

**International Law Weekend 2007
Panel Discussion**

Are There Lawful Exceptions to Investment Treaty Obligations?

Panel:

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Remarks by Tai-Heng Cheng

Good afternoon. It is an honor to chair this truly distinguished panel of arbitrators and professors. Joining me today are Ms. Lucy Reed, a partner at Freshfields Bruckhaus Deringer and President-Elect of the American Society of International Law, and Professor W. Michael Reisman, the Myres S. McDougal Professor of International Law at Yale Law School. Professor Brigitte Stern unfortunately could not join us as a panelist due to developments in a pending arbitration on which she serves as arbitrator. I am, however, pleased and delighted to welcome Professor Stern as an audience member. The panel will discuss whether there are lawful exceptions to investment treaty obligations.

In the next fifteen minutes or so, I plan to set the stage for my fellow panelists in three parts. First, I will introduce the history of the defense of necessity and some of the global policies at stake. Second, I will discuss possible limits to protections within each investment provision itself without recourse to necessity. Third, I will discuss the necessity defense of acts that would otherwise violate investment protection provisions.

I. The History and Policies Concerning Necessity

Let's start with the history and policies concerning necessity. For as long as states have entered into treaties, they have claimed exceptions to treaty obligations on grounds of necessity. According to Thucydides, in 423 B.C., the Corinthians urged the Peloponnesian League to cast aside the Thirty Years' Peace Treaty and take military action against Athens because they had reached a "moment of necessity."¹ Almost 2,400 years later, Argentina claimed the right to suspend its investment treaty obligations and take emergency actions to

¹ THUCYDIDES, HISTORY OF THE PELOPONNESIAN WAR 30 (P. Woodruff ed., Hackett Publishing Co. 1993).

resolve its financial crisis. Although civilization is more advanced today and international law is more developed, state behavior in times of crisis has remained largely unchanged: a state will tend to discard its international obligations – lawfully if possible, unlawfully if necessary – if that is the only way to neutralize an actual or perceived threat to its very existence.

In the context of investment treaty obligations, the challenges for arbitrators, investors, judges and government officials are to distinguish between legitimate and illegitimate claims of necessity and to respond appropriately. If states are given too much latitude to escape their investment protection obligations, investors may lose faith in the global BIT regime and BITs will fail to promote investments. But if states are unable to protect their essential state interests within the BIT system, then they may withdraw from ICSID, as Bolivia has done, turn to diplomacy rather than law to resolve disputes, as Argentina now seems to favor, or simply not enter into BITs, as Afghanistan has decided vis-à-vis the United States.

II. The Limits Within Investment Protection Provisions

Let's turn now to Part II: the limits within each investment protection provision itself. A state may reduce the risk of disputes over its regulation of core sovereign matters by explicitly reserving its authority over such matters when concluding BITs. This is the approach favored by the U.S. Model BIT, which clarifies in an Annex that non-discriminatory measures generally do not constitute expropriation if they are taken to protect public welfare objectives, including “public health, safety, and the environment.”²

Even in the absence of an explicit reservation, a state may succeed in arguing that certain types of injurious regulatory acts are nonetheless permissible. It is not a simple task, however, to divine a line between permissible and impermissible acts.

² U.S. Model Bilateral Investment Treaty, Annex B, ¶ 4(b).

A brief excursion into the relationships among environmental regulation and direct and indirect expropriation illustrates this complexity. Direct expropriation refers to the actual dispossession of property by a state against an investor, such as through nationalization, transfer of title, or outright physical seizure.

According to *Santa Elena v. Costa Rica*, direct expropriation always triggers an obligation by the state to provide compensation to the investor, even if the direct taking for environmental reasons is be for a public purpose and legitimate.

The jurisprudence is less clear with indirect expropriation. Indirect expropriation does not involve the actual taking of property or title. Instead, a state may interfere with the use, benefits or value of the investor's property to such an extent that it is tantamount to expropriation.

In *Metalclad*, Mexico granted a U.S. corporation a landfill concession but subsequently issued an Ecological Decree designating an area encompassing the landfill as a preservation zone for a rare species of cactus. The tribunal found that the decree was tantamount to expropriation and violated Article 1110 of NAFTA. It stated that it "need not decide or consider the motivation or intent of the adoption of the Ecological Decree."³ This statement seems to suggest that even if the environmental regulation was carried out with a legitimate intent, that intent would not cleanse the regulation of its expropriatory taint.

In contrast, the tribunal in *Methanex* seemed to take a different view of the law. In *Methanex*, the tribunal rejected Methanex's indirect expropriation claim under Article 1110 against the United States. The regulation in question was California's ban on a chemical called

³ *Metalclad Corp. v. United Mexican States*, Award, ICSID Case No. ARB (AF)/97/1 (Aug. 30, 2000), ¶ 111; *set aside in part on other grounds*, 2001 B.C.S.C. 664.

oxygenate MTBE because it contaminated groundwater. The tribunal explained that this ban did not constitute indirect expropriation because it was made for a public purpose, was non-discriminatory, and was accomplished with due process.

To further complicate matters, the award of August 20, 2007 in the *Vivendi* arbitration suggested, citing *Santa Elena*, that a state will always have to provide compensation for indirect expropriation even if its actions were for legitimate public purposes. However, since the tribunal found that the indirect expropriation in *Vivendi* was for illegitimate purposes, one could say this *dictum* was *obiter* (that is, if there is a system of precedent in arbitration.)

So much for the law. What of the policies at stake? If direct expropriation always requires compensation even if it was for a legitimate public purpose, why should legitimate indirect expropriation not require compensation simply because the modality is different? In both types of expropriation, the investor may suffer losses of the same magnitude, and the public purposes served by the expropriatory acts may be equally noble. Conversely, if the law recognizes that a state must retain freedom to act on core sovereign concerns in cases of indirect expropriation, why does this policy not extend in direct expropriation?

Moving on from our brief tour of environmental protection, states have another argument to shield their regulatory acts from an obligation to provide compensation. They may argue that an investment obligation – like a chameleon that changes color according to its background – takes on a different hue depending on the context of a state’s development. In *Genin*, Estonia revoked, in a rather summary fashion, a foreign investor’s banking license for failures to comply with requests for information. The tribunal found that Estonia had not violated the U.S-Estonia BIT because, *inter alia*, “the circumstances of political and economic

transition prevailing in Estonia at that time justified [Estonia's actions]."⁴ Does this mean that a developing state is allowed to take some actions that a developed state is not?

Conversely, in *Methanex*, the tribunal seemed to suggest that one reason for its finding that there was no expropriation was that Methanex was aware of and participated in the "notorious" U.S. political process that ultimately resulted in the regulation in question.⁵ Might this statement imply that an unregulated state has less latitude to subsequently protect its environment than a highly-regulated state?

III. The Necessity Defense

We now reach Part III: the necessity defense. The necessity defense completely absolves a state under customary law for actions that would otherwise have breached an investment treaty obligation. Article 25 of the Articles of State Responsibility provides that a state may assert the necessity defense to an alleged breach of an international obligation if four conditions are met:

- (1) The act is the only way to safeguard an essential interest against a grave and imminent peril;
- (2) The act does not seriously impair an essential interest of the state towards which the obligation exists;
- (3) The obligation does not exclude the possibility of invoking necessity; and
- (4) The state has not contributed to the situation of necessity.

⁴ *Genin v. Republic of Estonia*, Award, ICSID Case No. ARB/99/2 (June 25, 2001), ¶ 370.

⁵ *Methanex v. United States of America*, UNCITRAL Arbitration, Part IV, Chp. D, page 5, ¶¶ 9-10.

Similarly, but perhaps not identically, BITs may contain emergency clauses under which a state may shelter. For example, Article XI of the U.S.-Argentina BIT provides:

“This Treaty shall not preclude the application by either Party of measures necessary for the maintenance of public order, the fulfillment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests.”

These defenses raise questions of law and policy. Does the necessity defense or an emergency clause extend to economic measures? On one hand, the *CMS* and *Enron* awards, which concerned compensation for Argentina’s financial measures pursuant to the U.S.-Argentina BIT, stated that it did not in their respective disputes, although the *CMS* tribunal did suggest that in other situations economic necessity might well provide a defense.

On the other hand, the *LG&E* award, concerning virtually identical measures by Argentina, responding to the same crisis, and implicating the same BIT, stated that economic necessity did excuse Argentina from liability.

To further confuse matters, Judge Francisco Rezek sat on the *LG&E* and *CMS* tribunals which reached opposite results, and Professor Albert van den Berg sat on the *LG&E* and *Enron* tribunals, which also reached opposite results. A 2007 decision of the German constitutional court echoed this apparent dissonance. In that decision, a majority of judges favored the *Enron* approach, but a dissenting judge held that necessity could extend to economic measures for the protection of the life and health of citizens.

Another issue is whether or not an emergency clause is self-judging. If it is self-judging, then a state may decide for itself whether its actions were justified. A tribunal may

consequently be limited to an inquiry into whether the state made its determination in good faith. If it is not self-judging, a tribunal may substantively examine whether a state's actions were in fact the only means available to avert a national disaster. This is a question of treaty interpretation on which eminent minds might reasonably differ. In the *Enron* dispute, Dean Anne-Marie Slaughter, a former ASIL President, argued in her expert opinion that the emergency clause in the U.S.-Argentina BIT was self-judging, whereas Columbia Law Professor Jose Alvarez, the current ASIL President, took the opposite view. The policy implications of this issue are grave. Self-judging provisions encourage self-help, because they whittle down the authority of neutral arbiters to subsequently rectify lapses of judgment by a state that has taken self-serving measures.

A third issue, raised by the recent *CMS Annulment* decision, is the relationship between an emergency clause and the customary necessity defense. In any BIT dispute, is the emergency clause in the BIT coextensive with the necessity defense? If it is not, which offers a wider defense to the host state? Does the host state get the benefit from the wider defense or is it confined to the narrower exception to its investment treaty obligations?

Happily for me today, I am able to turn to my esteemed colleagues on this panel and in this room for help in answering these and other related questions. Ms. Reed will speak about the effect of domestic law exceptions claims by states to treaty obligations, focusing on the relationship of a state's domestic commitments (especially of a non-sovereign private law nature) on investor's legitimate expectations, as well as umbrella clauses and applicable law. Professor Reisman will round off the panel with his remarks and observations. We will then have an opportunity to comment on each other's presentations before taking questions from the audience. It is my pleasure to now cede the floor to Ms. Reed.