social and labor standards,[18] cultural exceptions,[19] human rights,[20] and the regulation of the economy in times of financial crisis.[21] However, not all of these regulatory interests are recognized to the same extent and not all contain the same conditions for implementing regulatory measures.

State of Necessity and IIA Provisions for the Protection of National Security and Public Order

Regulatory interests and the right to regulate have been extensively discussed in investment arbitration cases dealing with Argentina's financial crisis in 2001 and its aftermath.[22] Two specific legal categories potentially granting a right to regulate

[14]E.g., ICSID, Case No. ARB/01/8, *CMS Gas Transmission Company/ Argentine Republic*, Award (May 12, 2005), para. 251.

[15]E.g., ICSID, Case No. ARB/02/1, *LG&E Energy Corp, LG&E Capital Corp, LG&E International Inc/Argentine Republic*, Decision on Liability (October 3, 2006), para. 205.

[16]E.g., ICSID, Case No. ARB/00/2, *Tecnicas Medioambientales Tecmed SA/United Mexican States*, Award (May 29, 2003), para. 121.

[17]E.g., NAFTA/UNCITRAL Tribunal, *Methanex Corporation/United States of America*, UNCITRAL (NAFTA), Award (August 3, 2005), Part IV Chapter D, para. 9.

[18]ICSID, Case No. ARB/02/1, *LG&E Energy Corp, LG&E Capital Corp, LG&E International Inc/ Argentine Republic*, Decision on Liability (October 3, 2006), para. 195.

[19]Article 10(6) Canadian Model BIT (2003).

[20]ICSID, Case No. ARB(AF)/07/1, *Piero Foresti, Laura de Carli and others/Republic of South Africa*, Award (August 4, 2010) Coleman/Williams, South Africa's Bilateral Investment Treaties, Black Economic Empowerment and Mining: A Fragmented Meeting? Business Law International 9 (2008) 1, pp. 56 et seq. (83); Peterson, Human Rights and Bilateral Investment Treaties: Mapping the Role of Human Rights Law Within Investor–State Arbitration, International Centre for Human Rights and Democratic Development, 2009, Volume 3 of Investing in Human Rights series, http://www.dd-rd.ca/site/_PDF/publications/globalization/HIRA-volume3-ENG.pdf.

[21]Van Aaken/Kurtz, The Global Financial Crisis: Will State Emergency Measures Trigger International Investment Disputes? Columbia FDI Perspectives, No. 3 (March 23, 2009), http://www.vcc.columbia.edu/documents/Perspective3-vanAakenandKurtz-FINAL.pdf; Subrate Bhattacharjee, National Security with a Canadian Twist, Columbia FDI Perspectives No. 10 (July 30, 2009), http://www.vcc.columbia.edu/pubs/documents/ICAPerspective-Final.pdf.

[22]Di Pietro, State of Necessity in Investment Arbitration, The European and Middle Eastern Arbitration Review 2009, pp. 25 et seq.; Aguirre Luzi, BITs & Economic Crises: Do States have *carte blanche?* in: Weiler (ed.), *Investment Treaty Arbitration and International Law – Volume 1*, 2008, pp. 188 et seq.; Bottini, Protection of Essential Interests in the BIT Era, in: Weiler (ed.), *Investment Treaty Arbitration and International Law – Volume 1*, 2008, pp. 147 et seq.; Kurtz, Adjudging the Exceptional at International Law: Security, Public Order and Financial Crisis, Jean Monnet Working Paper No. 6, 2008, http://centers.law.nyu.edu/jeanmonnet/papers/08/080601.html; Binder, Changed Circumstances in Investment Law: Interfaces between the Law

were invoked and analyzed: the state of necessity under customary international law and clauses in IIAs for the protection of national security and public order – also called nonprecluded measures clauses. The former may preclude the wrongfulness of the host state's regulation if it constitutes the only way for the host state to safeguard essential interests against grave and imminent peril and if the act does not seriously impair an essential interest of the state towards which the obligation exists.[23] The latter allow host states to take far-reaching regulatory measures as long as interests of national security and public order are concerned.[24] Both the scope of and the differences[25] between the two categories have already been debated at length and will not have to be addressed by this article.

Declaratory Right to Regulate

This article will also not engage in an analysis of what seems to be a mere declaratory right to regulate. Such a right can be found, for example, in Article 12 of the Norway Model BIT.[26] Article 12 essentially provides that the host state of

of Treaties and the Law of State Responsibility with a Special Focus on the Argentine Crisis, in: Binder/Kriebaum/Reinisch/Wittich (eds.), *International Investment Law for the 21st Century: Essays in Honour of Christoph Schreuer*, 2009, pp. 608 et seq.; Alvarez/Khamsi, The Argentinean Crisis and Foreign Investors: A Glimpse into the Heart of the Investment Regime, in: Sauvant (ed.), *Yearbook on International Investment Law & Policy 2008-2009*, 2009, pp. 379 et seq.; Bjorklund, Economic Security Defenses in International Investment Law, in: Sauvant (ed.), *Yearbook on International Investment Law & Policy 2008-2009*, 2009, pp. 479 et seq.; Burke-White/von Staden, Investment Protection in Extraordinary Times: The Interpretation and Application of Non-Precluded Measures Provisions in Bilateral Investment Treaties, Virginia Journal of International Law 48 (2008), pp. 307 et seq.

[23]See Article 25 ILC Draft Articles on the Responsibility of States for Internationally Wrongful Acts, International Law Commission, Draft Articles on Responsibility of States for Internationally Wrongful Acts, with Commentaries, Report of the Work of the ILC's 53rd session, A/56/10 (2001), Yearbook of the International Law Commission 2001 II, pp. 31 et seq. (80 et seq.); ICJ, *Gabčíkovo-Nagymaros Project (Hungary/Slovakia)*, Judgment (September 25, 1997), ICJ Reports 1997, pp. 7, 40, para. 52.

[24]See, e.g., Article 24(3) ECT; Article 11 Argentina-USA BIT; Article 18 Uruguay-USA BIT; Article 3(2) at the end of the German Model BIT (2009); Article 2102 NAFTA. Further references in Muchlinski, Trends in International Investment Agreements, Balancing Investor Rights and the Right to Regulate. The Issue of National Security, in: Sauvant (ed.), *Yearbook on International Investment Law & Policy 2008-2009*, 2009, pp. 35 et seq. (52), footnote 83.

[25]ICSID, Case No. ARB/01/8, *CMS Gas Transmission Company/Argentine Republic*, Decision on Annulment (September 25, 2007), para. 130; Binder, Changed Circumstances in Investment Law: Interfaces between the Law of Treaties and the Law of State Responsibility with a Special Focus on the Argentine Crisis, in: Binder/Kriebaum/Reinisch/Wittich (eds.), International Investment Law for the 21st Century, Essays in Honour of Christoph Schreuer, 2009, pp. 608, 613.

[26]Similar provisions can be found, for example, in Article 1114(1) NAFTA; Article 12(2) Rwanda-USA BIT.

the investment may freely regulate in the interest of health, safety, or environmental concerns as long as the host state's measures are consistent with the IIA.[27] The provision appears to be somewhat redundant since it does not provide the host state with additional regulatory freedom.[28] The host state is restricted – as it would be without Article 12 – to regulating the investment within the boundaries of the substantive standards of the Norway Model BIT.

Regulation in the Public Interest

Instead, the article will try to focus on a "regulation in the public interest" – or "general exceptions" as they are called in the GATT/GATS context. Such regulatory interests pursue legitimate public welfare objectives and include the preservation of life, health, the environment, and social standards as well as the promotion of sustainable development and social and ecological progress of the host state. Although such regulation is not triggered by a state of necessity or national security concerns, it may still impair the profitability of an investment and conflict with substantive provisions in IIA.

A classic example is the establishment of a natural preserve at the site of a foreign investment.[29] Even if the host state's regulation promotes the environment, is nondiscriminatory, and is in compliance with the minimum standards under customary international law, the host state might still be under the obligation to pay compensation in accordance with the expropriation provisions of an applicable IIA.[30] Although the host state's right to regulate is not affected, the host state might feel that the obligation to compensate the investor impedes its sovereign freedom of action. The obligation to compensate might come at such a high cost to the host state that it causes a "regulatory chill." Ultimately, this could lead to the

[27]See Article 12 Norway Model BIT (2007): "Nothing in this Agreement shall be construed to prevent a Party from adopting, maintaining or enforcing any measure otherwise consistent with this Agreement that it considers appropriate to ensure that investment activity is undertaken in a manner sensitive to health, safety or environmental concerns."

[28]See Newcombe/Paradell, *Law and Practice of Investment Treaties, Standards of Treatment*, 2009, p. 509; Muchlinski, Trends in International Investment Agreements, Balancing Investor Rights and the Right to Regulate. The Issue of National Security, in: Sauvant (ed.), *Yearbook on International Investment Law & Policy 2008-2009*, 2009, pp. 35 et seq. (45).

[29]See, e.g., ICSID, Case No. ARB/96/1, *Compañía del Desarrollo de Santa Elena/Costa Rica*, Final Award (February 17, 2000), paras. 17 and 18.

[30]Confirming an obligation to pay compensation or damages on the part of the host state based on environmental regulations of the host state, ICSID, Case No. ARB/96/1, *Compañía del Desarrollo de Santa Elena/Costa Rica*, Final Award (February 17, 2000), para. 72; ICSID, Case No. ARB/00/2, *Tecnicas Medioambientales Tecmed SA/United Mexican States*, Award (May 29, 2003), paras. 151, 195; ICSID, Case No. ARB(AF)97/1, *Metalclad Corporation/United Mexican States*, Award (August 30, 2000), para. 111.

undesirable result that host states lower or abolish substantive standards of protection in future IIAs.

Up to now, the balancing between investors' rights and the "regulation in the public interest" by host states has received little attention. Therefore, an analysis of the problems associated with a balancing of interests could lead to useful conclusions. In what follows, the article will analyze various concepts that might be useful in resolving the described conflict between investors' rights and state regulatory interests.

Concepts of Achieving a Balance of Interests

Possible ideas for a balance of interests can be derived from a critical analysis of the status quo, as well as from considerations *de lege ferenda*. The former will show that substantive provisions in IIAs and rules of customary international law allow host states to implement regulatory interests to a considerable, yet still unsatisfactory, extent. *De lege ferenda* considerations therefore have to solve the question of how best to enshrine regulatory interests in IIAs.

Pursuing Host States' Regulatory Interests under the status quo

A closer look reveals that there exist various ways for host states to pursue regulatory interests despite their obligations toward investors under IIAs. Both substantive provisions of IIAs and customary international law seem to leave enough leeway for host states to take regulatory measures without violating provisions in IIAs. Yet, it remains to be examined whether these options are capable of achieving a balance of interests that is satisfactory for host states and investors alike.

Status quo of IIAs

IIAs contain various provisions that seem to allow a regulation in the public interest without compensation even if such regulation is not mentioned explicitly. As will be seen, among them are clauses governing the admission of investments, sector-specific exceptions, clauses allowing host states to influence investment disputes, limited dispute settlement clauses, and "relative" standards of protection.

The broadest regulatory freedom in IIAs can be found in clauses governing the admission of investments into the host state. The admission of investments must usually comply with the national legislation in force in the host state.[31] This gives

[31]See, e.g., Article 2(1) German Model BIT (2009).

the host state the possibility to regulate the admission of investments or the modalities thereof without breaching other substantive provisions of the IIA. Although, for example, Germany amended its Foreign Trade Act in 2009 with a view to restricting the market access of foreign sovereign wealth funds, it was generally not considered to be an infringement of the substantive standards of protection in German investment treaties.[32] Even states such as the USA and Canada, whose BITs and free trade agreements (FTAs) usually protect the admission of investments,[33] preserve the right to regulate admissions. Either the admission rights of potential investors are subject to extensive sector-specific exceptions or the right to initiate arbitration proceedings to enforce admission rights is excluded.[34] This – at least de facto – regulatory freedom is evidenced by Canada's tightening of the Investment Canada Act by introducing a broad national security test[35] and by the US Congress blocking investments of United Arab Emirates-based Dubai Ports World in US trade ports and investments of China National Offshore Oil Corporation in a US oil firm.[36] The weakness of the regulation of the admission of investment is that it only allows host states to preemptively block the entry of investments into the host state. It does not permit the balancing of interests with regard to investments that have already been made.

In contrast, other provisions in IIAs allow for an unrestricted regulation of investments already made. Among them are sector-specific exceptions for individual categories of state regulation. Some IIAs, for example, provide that their substantive protections do not extend to the regulation of taxation, state aid, or financial services.[37] Sector-specific exceptions can take the form of general clauses in IIAs or be included as part of individual protection provisions.[38] However, to

[32]But see Otto Sandrock, Staatsfonds und deutsche bilaterale Investitionsförderungs- und -Schutzverträge – Die Kontrolle von Staatsfonds ist mit diesen Verträgen nicht zu vereinbaren –, in: Grundmann/Kirchner/Raiser/Schwintowski/Weber/Windbichler (eds.), *Festschrift für Eberhard Schwark*, 2009, pp. 729 et seq.

[33]Muchlinski, Trends in International Investment Agreements, Balancing Investor Rights and the Right to Regulate. The Issue of National Security, in: Sauvant (ed.), *Yearbook on International Investment Law & Policy 2008-2009*, 2009, pp. 35 et seq. (40).

[34]Canadian Model BIT (2003), Annex IV; Article 1138 NAFTA and Annex 1138.2 NAFTA.

[35]Subrate Bhattacharjee, National Security with a Canadian Twist, Columbia FDI Perspectives No. 10 (July 30, 2009), http://www.vcc.columbia.edu/pubs/documents/ICAPerspective-Final.pdf.

[36]C.H. Brower II, Obstacles and Pathways to Consideration of the Public Interest in Investment Treaty Disputes, in: Sauvant (ed.), *Yearbook on International Investment Law & Policy 2008-2009*, 2009, pp. 347 et seq. (352, para. 30, 353, para. 31) with further supporting documentation; UNCTAD, The Protection of National Security in IIAs, UNCTAD/DIAE/IA/2008/5, 2009, p. 11, http://www.unctad.org/templates/Download.asp?docid=11891&lang=1&intItemID=2983 with additional examples.

[37]Article 20 (financial services), Article 21 (taxation) US Model BIT (2004); further examples in Newcombe/Paradell, *Law and Practice of Investment Treaties, Standards of Treatment*, 2009, pp. 506–508.

[38]The scope of protection afforded by most-favoured-nation clauses, for example, is often restricted regarding free trade zones or customs unions, see German Model BIT (2009), Article 3(3)-(5).

date such clauses are rare and usually restricted to very narrowly defined categories. Based on the status quo, these categories would not encompass a regulation in the public interest or allow the promotion of social or environmental goals.

In some cases, IIAs provide for a right of host states to influence investment disputes after they have arisen. For example, under North American treaty practice, the tax authorities of the contracting states may concur that their tax measures do not constitute an expropriation (so-called *joint tax veto*).[39] This would preclude a request for arbitration by investors.[40] Some IIAs also stipulate that the contracting states may interpret the IIA in a manner that is binding for arbitral tribunals.[41] This would allow contracting states to "interpret" standards of protection in such a way that gives them more regulatory discretion. Both mechanisms are rightly called into question, as they permit host states and their authorities to "judge their own cause" and to thereby compromise the legitimate expectations of investors.[42] This does not seem conducive to ensuring a fair balance of interests. At the same time, the scope of application (taxes) and the effect (an interpretation providing clarification) of the measures are too limited to guarantee host states extensive regulatory freedom in the public interest.

Another way for states to exercise de facto regulatory freedom consists in restricting the scope of investor–state dispute settlement clauses. Some next-generation FTAs and IIAs dispense with investor–state dispute settlement clauses altogether[43]; others exclude from their scope of application certain protection provisions, such as the admission of an investment.[44] As a result, state measures might possibly violate the protections provided for in the IIA. Yet, this may not necessarily lead to the enforcement of the investor's rights, as the affected investor would not be able to initiate arbitration proceedings against the host state. Whether the investor's home state would claim a violation of the IIA by way of diplomatic protection is questionable. Given the increased desire of states to regulate during tougher

[39]Article 21(2) US Model BIT (2004); Article 16(3) Canadian Model BIT (2003); Article 2103(6) NAFTA; Article 170(4) b Japan-Mexico FTA; similarly Article 21(5)(b) ECT; Kolo, Tax "Veto" as a Special Jurisdictional and Substantive Issue in Investor-State Arbitration: Need for Reassessment? Suffolk Transnational Law Review 32 (2009) 2, pp. 475 et seq.

[40]Not the case in the Energy Charter Treaty, see Article 21(5)(b)(iv) ECT.

[41]Article 1131 NAFTA; Article 30(3) US Model BIT (2004); Article 40(2) Canadian Model BIT (2003).

[42]Kolo, Tax "Veto" as a Special Jurisdictional and Substantive Issue in Investor-State Arbitration: Need for Reassessment? Suffolk Transnational Law Review 32 (2009) 2, pp. 475 et seq. (479); Weiler, Investment Arbitration and the Growth of International Economic Law, Business Law International 2 (2002) 2, pp. 158 et seq. (181–185); Whitsitt, NAFTA fifteen years later: the success, failures and future prospects of Chapter 11 (Interview with Todd Weiler) (February 16, 2009), http://www.investmenttreatynews.org/cms/news/archive/2009/02/17/nafta-fifteen-years-later-the-successes-failures-and-future-prospects-of-chapter-11.aspx.

[43]Article 11.16 Australia-US FTA; Article 107 Japan-Philippines FTA.

[44]Schedule Article 12 Mexico-Netherlands BIT; Canadian Model BIT (2003), Annex IV; Article 1138 NAFTA and Annex 1138.2.

economic times, it might be in the states' own interest to grant each other extensive regulatory freedom.

Expropriation provisions generally do not prevent states from pursuing regulatory interests. If an expropriation is nondiscriminatory and in the public interest, the host state's regulation is usually not considered to be illegal. However, expropriation clauses in IIAs usually provide that even a legal expropriation creates an obligation to pay compensation. Yet, some IIAs contain explicit exceptions from the duty to pay compensation in the case of indirect expropriations through nondiscriminatory regulations in the public interest.[45]

Finally, the terms of most provisions in IIAs are kept so general that, when interpreted, they seemingly allow for the accommodation of states' regulatory interests.[46] The wording of some provisions even permits the reading into them of implicit exceptions. The standards of national or most-favored-nation treatment, for example, are inherently relative and presuppose a comparison between the investor and another domestic or foreign investor. However, IIAs do not normally stipulate when "comparability" exists. This grants a rather broad discretion to host states and arbitral tribunals.[47] As long as no "comparability" exists, the host states are free to regulate without violating the national or most-favored-nation treatment provisions. Similarly, the broad wording of most fair and equitable treatment provisions[48] allows one to take into account whether a regulation occurred in the public interest when considering whether a treatment of an investor was fair or equitable. However, despite – or perhaps because of – the leeway certain provisions allow in their interpretation, the distinction between admissible regulations and violations of substantive protections remains a difficult one to make.[49]

As the status quo of IIAs shows, host states generally remain free to pursue regulatory interests without incurring an obligation to pay compensation – even in the absence of specific regulatory clauses in IIAs. However, the existing IIA provisions are too limited and diffuse to achieve a comprehensive balance of interests between investors and host states. For host states and investors alike,

[45]See Annex B.4(b) US Model BIT 2004; Article 13 Footnote 4 and Annex B(13)(1)(c) Canadian Model BIT (2003).

[46]McLachlan/Shore/Weiniger, *International Investment Arbitration, Substantive Principles*, 2007, para. 1.62.

[47]See Newcombe/Paradell, *Law and Practice of Investment Treaties, Standards of Treatment*, 2009, pp. 176–181, 504; Wilske/Raible, The Arbitrator as Guardian of International Public Policy? Should Arbitrators Go Beyond Solving Legal Issues? in: Rogers/Alford (eds.), *The Future of Investment Arbitration*, 2009, pp. 249 et seq. (268); Kalderimis, Investment Treaties and Public Goods, TDM 7 (2010) 1, p. 10.

[48]This might be different for clauses that are limited to the minimum standard of protection under international law, see Article 5(2) US Model BIT 2004.

[49]The same applies to incorporating the stage of development of a host state in the interpretation process, which could justify regulation in an individual case; see Article 15(d) ASEAN-Australia-New Zealand FTA; Gallus, The Influence of the Host State's Level of Development on International Investment Treaty Standards of Protection, Journal of World Investment & Trade 6 (2005) 5, pp. 711 et seq.

IIAs do not provide sufficient legal certainty when it comes to regulatory measures in the public interest. It remains to be examined whether public international law standards beyond IIAs will be able to create a more satisfactory balance.

Status quo in international law beyond IIAs

Public international law norms beyond IIAs might provide for a more consistent balance between investors' rights and the host states' regulatory interests.[50] It will be examined whether the application of Article 31(3)(c) of the Vienna Convention on the Law of Treaties of 1969 (VCLT) might achieve a homogenization of IIAs and other international law regimes by means of interpretation.[51] Also, a broader understanding of the state of necessity under international law or the taking into account of peremptory norms (*jus cogens)* could increase states' regulatory freedom in investment protection.

Pursuant to Article 31(3)(c) VCLT, "*any relevant rules of international law applicable in the relations between the parties*" must be taken into account when interpreting IIA clauses.[52] This rule of interpretation could serve as a "gateway" for conventions governing the protection of the environment, human rights, or other areas covered by state regulatory interests applicable in relations between state parties to an IIA.[53] For example, this could mean that discrimination provisions in IIAs may have to be interpreted narrowly if this were the only way of achieving the purpose of environmental obligations applicable between the parties to an IIA. The problem with such homogenization is that it presupposes a concrete link between the IIA provision and the international law norm to be taken into account. This can be derived from the wording of Article 31(3)(c) VCLT, which stipulates that (only) "*relevant*" provisions are to be taken into account.[54] Ignoring the important qualifier "*relevant*" could lead to an inadmissible modification of the relevant IIA

[50]See also Hirsch, Interactions between Investment and Non-Investment Obligations, in: Muchlinksi/Ortino/Schreuer (eds.), *The Oxford Handbook of International Investment Law*, 2008, pp.154 et seq.

[51]German Federal Law Gazette 1985 II, pp. 927 et seq.

[52]For a study of Article 31(3)(c) VCLT, see French, Treaty Interpretation and the Incorporation of Extraneous Legal Rules, International and Comparative Law Quarterly 55 (2006) 2, pp. 253 et seq.; McLachlan, The Principle of Systemic Integration and Article 31(3)(c) of the Vienna Convention, International and Comparative Law Quarterly 54 (2005) 2, pp. 279 et seq.

[53]For examples, see van Aaken, Fragmentation of International Law: The Case of International Investment Law, Finnish Yearbook of International Law 17 (2008), pp. 91 et seq. (117–121).

[54]See examples cited in Binder, Changed Circumstances in Investment Law: Interfaces between the Law of Treaties and the Law of State Responsibility with a Special Focus on the Argentine Crisis, in: Binder/Kriebaum/Reinisch/Wittich (eds.), *International Investment Law for the 21st Century: Essays in Honour of Christoph Schreuer*, 2009, pp. 608 et seq. (618).

provision instead of a clarification of its meaning by interpretation.[55] Whether a particular provision is indeed "*relevant*" can only be determined on the basis of the specific facts. So far, the mechanism of Article 31(3)(c) VCLT is largely untested and without real precedent regarding the interaction between IIA provisions and states' regulatory interests. As a result, there is – at least presently – a great deal of legal uncertainty as to whether Article 31(3)(c) VCLT can adequately balance states' regulatory interests and investors' rights under IIAs.

Another way of pursuing regulatory measures in the public interest under customary international law could be to invoke the state of necessity. Some argue that the protection of material interests of host states under the state of necessity can also include economic or environmental interests.[56] This reasoning was adopted by Argentina in arbitration proceedings resulting from the Argentine financial crisis, in which it cited "an economic state of necessity" in justification of its measures. Zimbabwe used similar legal reasoning. It justified the expropriation and subsequent seizure of farms by war veterans with the catastrophic living conditions in the country.[57] To date, this justification has usually failed owing to the narrowly defined requirements for invoking the state of necessity. The requirements presuppose that measures taken by a host state must represent the only way for the state to safeguard an essential interest against grave and imminent peril. Only in rare instances have host states managed to convince arbitral tribunals that they have met these prerequisites.[58] Moreover, necessity as defined under customary international law only represents a ground for justification of a regulatory measure and cannot remedy a violation of the IIA.[59] Article 27(b) of the Articles on the Responsibility of States for Internationally Wrongful Acts therefore prescribes an obligation on the part of the state to provide for compensation even in the event of a

[55]SCC, Case No. 079/2005, *RosInvestCo UK Ltd./Russian Federation*, Award on Jurisdiction, October 2007, para. 39.

[56]Aguirre Luzi, BITs & Economic Crises: Do States have *carte blanche?* in: Weiler (ed.), *Investment Treaty Arbitration and International Law – Volume 1*, 2008, pp. 165 et seq. (172); Muchlinski, Trends in International Investment Agreements, Balancing Investor Rights and the Right to Regulate. The Issue of National Security, in: Sauvant (ed.), *Yearbook on International Investment Law & Policy 2008-2009*, 2009, pp. 35 et seq. (57–58).

[57]ICSID, Case No. ARB/05/6, *Bernardus Henricus Funnekotter/Zimbabwe*, Award (April 22, 2009), paras. 102–107.

[58]See, e.g., ICSID, Case No. ARB/02/1, *LG&E Energy Corp, LG&E Capital Corp, LG&E International Inc/Argentine Republic*, Award (October 3, 2006), para. 239; ICSID, Case No. ARB/03/9, *Continental Casualty Company/Argentine Republic*, Award (September 5, 2008), para. 213.

[59]For a dogmatic underpinning see Kurtz, Adjudging the Exceptional at International Law: Security, Public Order and Financial Crisis, Jean Monnet Working Paper No. 6, 2008, p. 41, http://centers.law.nyu.edu/jeanmonnet/papers/08/080601.html; Binder, Changed Circumstances in Investment Law: Interfaces between the Law of Treaties and the Law of State Responsibility with a Special Focus on the Argentine Crisis, in: Binder/Kriebaum/Reinisch/Wittich (eds.), *International Investment Law for the 21st Century: Essays in Honour of Christoph Schreuer*, 2009, pp. 608 et seq. (615); ICSID, Case No. ARB/01/8, *CMS Gas Transmission Company/Argentine Republic*, Decision on Annulment (September 25, 2007), para. 134.

state of necessity.[60] Thus, just like under most expropriation provisions, the host state might be free to regulate but has a duty to compensate. This might again lead to a "regulatory chill" for host states, which is precisely what the balancing of interests seeks to avoid.

Finally, the principles of *jus cogens* could be taken into consideration when host states pursue regulatory interests. In connection with the ICSID case of *Piero Foresti et al. v. Republic of South Africa*, for example, it was asserted that South Africa's active elimination of racial discrimination that prevailed under the apartheid regime could fall within the scope of *jus cogens*. It was argued that this had to be taken into account when reviewing a violation of the IIA.[61] This line of argument is based on the notion that measures taken by a host state to protect human rights should be covered by *jus cogens*. In this case, such measures would – according to the hierarchy of norms in public international law – take priority over obligations arising out of an IIA and displace such obligations pursuant to Article 53 VCLT. A regulatory measure could thus not lead to a claim for compensation or damages. Although it is doubtful whether norms of *jus cogens* can trigger an obligation of "*affirmative action*" on the part of host states, the question ultimately remains irrelevant. In any case, states' regulatory interests would not generally and sufficiently be protected. First, it remains highly disputed as to precisely which rules form part of *jus cogens*,[62] causing a lack of legal certainty for future host states' regulation. Second, the few rules that are actually widely recognized as forming part of *jus cogens* (e.g., prohibition of slavery and genocide)[63] will likely never become relevant in an investment scenario.[64]

In conclusion, the standards of public international law may add to a certain degree to the regulatory freedom for host states. However, such freedom is paired with considerable legal uncertainty, only guaranteed in part, and does not lead to a more satisfactory balance of interests than under the IIA regime. Therefore, it is currently largely up to arbitral tribunals to decide whether, how, and in whose favor investors' rights under IIAs and host states' regulations in the public interest will be balanced.

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[60]See also ICJ, *Gabčíkovo-Nagymaros Project (Hungary/Slovakia)*, Judgment (September 25, 1997), ICJ Reports 1997, pp. 7 et seq. (39, para. 48).

[61]*Amicus curiae* petition by the International Commission of Jurists, para. 25, http://www.investmenttreatynews.org/documents/p/215/download.aspx.

[62]ILC, Draft Articles on the Law of Treaties with Commentaries, Yearbook of the International Law Commission 1966 II, pp. 187 et seq. (248 para. 2).

[63]ICJ, *Barcelona Traction, Light and Power Company (Belgium/Spain)*, Judgment (February 5, 1970), ICJ Reports 1970, pp. 3, 32, para. 34; ILC, Draft Articles on the Law of Treaties with Commentaries, Yearbook of the International Law Commission 1966 II, pp. 187 et seq. (248 para. 3).

[64]C.H. Brower II, Obstacles and Pathways to Consideration of the Public Interest in Investment Treaty Disputes, in: Sauvant (ed.) *Yearbook on International Investment Law & Policy 2008-2009*, 2009, pp. 347 et seq. (372).

Role of tribunals under the status quo

Where host states pursue regulatory measures in the public interest which are not clearly justified under IIAs or other standards of international law, it is left to arbitral tribunals to assess whether the measures result in a violation of the IIAs and in the obligation to pay damages.

This ultimately leads to a shifting of responsibility to arbitral tribunals. Whether regulatory interests can be implemented – without incurring the obligation to pay compensation – largely depends on the tribunal's approach adopted with regard to interpreting IIAs. A predominantly teleological interpretation will frequently lead to recourse to the preamble of the IIA and the tipping of the balance in favor of the "protection of investments" prescribed therein.[65] As a result, the implementation of regulatory interests will usually be accompanied by a duty to pay compensation or damages in furtherance of investor protection.

The currently existing legal uncertainty is further compounded by the fact that arbitral awards do not establish precedents for future tribunals. As evidenced by the divergent case law on the state of necessity in the Argentine cases, arbitral tribunals are not bound by awards previously rendered. Case law is currently far from uniform, especially when it comes to balancing investors' rights and regulatory interests of host states. This situation is described by more pessimistic voices as the "legitimacy crisis" of investment law.[66] It is argued that IIAs – which are aimed at remedying the legal uncertainty of the customary international law governing aliens – fail to serve their purpose. This is not least due to the fact that arbitral case law has failed to provide IIAs with a uniform scope of application.

This view, however, fails to take into account that investment law is still in its infancy. Initial inconsistencies seem unavoidable given the abundance of novel legal problems and of differently worded IIAs. It can be expected that in the medium term the best legal solutions will prevail because of their persuasiveness – and not because any precedent has been set.[67] Against this background, the regulatory interests already recognized under the current status quo might in the long run lead to the development of case law establishing a proper balance of interests between investors and host states. As shown above, existing provisions in IIA as

[65]Dolzer/Schreuer, *Principles of International Investment Law*, 2008, p. 32; Van Aaken, Fragmentation of International Law: The Case of International Investment Law, Finnish Yearbook of International Law 17 (2008), pp. 91 et seq. (126); Kurtz, Adjudging the Exceptional at International Law: Security, Public Order and Financial Crisis, Jean Monnet Working Paper No. 6, 2008, p. 33, http://centers.law.nyu.edu/jeanmonnet/papers/08/080601.html.

[66]See Burke-White, The Argentine Financial Crisis: State Liability under BITs and the Legitimacy of the ICSID System, Asian Journal of WTO & International Health Law and Policy 3 (2008) 1, pp. 199 et seq. (221–223); Franck, The Legitimacy Crisis in Investment Treaty Arbitration: Privatizing Public International Law Through Inconsistent Decisions, Fordham Law Review 73 (2005), pp. 1521 et seq. (1557, 1582, footnote 303 with further references).

[67]Paulsson, International Arbitration and Generation of Legal Norms: Treaty Arbitration and International Law, TDM 3 (2006) 5, pp. 1 et seq. (4).

well as public international law standards already allow for some measure of regulatory discretion of host states.[68]

"Codifying" a right to regulate in the public interest in future IIAs would nevertheless make sense for three reasons. First, the issue of balancing investors' and host states' interests is currently perceived as a serious problem in international investment law. A gradual development of arbitral jurisprudence balancing the interests might possibly come too late. States might decide to significantly weaken or depart entirely from the current regime of investment protection before arbitral jurisprudence can be fully developed. Second, the incorporation of regulatory interests in IIAs would merely take up a process that has already been set in motion. States have become acutely aware of the need to incorporate regulatory freedoms in IIAs and many of the more recent IIAs address the problem, at least to some extent. Therefore, it presently makes sense to discuss and develop uniform concepts – particularly with a view to the new competences of the EU. Third, an incorporation of a right to regulate in IIAs will provide arbitral tribunals with better guidance on how to deal with regulatory measures of host states. It is not least the current legal uncertainty closely associated with the host states' regulation in the public interest that causes dissatisfaction with the status quo under IIAs and public international law. Of course, one might argue that provisions containing a right to regulate would themselves be subject to interpretation and thus a potential source of divergent awards. Yet, it can be safely assumed that an incorporation of the right to regulate in IIAs will produce consistent case law much more quickly than if it remained unclear as to when a host state's liability for a regulation in the public interest is triggered under an IIA.

Incorporating a Right to Regulate in the Public Interest in IIAs

There seem to be various alternatives of incorporating a right to regulate in IIAs. The regulatory interests could be made part of the preamble, of the respective standards of protection, or drafted as a clause dealing specifically with the right to regulate. These possibilities also exist for IIAs that so far do not contain a right to regulate. The contracting states to an IIA are in principle free to implement a right to regulate at any time. IIAs only limit a state's sovereign freedom of action insofar as the contracting states to an IIA have voluntarily restricted their sovereignty on the basis of contractual obligations. The contracting states can remove these restrictions by mutual consent.[69] IIAs provide investors with rights and protections only to the extent that these have been granted by the contracting states and have not

[68]For examples, see Newcombe, General Exceptions in International Investment Agreements, in: Cordonier Segger/Gehring/Newcombe (ed.), *Sustainable Development in International Investment Law*, forthcoming 2010.

[69]Alvarez/Khamsi, The Argentinean Crisis and Foreign Investors: A Glimpse into the Heart of the Investment Regime, in: Sauvant (ed.), *Yearbook on International Investment Law & Policy 2008-2009*, 2009, pp. 379 et seq. (478).

been subsequently rescinded or restricted. Which of the three possibilities seems preferable or most practical will be examined next.

Incorporating the Right to Regulate in the Preamble

The incorporation of regulatory interests in the preamble of an IIA would have the advantage that the typical structure of the IIA would be maintained. It would furthermore clarify that the regulatory interest must be taken into account when interpreting the substantive provisions of the IIA. The preamble could establish a balance between the goal of investment protection it already stipulates and a sufficient degree of regulatory freedom on the part of the host state.[70]

However, embedding regulatory interests in the preamble seems to have serious drawbacks. The right to regulate would not be of a binding nature. It could only be used to interpret the substantive protections in the IIA and would be of limited effectiveness. Since the host state's right to regulate without paying compensation and the protection of investments are often incompatible, the conflicting policy goals might plainly neutralize each other in the interpretation of IIA provisions. The main effect of inserting regulatory interests into the preamble might well be that it prevents arbitral tribunals from interpreting IIAs one-sidedly in favor of the investor by invoking the goal of investment protection contained in the preamble. However, the incorporation of the right to regulate would not guarantee that states' regulatory interests are unequivocally asserted.

Incorporating the Right to Regulate in the Respective Standards of Protection

It would also be possible to lay down the regulatory interests in the respective standards of protection of an IIA. States are already pursuing this option in their newer treaties. Article 3 of the German Model BIT (2009), for instance, provides for national and most-favored-nation treatment. At the same time, Article 3(2) of the German Model BIT (2009) stipulates that measures that have to be taken for reasons of public security and order will not be deemed treatment less favorable within the meaning of the article. The other standards of protection are not affected by this exception. Another possibility would be to exclude an obligation to pay compensation in the case of an expropriation for reasons of environmental protection,[71]

[70]See, e.g., the preamble of the Norway Model BIT (2007): "Desiring to achieve these objectives in a manner consistent with the protection of health, safety, and the environment, and the promotion of internationally recognized labour rights; (. . .)."

[71]See López/Ortiz, New BIT between Spain and Libya: Promoting investments while protecting the environment (November 5, 2009), http://arbitration.practicallaw.com/0-500-6695.

without abrogating the requirement of fair and equitable treatment or the prohibition of discrimination.

This option makes the protection provisions in IIAs more complex and entails the risk that investors will perceive a reduction in the level of substantive protection afforded by the IIA. It increases the probability that arbitral tribunals will come to different interpretations of such provisions and issue diverging awards. The upside for investors is, however, that the host state's regulatory freedom is restricted to the very provision with which it could come into conflict. Other provisions are not affected. This means greater protection for the investor than would be the case if the host state were to have general freedom to regulate. Therefore, this option seems to represent one feasible way of balancing investors' rights and states' regulatory interests. Given that the protection provisions in IIAs vary widely, it is, however, difficult to undertake a general assessment of how they would interact with regulatory provisions in a given case. A detailed case-by-case analysis of possible interactions would go beyond the scope of this article.[72] The following analysis of specific regulatory clauses could, however, to some extent be applied mutatis mutandis to a right to regulate which is incorporated in the respective standards of protection of an IIA.

Incorporating the Right to Regulate by Drafting Specific Regulatory Clauses

The third option of incorporating a right to regulate in IIAs would be to draft a specific clause dealing with the host states' right to undertake regulatory measures in the public interest.

There would appear to be three possible ways of embodying the state's regulatory interest in a specific provision of the IIA. One possibility would be for the contracting states to agree on a general clause granting the host state the unfettered freedom to regulate. Another possibility would be to draft a provision containing specific examples of public interests and rules on how they should be implemented. The third possibility would be to include provisions covering only very particular types of public interests.

The third solution is already being used in the area of environmental protection. The BIT between Libya and Spain which came into force in 2009 contains a clause in which the contracting states explicitly reserve the right to regulate environmental matters without being obliged to pay compensation.[73] The problem with provisions

[72]See the in-depth study by Ceyssens/Sekler, Bilaterale Investitionsabkommen (BITs) der Bundesrepublik Deutschland: Auswirkungen auf wirtschaftliche, soziale und ökologische Regulierung in Zielländern und Modelle zur Verankerung der Verantwortung transnationaler Konzerne, 2005.

[73]López/Ortiz, New BIT between Spain and Libya: Promoting investments while protecting the environment (November 5, 2009), http://arbitration.practicallaw.com/0-500-6695. Similar, but without dealing with the question of compensation, Article 10 of the El Salvador-Nicaragua

of this kind is that they do not take into account other public interests possibly colliding with IIA protections. The host state's freedom of regulation would be restricted to the particular type of public interest incorporated in the IIA.

The advantage of a general clause providing a universal right to regulate without a duty to compensate is that it gives the host state the greatest possible freedom in this regard. The downside of such a clause is, however, that it basically renders the IIA's protection provisions useless. The IIA no longer provides sufficient protection for investors' entrepreneurial interests and the profit from their investments. Whenever the investors' rights under the IIA are affected, the host state could claim that it has undertaken a regulatory measure within the meaning of the general clause. This could have significant adverse effects on the host state's investment climate. It is particularly true if the host state misuses the general clause to argue that arbitrary actions targeting the investors are no longer covered by the protection provisions in the IIA. Accordingly, general clauses providing for a right to regulate *in the public interest* do not seem to be used in IIA practice. However, IIA clauses allowing for host states' regulation in the interest of national security and public order often do take the form of general clauses and seem to be modeled after the "security exceptions" in Article XXI GATT/Article XIV GATS. One reason for the use of general clauses might be that the need to regulate is particularly politically sensitive and contracting states therefore insist on sufficient room to maneuver.[74] Another reason for using general clauses may be that the contracting states are relying on customary international law – such as the state of necessity – to fill in potential gaps left open by the general wording of the clauses.[75]

However, such considerations do not apply to a right to regulate in the public interest. Neither does customary international law seem suited to fill gaps in the regulation in the public interest, nor is such regulation necessarily as politically sensitive as a regulation in the interest of national security. Taking into account the criticism of general clauses just examined above, and in line with the sparse treaty

BIT. The Belgium/Luxembourg-Libya BIT lays down environmental protection provisions in Article 5 and provisions on labor standards in Article 6; likewise the US Model BIT (2004) in Articles 12 and 13.

[74]In treaty practice, the room to maneuver is also guaranteed by formulating clauses in such a way that they are "*self-judging*" [see, e.g., Article 18 US Model BIT (2004)] and, therefore, not subject to review by the courts. However, the measure should still be subject to review according to the principles of good faith, see UNCTAD, The Protection of National Security in IIAs, UNCTAD/DIAE/IA/2008/5, 2009, p. 60, http://www.unctad.org/templates/Download.asp?docid=11891&lang=1&intItemID=2983.

[75]See Schill, Auf zu Kalypso? Staatsnotstand und Internationales Investitionsschutzrecht – Anmerkungen zur Entscheidung LG&E Energy Corp/Argentina, SchiedsVZ (2007) 4, pp. 178 et seq. (184). It is, however, doubtful as to whether sufficient comparability exists to apply the principles of necessity mutatis mutandis to clauses aimed at protecting national security, see ICSID, Case No. ARB/01/3, *Enron Corporation Ponderosa Assets L.P./Argentine Republic*, Award (May 22, 2007), para. 334; but see Muchlinski, Trends in International Investment Agreements, Balancing Investor Rights and the Right to Regulate. The Issue of National Security, in: Sauvant (ed.) *Yearbook on International Investment Law & Policy 2008-2009*, 2009, pp. 35, 67.

practice,[76] one might better draft clauses allowing for a regulation in the public interest in the form of provisions containing specific examples of public interests and rules on how they should be implemented. Such drafting would be in line with the "general exceptions" clauses in Article XX GATT/Article XIV GATS. These clauses, despite being referred to as "general," do not provide a general or universal right to regulate, but instead lay down specific examples of public regulatory interests. This form of implementation increases legal certainty for investors and seems to be suited for an adequate balancing of interests in the case of regulations not justified by a state of necessity or by the protection of national security and public order.[77]

Article 10 of the Canadian Model BIT (2003) constitutes one of the few examples of specific clauses allowing for a regulation in the public interest[78]:

1. Subject to the requirement that such measures are not applied in a manner that would constitute arbitrary or unjustifiable discrimination between investments or between investors, or a disguised restriction on international trade or investment, nothing in this Agreement shall be construed to prevent a Party from adopting or enforcing measures necessary:
   (a) to protect human, animal or plant life or health;
   (b) to ensure compliance with laws and regulations that are not inconsistent with the provisions of this Agreement; or
   (c) for the conservation of living or non-living exhaustible natural resources.

Although the incorporation of specific regulatory clauses in IIAs seems suited to establish a balance between investors' rights and host states' regulatory interests, there remain a number of problems, and these will be considered in greater detail below.

[76]For examples of FTAs with investment chapters see Newcombe/Paradell, *Law and Practice of Investment Treaties, Standards of Treatment*, 2009, p. 490. "Security exceptions" and "general exceptions" are combined in Article 24 ECT. Article 24(1) and (2) ECT relates to public interest, whereas Article 24(3) ECT deals with the protection of national security and public order.

[77]*Newcombe* points out that the incorporation of specific regulatory clauses in IIAs might even prove beneficial for investors. Experience in WTO law has shown that a codification of regulatory clauses can limit the regulatory flexibility of host states. Host states might find themselves limited to a regulation of the particular public interests embodied in the specific regulatory clause. They would, however, be prevented from pursuing other kinds of public interests not contained in such a clause; see Newcombe, General Exceptions in International Investment Agreements, in: Cordonier Segger/Gehring/Newcombe (eds.), *Sustainable Development in International Investment Law*, forthcoming 2010. Thus, specific regulatory clauses seem to constitute an appropriate form of balancing investors' rights and host states' interests. The express confirmation of the regulatory freedom of host states through incorporation in an IIA is balanced by the increased legal certainty for investors as to what can be regulated.

[78]See also Article 24 Norway Model BIT (2007); Article 15(1)(c) Japan-Vietnam BIT. For additional examples see Newcombe, General Exceptions in International Investment Agreements, in: Cordonier Segger/Gehring/Newcombe (eds.), *Sustainable Development in International Investment Law*, forthcoming 2010.

Issues of Implementing the Balance of Interests

To actually *balance* the interests concerned when drafting a clause containing the right to regulate in the public interest, the legal nature of such a clause and the legal consequences associated with it have to be analyzed. One must also consider how regulatory clauses can be drafted in a way that sufficiently protects the investors' rights and prevents abuse by host states despite their greater regulatory freedom. If regulatory clauses are – in accordance with prevailing treaty practice – modeled on the provisions of the "general exceptions" of the GATT/GATS, one must also determine whether and how arbitral tribunals could draw on interpretative principles established in WTO case law dealing with "general exceptions."

Legal Nature and Legal Consequences of Regulatory Clauses

There seem to be two possible ways of incorporating a right to regulate in the public interest in IIAs. One would be to draft the regulatory clause as a true exception to the protections granted to investors in the IIA. The other would be to design the regulatory clause as a justification for the breach of IIA obligations. As both approaches are not free from criticism, a third way might be to focus on the legal consequences of regulatory clauses rather than on their legal nature.

Regulatory Clause as an Exception

Regulatory clauses that are drafted in the form of an exception to IIA obligations afford the contracting states ample freedom to act. If the clause applies, it excludes the operation of the substantive provisions of the IIA as well as the host state's obligation to pay compensation as a legal consequence of its regulatory measure.[79] The above-cited Article 10 of the Canadian Model BIT (2003) represents an example of such a type of clause.[80]

However, it is doubtful whether drafting regulatory clauses as exceptions to IIA obligations would establish an adequate balance of interests. With this type of clause, an investor could in some situations be worse off than he would be under the principles of customary international law governing the treatment of aliens.[81]

[79]ICSID, Case No. ARB/01/8, *CMS Gas Transmission Company/Argentina*, Decision on Annulment (September 25, 2007), para. 146.

[80]Similarly Article 24(2) ECT: "*The provisions of this Treaty (. . .) shall not preclude any Contracting Party from adopting or enforcing any measure (. . .).*"

[81]Newcombe/Paradell, *Law and Practice of Investment Treaties, Standards of Treatment*, 2009, pp. 505, 506.

Should the regulatory clause permit measures to protect the environment and should the investor's property be expropriated on account of the establishment of a natural preserve, he would not receive any compensation.[82] Because of the clause's legal nature as an exception, the application of the expropriation provision in the IIA would be excluded.

It could be argued that drafting regulatory clauses as veritable exceptions might run counter to the IIAs' aim of protecting and promoting investments. If instead of pursuing a balance of interests only the host state's interests are promoted, the host state's investment climate might deteriorate and the promotion of investments could be frustrated. One might object that this only applies to the specific regulatory interests that are contained in the regulatory clause. However, very much will depend on the drafting of the clause and the breadth of regulatory interests it encompasses.

Regulatory Clause as Justification

Another dogmatic possibility would be to draft the regulatory clause as a justification for the breach of obligations. It could be modeled after Article 25 ILC of the Articles on the Responsibility of States for Internationally Wrongful Acts and provide that a regulation in the public interest precludes the wrongfulness of a regulatory measure not in conformity with substantive IIA obligations. If this consequently precluded the host state's duty to pay compensation, it would actually not make much of a difference which legal nature the regulatory clause is given.

If, however, the justification entailed that, similarly to Article 27(b) of the Articles on the Responsibility of States for Internationally Wrongful Acts, the host state remained liable to pay compensation to the investor, other problems emerge. Such a regulatory clause would seem to be of little use because host states under the current system are already free to regulate – as long as they accept that the breach of the IIA leads to a duty to pay compensation or damages. Also, such a regulatory clause might not increase the regulatory freedom for host states because the host state's obligation to pay compensation could cause a "regulatory chill."[83]

[82]Therefore, even when framing the regulatory clause as an exception, the drafters of the regulatory clause should ensure that the duty to pay compensation in the case of an expropriation remains. Otherwise, the very principles of investment protection would be eroded. See also Newcombe, General Exceptions in International Investment Agreements, in: Cordonier Segger/Gehring/Newcombe (eds.), *Sustainable Development in International Investment Law*, forthcoming 2010.

[83]This also applies to the concept of regulatory freedom as laid down in Article 24 ECT. Although the clause is effectively designed as an exception in Article 24(2) ECT, Article 24(1) ECT provides that the exception is not to be applied to compensation in the case of expropriation. Despite the freedom to regulate contained in Article 24(2) ECT, the host state would therefore still be obliged to pay compensation in the case of expropriation. See also Article 15 Japan-Vietnam BIT.

Focus on Legal Consequences of Regulatory Clauses

As the preceding discussion has shown, it is not so much the legal nature of regulatory clauses but much more their legal consequences – compensation/damages or not – which create a dilemma when trying to balance investors' rights and state regulatory interests.

This could call for a moving away from the current "all-or-nothing" model for compensation. Instead, a solution in accordance with the principle of proportionality[84] should be found which takes into consideration the importance of the host state's regulatory interest. The more the host state's regulation promotes the public interest and the less it impairs the investor or its investment, the lower the compensation payable would be. Conversely, the lesser the effect on the public interest and the greater the impairment of the investor's interests, the higher the compensation payable. Working out the specifics of such a balanced model for compensation would go beyond the scope of this article. That said, it should be pointed out that *Kriebaum* has already done the basic groundwork on the "proportionality of compensation" in connection with a study on expropriation in international law.[85] Her findings could be used as a basis for the balancing of interests when it comes to a right to regulate in the public interest. When the findings are transferred to the case of regulation in the public interest, it will be necessary to balance the impact of the regulatory measure and the justified expectations of the investor against the relevance of the measure for the regulatory objective[86] and the relevance of the public interests protected or pursued by the measure and the particular interest of the host state in paying reduced compensation.

Preconditions of a Regulation in the Public Interest

Besides focusing on the legal consequences of regulatory measures, the drafting of particular conditions for the exercise of a right to regulate could also lead to a reasonable balance of interests.

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[84]On the principle of proportionality in international law, see van Aaken, Defragmentation of Public International Law Through Interpretation: A Methodological Proposal, Indiana Journal of Global Legal Studies 16 (2009) 2, pp. 483 et seq.

[85]Ursula Kriebaum, *Eigentumsschutz im Völkerrecht – Eine vergleichende Untersuchung zum internationalen Investitionsrecht sowie zum Menschenrechtsschutz*, 2008, p. 554; similarly Hirsch, Interactions between Investment and Non-Investment Obligations, in: Muchlinksi/Ortino/Schreuer (eds.), *The Oxford Handbook of International Investment Law 2008*, pp. 154 et seq. (177).

[86]Whether the regulation was necessary to achieve the desired effects will often have already been examined when the chapeau of the regulatory provision was reviewed, see, e.g., Article 10 Canadian Model BIT (2003) ("*necessary*").

In a study on the implementation of states' regulatory interests in the area of national security, the Organization for Economic Cooperation and Development (OECD) has prepared guidelines to be followed by host states when taking regulatory measures.[87] For example, it is suggested that the investor and the public should be notified and consulted in good time with regard to planned state measures and the related objectives pursued by such measures. The guidelines also call for effective and objective judicial and official reviewability as well as involvement of high government levels in the event of restrictive investment policy measures. These guidelines could be applied to a regulation in the public interest and appear suitable for taking into account the investor's interests in the case of regulatory measures. Although incorporating the entire guidelines into a regulatory clause of an IIA would likely exceed the scope of such a clause, a reference to the OECD guidelines might constitute a possibility.

The GATT/GATS-like Article 10 of the Canadian Model BIT (2003) contains a different kind of precondition for the exercise of a right to regulate. Its introductory clause ("*chapeau*") stipulates that the regulatory measure may not constitute arbitrary or unjustifiable discrimination or a disguised restriction on investment. In addition, such a measure must be necessary to achieve the regulatory objectives pursued. The final part of Article 24(2) Energy Charter Treaty sets forth a very similar provision. Both of these clauses embody the principle of good faith and the prohibition of the abuse of rights[88]: A host state that regulates in the public interest must safeguard the rights of the other contracting state – and therefore, indirectly, the rights of the investor. If this is not done, the right to regulate is precluded.

It is remarkable that "chapeau clauses" or similar clauses[89] seem to reintroduce through the "back door" some of the substantive IIA provisions – such as discrimination and fair and equitable treatment provisions – which the regulatory clauses are meant to exclude or justify. The *chapeau* contains standards similar to those of IIAs: The host states' *chapeau* obligations contained in Article 10 of the Canadian Model BIT (2003), the final part of Article 24(2) Energy Charter Treaty, or Article 4 (2)(a)-(c) Azerbaijan-Belgium/Luxembourg BIT can be found in a nearly identical form in the substantive IIA provision prohibiting discrimination and requiring fair and equitable treatment. If a just balancing of interests only appears possible by including typical substantive IIA standards in *chapeau* clauses, the question arises why explicit clauses for regulation of public interests should be included in IIAs at all. This question will be taken up again in the summary of this article.

[87]OECD, Building Trust and Confidence in International Investment, 2009, p. 17, http://www.oecd.org/dataoecd/18/47/42446942.pdf.

[88]Newcombe/Paradell, *Law and Practice of Investment Treaties, Standards of Treatment*, 2009, p. 504.

[89]See, e.g., Article 4(2) Azerbaijan-Belgium/Luxembourg BIT, which, however, only applies to regulation aimed at protecting national security.

Using GATT/GATS and WTO Jurisprudence as a Basis for Arbitral Decisions

Most of the clauses that provide for a right to regulate in the public interest in IIAs are either based on the provisions of Article XX GATT/Article XIV GATS or make direct reference to them.[90] Despite the indisputable differences between investment law and WTO law,[91] it seems possible to use tried and tested regulatory clauses as a model.[92] Arbitral tribunals basing their interpretative process on established WTO principles might provide greater legal certainty for the parties to arbitration proceedings.

Newcombe and *Paradell* are explicitly in favor of investment arbitration tribunals referring to WTO case law when interpreting regulatory clauses in IIAs.[93] They point to already developed principles that would promote the balance of interests between the investor and the host state. For example, the burden of proof that a measure falls within the regulatory clause should rest on the state taking the regulatory measure.[94] Moreover, a multistage analysis of "general exceptions" has emerged. Transferred to an investment arbitration scenario, one would first have to check whether the state regulation falls under the scope of the regulatory clause and in a second step examine whether the regulation meets the requirements of the "*chapeau*." In particular with regard to the question of whether a regulatory measure was "necessary," a finely differentiated WTO jurisprudence with multiple weighing and balancing steps has developed[95] which could also be applied when interpreting regulatory clauses in IIAs.

However, it remains doubtful whether arbitral tribunals are willing to take into consideration the already developed WTO jurisprudence on "general exceptions" when interpreting clauses for the regulation in the public interest.[96] This might be

[90]E.g., Article 200 China-New Zealand FTA.

[91]Kalderimis, Investment Treaties and Public Goods, TDM 7 (2010) 1, p. 1; Kurtz, The MFN Standard and Foreign Investment – an Uneasy Fit? Journal of World Investment & Trade 5 (2004) 6, pp. 861 et seq. (866–872).

[92]See ICSID, Case No. ARB/03/9, *Continental Casualty Company/Argentine Republic*, Award (September 5, 2008), para. 192.

[93]Newcombe/Paradell, *Law and Practice of Investment Treaties, Standards of Treatment*, 2009, p. 504.

[94]For a differentiated distribution of the burden of proof in the case of regulation aimed at protecting national security, see Muchlinski, Trends in International Investment Agreements, Balancing Investor Rights and the Right to Regulate. The Issue of National Security, in: Sauvant (ed.), *Yearbook on International Investment Law & Policy 2008-2009*, 2009, pp. 35 et seq. (71).

[95]Newcombe/Paradell, *Law and Practice of Investment Treaties, Standards of Treatment*, 2009, p. 504.

[96]According to *Newcomb* and *Paradell*, arbitral tribunals display a good deal of skepticism toward using WTO case law in their interpretative process, Newcombe/Paradell, *Law and Practice of Investment Treaties, Standards of Treatment*, 2009, p. 503, with reference to NAFTA/UNCITRAL Tribunal, *Methanex Corporation/United States*, Final Award (August 3, 2005), Part IV para. 21.

due to the fact that it is unsettled as to how and to what extent arbitral tribunals should take into account such WTO jurisprudence. For this reason, contracting states to an IIA could agree on interpretative guidance in IIAs and refer arbitral tribunals to WTO jurisprudence on "general exceptions" in a subparagraph of the regulatory clause, in an annex to the IIA, or in the documented negotiation history of the IIA. Regulatory clauses which make direct reference to the GATT/GATS provisions[97] also seem to suggest that arbitral tribunals should take into consideration WTO jurisprudence on "general exceptions."

The use of WTO jurisprudence as a basis for the interpretation of regulatory clauses in IIAs could accelerate uniform case law with a view to new regulatory clauses. Therefore, such a trend should be welcomed as long as the regulatory clauses in IIAs are in fact sufficiently similar to Article XX GATT/Article XIV GATS and arbitral tribunals sufficiently take into account the differences between WTO and investment law when interpreting the regulatory clauses.

Conclusion

The analysis has shown that host states can pursue different regulatory goals in different ways. The status quo under IIAs and public international law allows for a regulation in the public interest – the exercise of which, however, lacks the necessary legal certainty. Therefore, the incorporation in IIAs of a clause containing specific examples of regulatory interests – similar to Article 10 of the Canadian Model BIT (2003) – appears to be a feasible approach.

In the analysis of the possible drafting of such a clause, it emerged that an appropriate balancing of interests might have to be pursued through a "proportionality of compensation" and a *chapeau* similar to GATT/GATS provisions. The application and interpretation of these new concepts bears the risk that arbitral tribunals will once again reach divergent conclusions. The situation could be aggravated by the fact that the concepts do not correspond to the already known standards of protection in IIAs and a uniform jurisprudence will yet have to develop. It also seems possible that some arbitral tribunals follow principles of WTO jurisprudence with regard to regulation in the public interest and the *cheapeau*, whereas others will opt for an investment-law-specific interpretation. In such a case, the incorporation of the right to regulate in IIAs might not resolve but instead intensify what is sometimes perceived as the legitimacy crisis in investment law. Therefore, some might argue that the legal uncertainty surrounding regulatory

By contrast, the arbitral tribunal in ICSID, Case No. ARB/03/9, *Continental Casualty Company/Argentine Republic*, Award (September 5, 2008), para. 192, was more open toward referencing WTO case law. This might be explained by the fact that the president of the arbitral tribunal, Professor Sacerdoti, was a member of the WTO Appellate Body from 2001 to 2009.

[97] Article 200 of the China-New Zealand FTA; Chapter 15 Article 1(2) of the ASEAN-Australia-New Zealand FTA.

interests should be dealt with by introducing an appellate mechanism[98] or an international investment court[99], and not by incorporating regulatory clauses in IIAs.

However, it currently seems that the insistence on such a "grand solution" fails to give proper consideration to practical realities. The introduction of completely new or additional dispute resolution mechanisms has become a distant prospect, particularly after ICSID withdrew its proposal on an appeals mechanism. A multilateral effort that would be necessary for such reforms cannot be expected, given the currently prevailing critical view of investment law taken by states.

By contrast, there is an emerging trend of incorporating regulatory interests in IIAs. This trend could be taken up in the sense of a "small solution." Even if the status quo already offers a certain amount of regulatory freedom, incorporating the right to regulate in IIAs promises to provide improved clarity and certainty on how to deal with regulations in the public interest. It would also signify a clear acknowledgement of the regulatory freedom of states and could help diminish the current criticism of the investment protection regime.

It will be the task of arbitral tribunals to give shape to such norms and to harmonize investors' rights and state regulatory interests by means of a consistent interpretation. The incorporation of regulatory clauses should ultimately make the tribunals' task easier[100]: Instead of having to selectively and implicitly read regulatory clauses into already existing standards of protection, arbitral tribunals could use a regulatory clause with examples of regulatory interests as a starting point. The clause might give arbitral tribunals useful guidance and prevent overly narrow or broad interpretations of standards of protection by reference to the preambles of IIAs.[101] Incorporating the right to regulate in a specific clause should aid in developing a uniform case law on regulatory interests more quickly. This could be further facilitated by taking into account the existing WTO jurisprudence on "general exceptions."

Therefore, it seems advisable to take up the emerging trend and give thought to how to incorporate regulatory interests in IIAs.[102] In so doing, an appropriate balancing of interests only seems possible if a possible abuse of regulatory clauses

[98]For a critical view, see Tams, An Appealing Option? The Debate about an ICSID Appellate Structure, Beiträge zum Transnationalen Wirtschaftsrecht Heft 57, 2006, p. 42, http://www.wirtschaftsrecht.uni-halle.de/Heft57.pdf.

[99]See, e.g., Van Harten, *Investment Treaty Arbitration and Public Law*, 2007, p. 180.

[100]See Wilske/Raible, The Arbitrator as Guardian of International Public Policy? Should Arbitrators Go Beyond Solving Legal Issues? in: Rogers/Alford (eds.), *The Future of Investment Arbitration*, 2009, p. 249 et seq. (270): "Arbitrators – like judges – can only be as good as the law they apply."

[101]Newcombe/Paradell, *Law and Practice of Investment Treaties, Standards of Treatment*, 2009, p. 504.

[102]Kalderimis, Investment Treaties and Public Goods, TDM 7 (2010) 1, p. 18; Alvarez/Khamsi, The Argentinean Crisis and Foreign Investors: A Glimpse into the Heart of the Investment Regime, in: Sauvant (ed.), *Yearbook on International Investment Law & Policy 2008-2009*, 2009, pp. 379 et seq. (478): "BIT parties can change the treaties they ratify (. . .) to incorporate more sovereignty-protective provisions. (. . .) Demanding that arbitrators recalibrate BITs by rewriting them for the state parties is not the best route to legitimize the investment regime."

by host states is prevented by provisions that bear resemblance to the existing nondiscrimination and fair and equitable treatment standards in IIAs. An additional possibility for balancing interests should follow from a "proportionality of compensation" that balances the investors' interests in their investments against the importance of the public interest at issue. Naturally, these ideas need to be further developed. However, they form a starting point for an incorporation of the right to regulate in future IIAs – and should also be of interest for possible future IIA negotiations in accordance with the Common Commercial Policy of the EU.