

Safeguarding Public Policy Space in International Investment Agreements: An ASEAN Perspective^{*}

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ABSTRACT

International investment agreements are treaties aimed at attracting foreign investment by providing protection for such investment in the host country. Over 3,200 of such agreements exist globally, including over 300 by ASEAN countries. These agreements also give investors the right to directly challenge their hosts for compensation, in case of breach. They therefore significantly affect the host country's space in the conduct of public welfare policy, which includes safeguarding the environment, public health or financial stability. This is why there has recently been a wave of critique against the current investment agreement regime.

This policy-oriented article highlights current issues relating to international investment agreements. Drawing examples from treaty-making experiences of ASEAN countries, the article shows how these countries attempt to protect their public policy space, most prominently through the inclusion of safeguard clauses into these agreements. However, this does not completely eliminate risks of litigation, and some ASEAN countries have taken more extreme measures by disengaging themselves from such agreements.

Keywords: International Investment agreement, bilateral investment treaty, free trade agreement, investor-state dispute settlement, public policy

JEL Classification: F02, F21, F58, F53, K33, K41, G28

1. Introduction

In 1997, the Mexican government had to pay over \$16.7 million to a U.S. hazardous waste disposal firm for allegedly closing a plant which harmed the local environment. In 2007, Argentine government was sued by over 60,000 bondholders following its sovereign debt restructuring in the aftermath its financial crisis. More recently, in 2012, the Australian government was sued by a Hong Kong subsidiary of a U.S. tobacco company for introducing plain packaging regulations on cigarette packages.²

These cases highlight a growing trend in international investment agreements. In particular, they show that these agreements have significant implications on public welfare measures, such as protecting public health or ensuring financial stability. This article therefore aims to draw attention to these concerns by providing an overview of the issues and challenges relating to international investment agreements. Particular, it discusses implications of these agreements on public welfare policies. Drawing examples from treaty-making experiences of ASEAN countries, the article shows how ASEAN countries protect their public policy space by various means, most prominently through the inclusion of tailored safeguard clauses into these agreements. However, this does not completely eliminate risks of litigation, and some ASEAN countries have taken more extreme measures by disengaging themselves from the investment treaty regime.

A review of recent literature on this issue points to a broad consensus that countries need “to strike a balance between principles regarding the protection and promotion of foreign investment on the one hand and principles regarding

² See: *Metalclad v. Mexico* (1997), *Abaclat v. Argentina* (2007) and *Philip Morris v. Australia* (2012)

the protection of society and the environment on the other” (Spears, 2010). Critiques of current treaty-making practice and attempts to reform them are currently espoused not only by key international organizations such as the United Nations Conference on Trade and Development (UNCTAD 2012, 2014a, 2014b and 2014c) or the Organisation for Economic Co-operation and Development (OECD, 2008), but also by many civil society groups which have realized the serious nature of the issue (Eberhardt et al., 2012; Traidcraft, 2015). The main thrust of this article shares the consensus view of the need to reform these agreements in order to safeguard public policy space. Going beyond the coverage in recent literature, this article uses examples of ASEAN countries’ experiences in designing investment agreements which have safeguards relating to the host country’s public policy space.

This article is divided into three sections: The first provides an introduction to international investment agreements, focusing on their purpose, forms and current proliferation. The second and main part discusses ways in which these agreements affect public policy-making, particularly highlighting obligations which may impinge on the host government’s public policy-making, drawing from ASEAN-based investment agreements. The final part assesses various avenues that countries have been taking to reform such agreements.

2. What are International Investment Agreements?

2.1. Background: The grand bargain

International investments agreements are legal commitments by host governments protecting foreign investments from measures by the hosts that may cause damage to such investments. If such damage were to occur,

investors have the right to remedy, among others, in an Investor-State Dispute Settlement (ISDS) under an international arbitration tribunal.

The first investment agreement was signed between Germany and Pakistan in 1959. This was in a period when newly independent countries in the developing world opened up to receive FDI from developed countries. However, a major cause of concern for these “first world” investors was that host countries in the developing world had unpredictable or even arbitrary policies that damaged their investments. These policies included nationalizations of foreign investments—particularly in resource extracting industries—that were a bane to investors.

There is a “grand bargain” between the contracting parties of such investment treaties through *promises* of protection for *prospects* of investment flows.³ The host country is obliged to ensure that investments by private investors of other signatory countries would be protected. Besides protection from arbitrary expropriation as highlighted above, this also includes fair and non-discriminatory treatment as well as free transfer of funds. The expected payoff from this is that the greater institutional and legal certainty established by these agreements would encourage investors of the other contracting party to invest in the host country.

Yet due to this protection, the host government has to limit some of its sovereign policy space in order to protect incoming investments: Any domestic laws, regulations or measures would be scoped down by obligations in the investment. These can cover the whole gamut of a government’s policy space, but this article will focus only on those which relate to a country’s public welfare objectives.

³ Salacuse (2010).

To illustrate, they include measures such as revoking licenses due to environmental issues, imposing laws relating to public health or safety, or recapitalization of banks during financial crises.

2.2. Forms of International Investment Agreements

International investment agreements initially took the form of “Bilateral Investment Treaties” or BITs. These treaties only cover investment *protection*, meaning that only investment that has already been established in the host country (so-called “post-establishment” phase) will be covered under the agreement. However, they do not deal with investment *liberalization* (the so-called “pre-establishment” phase) concerning the *admission* of foreign investments into the host country.

With the advent of Free Trade Agreements (FTAs), most prominently the North American Free Trade Agreement (NAFTA), investment chapters have become an integral part of FTAs. In the spirit of deepening economic integration, liberalizing trade in goods and services would need to be complemented with investment as well. This is why FTAs usually include investment *liberalization* and *protection*. This article will only focus on issues concerning investment protection.

On a multilateral level, however, a single investment agreement remains elusive. Currently, there are multilateral agreements in the trade in goods and services—the General Agreement on Trade in Goods (GATT) (1947) and the General Agreement on Trade in Services (GATS) (1995), both under the aegis of the World Trade Organization. There were attempts to create a multilateral investment treaty for members of the Organization for Economic Cooperation and Development (OECD) in the late 1990s under the

“Multilateral Investment Agreement” (MAI). However, the MAI failed to materialize as countries pulled out when civil society groups raised concerns that the MAI would threaten national sovereignty especially by limiting labor and environmental standards.⁴

2.3. Proliferation of International Investment Agreements

In light of the lack of a multilateral investment agreement, it is obviously more tempting for countries to sign bilateral investment agreements. There is thus a rapidly growing trend of countries signing BITs. Up until now, over 3,000 BITs have been signed worldwide. Previously, the country pairs were mostly between developing and developed countries, but over the past two decades, the picture has changed, with developing and developed countries signing agreements with their own peers. As mentioned, investment chapters are also now part of all FTAs, except for a few exceptions.

A prominent example of a region that has actively engaged in investment rule-making is the Association of Southeast Asian Nations or ASEAN. Each of the ten member countries have signed over 286 BITs and over 92 FTAs with investment chapters⁵. Among these are FTAs that are signed among the ten members or with other dialogue partners (such as Australia and New Zealand). These FTAs contain

⁴ See Tieleman (2000) on the failure of the negotiations of the MAI.

⁵ Source: UNCTAD Investment Policy Hub, which only includes agreements that are in force as of June 2015 and does not include FTAs without investment chapters (such as the ASEAN-Japan Economic Partnership Agreement, the investment chapter of which is being currently negotiated). The total number of BITs and FTAs incorporates multiple counting (such as the Thailand-Cambodia BIT or the ASEAN Comprehensive Investment Agreement).

investment chapters which include investment protection provisions similar to those found in BITs.

3. How International Investment Agreements Affect Public Policy

The structure of international investment agreements generally includes four key features: (1) Scope—which sets out the extent of coverage of the agreement and includes definitions of terms; (2) Obligations—which are provisions requiring host countries to protect investors and include elements such as national treatment, expropriation or transfers; (3) Safeguards or exceptions to the obligations; and (4) Investor-State Dispute Settlement—which provides direct legal remedies for investors in case obligations in the agreement are allegedly breached. The following part will discuss each feature and how it affects public policy-making.

3.1. *Scope and Definitions*

The scope and definitions sets out the applicability of provisions contained in the agreement. Most important are definitions of what constitute an **investment** and who is an investor. Generally, an asset-based, open-ended (i.e. non-exhaustive) definition is used to define “investment”, which take the following form:

ASEAN-Australia-New Zealand FTA (2009)

Article 2: Definitions

(c) “investment” means every kind of asset owned or controlled by an investor, including but not limited to the following

- (i) movable and immovable property;
- (ii) shares, stocks, bonds...
- (iii) intellectual property rights,

- (iv) *claims to money or to any performance under contract having financial value;...*

It is evident that, most investment agreements cover not only foreign direct investments, but any other assets of the investor as well. As shown in recent ISDS cases, these include as intellectual property rights⁶ or government debt securities⁷, which may not be the original intent of investment protection. Of note here is that the widely encompassing definition of investment also includes portfolio investment as well. Again, this goes beyond the original objective of protecting only “direct” as opposed to “indirect” or portfolio investment. This becomes relevant when certain measures imposed by the host government may have inadvertent impacts on portfolio investments—such as through falling share prices. A minority of investment agreements are therefore aimed at protecting only longer-term direct investment. The question here is which definition of the direct investment to choose from; or, from the other angle, which definition of portfolio investment to carve out from. While portfolio carve-outs are rare, they usually specify that any investments with having “less than 10 percent of a company through stock exchanges”⁸ shall not be covered for protection.

Another important definition is that of the “investor”, which usually includes natural and juristic persons. However, problems arise when parent companies of shell corporations (or so-called “mailbox companies”) which are legal entities

⁶ See *Philip Morris v. Australia* (2012).

⁷ See UNCTAD (2011) “Sovereign Debt Restructuring and International Investment Agreements” IIA Issues Note No. 2.

⁸ Tanzania-Turkey BIT (2011).

in their own right, use investment agreements in their own favor. This is particularly true for companies which “treaty-shop” for the best available treaty the host country has with the country of any of its subsidiaries. One way to address these risks is through denying the benefits of such companies. For instance, the ASEAN Comprehensive Investment Agreement (ACIA, 2009) denies benefits to investments owned by non-members or those without “substantive business operations” in the host country.

3.2. Key Obligations

3.2.1. *Relative Standards of Treatment: National Treatment (NT) and Most-Favored-Nation Treatment (MFN)*

National Treatment (NT) and Most-Favored-Nation Treatment (MFN) are standards which form the cornerstone in all modern trade and investment treaties, having antecedents in the trade treaties of the seventeenth century. These two obligations are *relative* standards of treatment, meaning that comparators are required to see whether the obligations are fulfilled or not.

For NT, it aims to achieve a level playing field of the foreign vis-à-vis domestic investment (or investor) by obliging the host to avoid discrimination with its own investors in like circumstances. Domestically, this may come into conflict with countries which may want to protect sensitive or infant industries by providing them with differential treatment. Internationally, this could also limit the rights of host countries in multilateral agreements such as the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) which allows members to derogate from NT provisions.

For MFN, the comparator is any other any other foreign investor or investment. This makes the MFN provision wide-

ranging, as investors may “treaty shop” to get the best treatment from any available treaty giving them superior treatment. There are several options to address the MFN clause. This is mostly done by limiting the scope of the provision itself. This may include sectoral exceptions (e.g. the Canada Model BIT carves out financial services) or temporal exceptions (carving out past agreements).

3.2.2. Absolute Standards of Treatment: Fair and Equitable Treatment

Unlike the NT and MFN provision, the “Fair and Equitable Treatment” provision is an absolute standard, i.e. there is no relative comparator. Essentially, it ensures foreign investors and their investments that a certain minimum standard of treatment is guaranteed. This very broad concept generally includes elements such as adherence of due process of law or protection from arbitrary or abusive treatment—something which is expected of any government.

ASEAN-Australia-New Zealand FTA (2009)

Article 6 - Treatment of Investment

Each Party shall accord to covered investments fair and equitable treatment and full protection and security.

For greater certainty:

*...
the concepts of "fair and equitable treatment" and "full protection and security" do not require treatment in addition to or beyond that which is required under customary international law, and do not create additional substantive rights.*

As seen above, the essence of the provision is usually termed as “fair and equitable treatment”, though nothing

determines what is actually meant by “fair and equitable”, as the notion is very subjective. There may be normative sources linking it to “customary international law”. Again, this is not defined but is understood to cover a whole gamut of international treaties, judgments or customs and practices. It is precisely because of the ambiguity of this provision that almost all ISDS claims involve alleged breaches of this provision. Yet there are agreements which address these litigation risks by delineating the provision or eliminating it altogether (such as the Australia-Singapore FTA (2003) or the China-Czech Republic BIT (2005))⁹.

3.2.3. *Expropriation*

Expropriation has always been the cornerstone obligation of investment agreements, which have arisen because of arbitrary or uncompensated takings by host governments. This provision therefore protects foreign investors against such actions. Generally, expropriations are permitted only under the conditions that they the expropriation is conducted (1) for a public purpose; (2) non-discriminatory; (3) under due diligence; and (4) with prompt and adequate compensation. Such kinds of expropriation also involve nationalizations in which property rights of the investor are transferred to the host government.

However, issue of contention is not such standard or direct cases of expropriation, but rather “indirect expropriation”. This occurs when measures or a series of measures by the host country have similar results as ordinary expropriation cases. This includes any governmental measure which *de facto* deprives an investor of his property even though his assets are not *de jure* transferred to the government. Examples of this could be excessive taxation or

⁹ APEC (2012)

licensing measures, or even a series of measures that result in the investor being deprived of his ability to function, called “creeping expropriation”.

Due to the wide coverage of this article, it remains one of the most often claimed in dispute settlement cases. This is especially true in the context of public welfare and environmental measures, which usually involve the granting of or the revocation of licenses. There have been attempts to refine the article itself, particularly to define what is exactly meant by “indirect expropriation”. This resulted from a landmark trial, when the Canadian firm Methanex sued the United States Government under NAFTA for having banned a gasoline additive due to environmental reasons. Methanex’s argument was that since its main business was producing that gasoline additive and the government’s actions was therefore tantamount to expropriation. In this and similar cases such as *Metalclad v. Mexico*, the arbitral tribunal only focused on the effect on the investor and deemed that the intent of the measure to be irrelevant (Gordon & Pohl, 2011).

The current practice is therefore to provide an “Annex on Expropriation” which would list their understanding of “indirect expropriation”.

***ASEAN Comprehensive Investment Agreement
(2009)***

Annex on Expropriation

3. The determination whether an action or series of action... constitutes an [indirect] expropriation requires a case-by-case, fact-based inquiry that considers, among other factors:

(a) the economic impact of the government action, although the fact that an action or series of actions...has an adverse effect on the economic value of an investment, standing alone, does not establish that such

- an expropriation has occurred;*
- (b) whether the government action breaches the government's prior binding written commitment to the investor whether by contract, license or other legal document; and*
 - (c) the character of the government action, including its objective and whether the action is disproportionate to the public purpose referred to in Article 14 (Expropriation)*
- 4. Non-discriminatory measures of a Member State that are designed and applied to protect legitimate welfare objectives, such as public health, safety and the environment, do not constitute [indirect] expropriation.*

Such Annexes, standard in many international agreements today, address previous concerns of interpretations of indirect expropriation. Most importantly, objectives of the measure should be considered in cases involving alleged breaches of this article. There are also specific carve-outs for measures that have “legitimate welfare objectives” such as “health, safety and the environment”.

3.2.4. Free Transfers of Funds

The freedom of transfers of funds has been one of the key guarantees in any international investment agreement. In essence, it allows investors to freely transfer funds relating to their investments in a freely usable currency.

When introduced in early BITs, the free transfers clause was not thought to limit host states' policy space on capital flows. This has changed in the past decades when particularly during external financial difficulties, countries may need to resort to the “capital flow management measures” to restrict

or delay the transfer of funds in order to safeguard economic stability. Capital flows are usually procyclical: Excessive outflows tend to occur when the situation is already bad, and inflows when things are already good.

A key example here is when a country faces balance-of-payments difficulties which may lead up to capital flight and currency instability, thus aggravating the situation. Hence, it may be necessary for the authorities to impose capital outflow measures be they through direct administrative controls or indirect controls through taxation. A less obvious example is during massive capital inflows, when they may induce bubbles or complicate macroeconomic policymaking. In either case, a free transfers provision without any policy reservations for such cases would increase the risk of ISDS claims (Anderson, 2009).

An approach to safeguard capital flows is incorporated into the ACIA, where there are derogations for members to use measures in “exceptional circumstances” where “movements of capital cause, or threaten to cause serious economic or financial disturbance” (q.v. para 4 (c) below). Yet this does not give host authorities a blank check in implementing measures, as they constrained by a series of conditions. These include, for instance, that the measures be non-discriminatory (NT and MFN), or that they be temporary and be phased out when not necessary (q.v. para 5 below).

***ASEAN Comprehensive Investment
Agreement (ACIA) (2009)***

Article 13 - Transfers

1. Each Member State shall allow all transfers relating to a covered investment to be made freely and without delay into and out of its territory.

...

4. Nothing in this Agreement shall affect the rights and obligations of the Member States as members of the IMF, under the Articles of Agreement of the IMF, including the use of exchange actions which are in conformity with the Articles of Agreement of the IMF, provided that a Member State shall not impose restrictions on any capital transactions inconsistently with its specific commitments under this Agreement regarding such transactions, except:...

(c) where, in exceptional circumstances, movements of capital cause, or threaten to cause, serious economic or financial disturbance in the Member State concerned.

5. The measures taken in accordance with sub-paragraph 4(c):

..
(c) shall be temporary and shall be eliminated as soon as conditions no longer justify their institution or maintenance;...

(e) shall be applied such that any one of the other Member States is treated no less favourably than any other Member State or non-Member State;

(f) shall be applied on a national treatment basis; ...

3.3. Safeguard/Exceptions

Similar to the safeguards discussed for the free transfers obligation, there are also safeguards or exceptions which are applicable to all provisions in the agreement. These usually

relate to public welfare objectives such as public health and safety, the environment, or financial stability. These exceptions allow for measures serving these objectives which would otherwise breach any other obligations in the agreement.

3.3.1. General Exceptions concerning Public Welfare

More general safeguards are incorporated into investment agreements that allow host countries to adopt measures that are “necessary to protect human, animal or plant life or health”. Again, as in other safeguards, there are constraints to the adoption of such measures, of note is the non-discriminatory and good faith nature of the measure.

Thailand-New Zealand Closer Economic Partnership

Article 15.2 General Exceptions for Investment and Trade in Services

4. ..., subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between the Parties where like conditions prevail, or a disguised restriction on trade in services, nothing in this Agreement shall be construed to prevent the adoption or enforcement by a Party...

(b) necessary to protect human, animal or plant life or health;...

Nevertheless, the number of agreements which incorporate these exceptions is very low. Thus far, only investment chapters of FTAs globally and a few of the more recent BITs have incorporated them. This also holds true for agreements signed by ASEAN countries. Yet incorporation

of general exception provisions does not eliminate risks of challenges, it is still “unclear how tribunals would interpret these general exceptions.” (Newcombe, 2008).

3.3.2. *Prudential Exceptions*

The “prudential” exception allows host countries to impose measures necessary to safeguard financial stability. The word “prudential” is not defined and covers a broad range of activities relating to the financial system. These range from capital adequacy requirements in peacetime to recapitalization of banks during crises (which can be seen as a form of nationalization). The language of this usually comes from the Financial Services Annex of the WTO’s General Agreement on Trade in Services and are deliberately vague by not defining “what should be considered ‘prudential’ and what not” (De Meester, 2014). These rights have to be imported into other agreements, which is what is the case in most current investment agreements in FTAs. :

***General Agreement on Trade in Services
(GATS)—Financial Services Annex
2. Domestic Regulation***

(a) Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, ..., or to ensure the integrity and stability of the financial system.... Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement.

It is however debatable whether the second sentence of the paragraph of the prudential carve-out shown above (“Where such measures...”) makes the whole safeguard self-canceling. There are those who view that the very purpose of the safeguard itself: “The provision may only be used to defend regulatory policies if such policies do not undermine [other] commitments and obligations” (Public Citizen, 2009). Yet others, such as Barbee and Lester (2014), consider that this interpretation “may be a stretch”, and argue that point of this sentence was that measures should not “be disguised as trade restrictions”. Nevertheless, they also stress that there is still ambiguity in the interpretation itself, given that there have been no cases where tribunals have formally interpreted the article.

Again, as in the general exceptions article, the prudential article is scarcely represented in the universe of investment agreements. It is more present in FTAs, as the idea has been imported from the services chapter, but is not usually present in BITs, save for in the more recent treaties.

3.4. Investor-State Dispute Settlement (ISDS)

The “claws” of the international investment agreement are the provisions on the Investor-State Dispute Settlement or ISDS. Unlike any other dispute resolution mechanisms in international trade which are settled among states, the ISDS provides investors with direct access to international arbitration to resolve disputes arising from alleged breaches of the agreement. The original rationale for this system was the foreign investors’ distrust of local judicial systems’ impartiality especially when the defendant is the host government.

Over the past 30 years, there has been a significant rise of ISDS cases, with 608 cases known worldwide, with 101 governments being challenged in arbitral tribunals. Of these,

Argentina, Venezuela and the Czech Republic are countries with the most numbers of claims. These are countries which had to implement recovery or reform measures during financial crises or transitions to market economies. Latest figures of concluded cases show that rulings are in favor of the investor in 27% of cases, in favor of the state in 36% of cases, with the remaining portion having decisions that are either neutral or unpublished or the case was discontinued. Yet despite this, most observers note that “states never win; they only do not lose”. This is because “only investors win awards of damages; states may, at best, receive an award of costs” (Mann, 2015).

As for ASEAN countries, the latest available statistics show that there have hitherto been 20 cases brought against seven members of ASEAN (only Brunei, Cambodia and Singapore have not had any claims against them). Thus far, only Thailand is the only known ASEAN country to have lost an ISDS case.¹⁰

3.4.1. ISDS Procedures

An investor can use any international investment agreement between his home country and host country to claim in an international tribunal. The process starts when the investor sends a notice to the host country’s government. After a period of mediation, the investor and the host government selects the arbitration tribunal and arbitral rules. Usually, there are three arbitrators—one chosen by each party and a third one to be appointed jointly. As for the arbitration rules, those of the International Centre for the Settlement of Investment Disputes (ICSID) or the United Nations Commission on International Trade Law (UNCITRAL) (UNCTAD, 2015).

¹⁰ Walter Bau AG v. Thailand (2007)

Proceedings usually last several years. Should the tribunal find that the host country's measures violate the concerned agreement, then the host country will usually have to compensate the investor. The amount of claims is usually large, with latest available figures (2014) ranging from US\$ 8 million to US\$ 2.5 billion. (UNCTAD, 2015) These figures may not only reflect the amount that the investor claims to have lost due to the measure, but also the expected future losses as well. On top of these claims, there are legal fees as well, which average \$ 8 million a case, exceeding \$ 30 million (Eberhardt et al., 2012).

3.4.2. Selected Cases Relevant to Public Policy-Making

There are several high-profile past and ongoing cases of ISDS cases which have significant relevance on public policy making. The following cases serve to highlight the issue concerned (Bernasconi-Osterwalder and Johnson, 2012):

- 1) ***Metalclad v. Mexico (1997)***: In a landmark case, a U.S. hazardous waste disposal facility operator sued the Mexican government for refusing a permit to operate due to the environmental impact of the facility in question. These measures allegedly violated, among others, indirect expropriation and minimum standards of treatment under NAFTA. The arbitration tribunal ruled in favor of the investor, which resulted in the Mexican government having to give compensation of \$ 16.5 million to the investor.
- 2) ***Vattenfall v. Germany (2012)***: In another environmental case which is currently pending, a Swedish nuclear plant operator is currently suing the German government under the Energy Treaty (which contains investment protection

provisions) for shutting down nuclear plants following the Fukushima nuclear incident in 2011. Recent media reports of claims as large as US\$ 5.8 billion for past and future lost profits.

- 3) ***Philip Morris v. Australia (2011)***: A Hong Kong subsidiary of a multinational cigarette manufacturer is suing the Australian government under the Hong Kong-Australia BIT mainly for indirect expropriation of intellectual property after Australia for introducing tobacco plain packaging measures which are part of a comprehensive public health strategy aimed to reduce the number of smokers in Australia.
- 4) ***Abaclat and others v. Argentina (2007)***: Following Argentina's financial crisis in 2001 and subsequent restructuring of its sovereign bonds, over 60,000 Italian bondholders are currently suing the Argentine government under the Italy-Argentina BIT for expropriation. This is one of the numerous cases facing Argentina following its financial crisis. Of note here is that the definition of investment is broadly interpreted by the claimants so as to include holdings of government bonds as well.

These representative cases are just a few that show how measures designed for public welfare purposes, be they for the environment, public health or financial stability, are prone to ISDS litigations, especially if they happen to breach an investment agreement. The risks are most prominent particularly in cases where there are no safeguard or exceptions present (as discussed earlier). Yet it does not imply that the presence of safeguards in investment agreements would not guarantee that public welfare measures

would be immune to claims. A case in point here is the *Metalclad v. Mexico* case where there is a vaguely worded environmental safeguard which apparently did not matter when the tribunal ruled against the state.

3.4.3. *Criticisms of the current ISDS system*

The surge in the ISDS cases over the past decade has prompted a wave of criticisms of the current system. This has not only come from governments, legislators and civil society of developing countries but also developed countries as well. In particular, in relation to public policy issues such as the environment, as in the *Vattenfall vs. Germany* case. The key points are highlighted as follows (UNCTAD, 2014c; Eberhardt et al., 2012):

- 1) **Questionable legitimacy:** past decisions particularly on public welfare policies have cast doubts whether tribunals are suitable to give verdict on issues particularly relating to public welfare. There are also reports of arbitrators becoming lawyers and *vice versa*, giving rise to a “business of investment agreement litigation”.
- 2) **Asymmetry of claims:** Only investors can challenge host countries in an arbitration tribunal, not vice versa.
- 3) **Finality of decisions:** The decision by the tribunal is final without appeals as in a usual judicial process. This does not leave room to rectify erroneous decisions, which have been documented.
- 4) **Lack of transparency:** Much information on cases are not disclosed to the public or relevant stakeholders.
- 5) **Chilling effect:** Decisions which affect public

policy can create a so-called “regulatory chill”. That is, governments may change the course of policy or refrain from taking one due to a fear of potential litigation.

- 6) **Enormous costs:** Compensation costs are huge and range from millions to billions of dollars, depending on the situation, thus placing huge strains on public finances, especially for developing countries. In addition to this, legal fees average at around \$8 million per case.

4. Options for Change

With rising worries of the effects of the current international investment agreement framework, countries are now facing several options on how to address the risks that these agreements have on policy-making. The options can be ranked in order of their severity as follows:

4.1. Default Position: Keeping the status quo

The first option is to keep the *status quo* of a country’s current investment agreement regime, which means that no attempts taken to reform future agreements. While this is the most investor-friendly approach, it naturally carries risks for the host country as policy space will be limited by agreements without adequate exceptions or safeguards.

This approach is usually taken capital-exporting developed countries. Nevertheless, even large capital-exporting, investor-friendly countries such as the United States are beginning to change their static position over the years. While the United States has never lost an investment dispute it has become more cautious in its investment rule-making. Its 2012 Model BIT, for instance, includes environment and labor interest as well as clarifies the

prudential exception. Similar to the United States, European and ASEAN countries have also moved away from this position and have become more forthright in including safeguards or implementing more drastic measures.

4.2. Safeguards and Limitations

The “middle ground” option for change is to negotiate safeguards or limitations in new agreements or renegotiate old ones. It is also the option that most countries are pursuing given the flexibility associated with it. These selective adjustments are particularly an ideal option for countries to target their safeguard based on a country’s needs. As mentioned earlier, these can include scoping definitions to grant protection mainly to FDI, or, taken from another angle, to carve out specific investments such as portfolio investments or sovereign bonds from the agreement. These can also include a wide array of safeguards which would allow derogation in general or specific cases, depending on country circumstance.

On one hand, this option still retains obligations of investment protection that many countries still care about, especially if they are negotiating not from the host country’s perspective, but also from the home country of their own investors. On the other hand, stressing the importance of policy space in the form of safeguards or limitations would greatly reduce—though not diminish—risks from ISDS litigations.

This approach also paves way for greater, more systematic, reform of international investment agreements. Various organizations such as UNCTAD, APEC or the International Institute for Sustainable Development have been proponents of investment agreements which promote sustainable development. As part of this, they have published model agreement texts which include such safeguards and

limitations, therefore enshrining these sustainability principles into investment rule-making.

4.3. Reform the ISDS System

This option specifically addresses the difficulties brought about by the ISDS system and therefore pursued by countries which have had experienced ISDS cases. There are also different shades of implementation of this option. The strongest one entails not utilizing ISDS as dispute resolution mechanism in an international investment agreement. Essentially, it removes the “claws” of the agreement for investors, but also removes risks of ISDS cases for the host government. Thus far, Ecuador has pursued this path, after having had to compensate a large amount to a foreign investor. Similarly, the previous government of Australia made it a policy to disengage from the ISDS system following the Philip Morris vs. Australia case, though the current government has toned down this position.

Other approaches involving reforming ISDS involves introducing an appeals facility or having alternative dispute resolution (ADR) mechanisms. The ADR could be used prior or in parallel to an ISDS-based litigation, but aims to create a less legalistic dispute resolution achieved through mediation and conciliation. However, given the nature of this method, there are no assurances that the ADR would lead to a resolution of the dispute.

4.4. No International Investment Agreement

The most drastic option would be a not having or not pursuing any further international investment agreements. Such disengagement implies a strong dissatisfaction of the host country with the current regime. Currently, some South American countries such as Venezuela and Bolivia are repealing investment agreements. There are also reports that

Indonesia, following a dispute with the Netherlands following a case under the Netherlands-Indonesia BIT, has also announced that it would terminate (or at least not renew) its 67 BITs. However, this would not affect Indonesia's FTAs with investment chapters, such as those signed with other ASEAN countries.¹¹ The most prominent example, however, is Brazil. While Brazil's government has signed several international investment agreements, its legislature has never ratified them, making Brazil the world's largest country without such an agreement.

The question therefore arises whether not having international investment agreements would discourage foreign direct investment or not. Brazil, despite not having an international investment agreement, is the world's fifth largest recipient of FDI inflows in 2013. Within ASEAN, many countries have been receiving Japanese FDI inflows since the 1960s, and yet only the first investment protection provisions between ASEAN countries and Japan were signed in the past ten years (JTEPA, JMEPA, etc.).

A literature review of economic studies trying to explain the impact of international investment agreements on FDI paints an ambiguous picture.¹² Some studies, such as UNCTAD (2014) cross-sectional time series of 72 countries over 23 years reveal that the relationship between BITs signed and FDI was "weak". Other studies point towards a correlation between the two variables. However, it is not clear whether that this correlation is a result of correlation or even reverse correlation, i.e. countries would choose to

¹¹ Trakman and Sharma (2014). Even if Indonesia were to cancel its BITs, investment protection would generally still be covered for another period of time (e.g. 15 years) under the so-called "survival clause".

¹² See UNCTAD's literature review of empirical studies from 1998-2014 in UNCTAD (2014).

negotiate international investment agreements exactly because there is a high FDI presence from another country (Berger et al., 2010).

5. Conclusion

This article provides an updated assessment of the implications of international investment agreements on public policy. The investment protection provisions of these agreements have considerable impacts for the host country's conduct of public policy. This is because provisions such as fair and equitable treatment, expropriation or free transfers of funds can infringe on the host country's wide range of public policies, from the environment to public health to financial stability. Should such public welfare measures breach investment protection provisions, then the host country can be challenged in an international tribunal under the ISDS provisions of the agreement. ISDS cases have risen dramatically in the past decade, among those include cases which involve challenges of a host country's public welfare measures. This has brought about a wave of critical views of international investment agreements, particularly the ISDS system, not only from governments, but also legislators and the civil society. Currently, governments are trying to find a way out of this, and this article has identified four approaches that are being taken, in order to weigh benefits investors and the host country. The most prominent and flexible approach is the inclusion of safeguards into new international investment agreements, as this could be tailored to meet country-specific needs. Yet this is only one alternative from a spectrum of choices the host country has to make: from maintaining the *status quo* to disengaging itself from international investment rule-making. Disengagement sends the strongest signal, but may counter-intuitively not affect

FDI, as empirical studies have shown that there are inconclusive links between FDI inflows and investment agreements. It is therefore up to the host country to choose the most appropriate approach by balancing its own public welfare interests vis-à-vis those of the foreign investors.

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