LEGAL FRAMEWORK FOR FOREING DIRECT INVESTMENT WITH SPECIAL REFERENCE TO PAKISTAN

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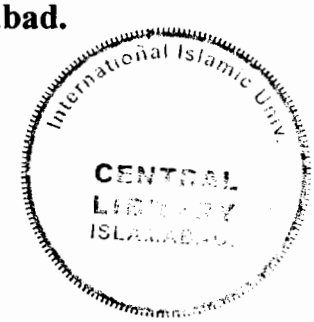

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GLOSSARY OF ABBREVIATIONS

APEC	Asian-Pacific Economic Cooperation
ACP	African, Caribbean and Pacific
BITS	Bilateral Investment Treaties
BOI	Board of Investment
ECOSOC	Economic and Social Committee
EU	European Union
FCNs	Treaties of Friendship, Commerce and Navigation
FDI	Foreign Direct Investment
FIRA	Foreign Investment Review Act
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
ICJ	International Court of Justice
ICSID	International Centre for Settlement of Investment Disputes
IDA	International Development Association
IFC	International Finance Corporation
ILM	International Legal Materials
ILO	International Labour Organization
IMF	International Monetary Fund
ITO	International Trade Organization
MAI	Multilateral Agreement on Investment
MFN	Most-Favored-Nation
MIF	Multilateral Investment Framework
MIGA	Multilateral Investment Guarantee Agency Multinational
MNEs	Enterprises
NAFTA	North American Free Trade Agreement
NGOs	Non-Governmental Organizations
NIEO	New International Economic Order
OECD	Organization for Economic Cooperation and Development
R&D	Research and Development
SEZs	Special Economic Zones
TNCs	Transnational Corporations
TRIMs	Trade-Related Investment Measures
TRIPS	Agreement on Trade-Related Aspects of intellectual Property Rights
UN	United Nations
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Conference on Trade and Development
UNCTC	United Nations Centre on Transnational Corporations
UNGA	United Nations General Assembly
WIPO	World Intellectual Property Organization
WTO	World Trade Organization

Chapter 1

INTRODUCTION

1.1 Introduction

We are in an era of globalization of the world economy. The gradual lifting of trade and investment barriers since the 1930s and the revolutions in telecommunications, transportation, and data processing technologies have, indeed accelerated the process of both market and production globalization, shrinking our world to a "global village". The globalization of markets, which used to exist only in economists theoretical treatises, has been translated into reality. National markets are increasingly losing their distinct statuses and getting integrated into a single global market. The globalization of production has further become an undisputed fact. Enterprises from all around the world are breaking up their production processes and distributing the components thereof to several countries in order to take advantage of extra-national location benefits, for instance, labour, taxation, etc. Along with international trade foreign direct investment (FDI) is the means by which this globalization of the world economy is being accomplished. The increasing volume of the latter underlines its importance to the world economy.[1]

Although several efforts were made to achieve a single comprehensive set of multilateral rules governing foreign direct investment (FDI), none has yet been successful. In contrast to a multilateral framework on trade, where the General Agreement on Tariffs and Trade (GATT) has been in place for half a century, the legal regime for international investment lags far behind. Given the fact that the practical need for a multilateral legal regime was greater in the case of trade than in the case of investment, the situation stems more from the political uncertainty about an internationally binding investment system. Generally, FDI would entail some forms of foreign control over production and assets, which gives rise to a complex of sensitive issues with respect to sovereignty, exploitation of natural resources as well as internal socio-economic policies. The statement of the international Court of Justice made thirty

[1] G.T. Ellinidis, "Foreign Direct Investment in Developing and Newly Liberalized Nations" [Summer 1995] 4 D.C.L. I. Int'l L. & Prac, 299 at p. 300.

years ago in the *Barcelona Traction Case* amply reflects even today's situation that there has been an absence of development of international law in the foreign investment:

> *Considering the important developments of the last half-century, the growth of foreign investments and the expansion of international activities of corporations, in particular of holding companies, which are often multinational, and considering the way in which the economic interests of States have proliferated, it may at first sight appear surprising that the evolution of the law has not gone further and that no generally accepted rules in the matter have crystallized on the international plane.*[2]

Developing countries have generally resisted the adoption of a multilateral treaty protecting and encouraging foreign investment. On the other end, industrialized nations have felt a great need for such an agreement because of the significant role FDI is playing in the strategies of their multinational enterprises to consolidate access to the global market around the world. The division between the developing countries and the developed countries was perhaps best illustrated in the first place by the votive practices occurring in the United Nations General Assembly during the 1970s on the Declaration on a New International Economic Order and the Charter of Economic Rights and Duties of States. It then assumed an opposite direction at the Singapore Ministerial Conference where the developed countries attempted to establish a Working Group for a comprehensive discussion on the issue of investment. Most of the recent integration of the world economy, referred to as globalization, thus continues to take place without the benefit of an internationally recognized set of rules. Admittedly, there have been tidal changes in national and international attitudes towards FDI during the past two decades. These changes are actually both causes and effects of the ongoing process of globalization and the changing role of FDI. In fact, host developing countries especially have come to realize the significant benefits that foreign investment brings to their national economies. Consequently, as part of broader market-oriented reforms of economic policy, most developing countries themselves have begun to unilaterally liberalize their national laws and relations pertaining to foreign investment, seeking to attract more external capitals, advanced technologies and access to the outside markets.

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[2] *Case Concerning the Barcelona Traction, Light* and *Power Co. Ltd (Belgium v. Spain),* [1970] I.C.J. Rep. 3 at pp. 46-47.

Two recent developments have brought this issue to the fore of the international community: First, the embodiment of a set of investment-related rules in the multilateral trading system. As a result of the Uruguay Round negotiations, the Agreement on Trade-Related Investment Measures, the General Agreement on Trade in Services, and the Agreement on Trade-Related Aspects of Intellectual Property Rights - all investment related in varying aspects - were included in the final package of the WTO Agreement. Second, the initiative of the Organization of Economic Cooperation and Development (OECD) to promote a Multilateral Agreement on Investment (MAI). In May 1995, following two decades of intense discussion on the issue, the Ministers of OECD formally launched the negotiations on the MAI, with a view to establishing uniform standards for the liberalization and protection of investment. Obviously, the issue of foreign investment, a matter conventionally of national concerns only, has gradually moved onto the international plane. The establishment of a multilateral agreement governing FDI has been inextricably built into the negotiation agenda for the international community.

1.2 Objectives and Synopsis of This Thesis

Although there has been extensive literature in this area, much repeats the debates essentially the old conflicts surrounding the state contracts for exploitation of natural resources, and the nationalization of foreign investment. While these issues remain important in the relations between the foreign investor and the host state, the focus of the clash has, by and large, shifted to some new areas in the context of globalization, both in legal and economic terms. The manner in which foreign investors operate today is no longer the same as that of the early post-war period, and meanwhile, host developing countries have adopted, if not reversed, tidally different perception on the role of FDI.

Accordingly, the legal discourse has changed its tone. A more pragmatic, policy-oriented approach is now followed when considering a possible solution to the current uncertainty. More discussions have been directed to a comprehensive multilateral investment framework, particularly under the banner of the MAI, but again, the majority of them look into the issue from the perspective of the developed countries, thus to great extent ignoring the special needs and concerns of the developing world. The purpose of

this thesis is to provide, first, a rather brief picture of the evolving conflicts between developed and developing countries, especially Pakistan, in the ambit of FDI. Second, to examine the international legal framework in existence, both at the bilateral and multilateral level. Based on these overviews and observations, an attempt is to identify some substantive problems and then propose possible solutions or recommendations if the option of a multilateral investment agreement is to be pursued, from the standpoint of developing countries. However, this thesis does not purport to offer any systematic negotiation approach. Third, to examine critically the legal regime for foreign investment in Pakistan in the perspective of the emerging international legal framework.

It is a fairly difficult, if not impossible, task for developing countries to achieve an anticipated balance at the international forums in today's world. The thesis, at least, serves to point out the problems involved and the magnitude of such a legal framework for the Third World countries. As the study proceeds, particular reference is made to the case of Pakistan wherever necessary.

There is no question that a receptive investment environment plays a primordial role in foreign investors' locational decisions. Pakistan is not oblivious to that reality and has taken measures to improve her foreign investment framework. Our assessment of Pakistan's investment framework also explores some of the ideological, political, cultural and historical causes underlying its treatment of foreign investment.

1.2.1 Limitations

The subject of this thesis needs to be explained in terms of its meaning and scope. Foreign investment law and policy of Pakistan is contained in a vast sea of legal regulations. Any writer embarking on a journey in this area has to navigate through narrow straits in order to avoid getting lost in the maze of information available. At the same time, he has to ensure that the readers are being informed about the course through which they are being taken. Consequently, the following are the parameters within which this thesis attempts to explain foreign investment regulation. First, this thesis is concerned with foreign direct investment (FDI). Second, this thesis does not attempt to cover all details governing the daily business operation of foreign investment enterprises in

Pakistan. Instead, the perception will rather be macro, with a view to materializing the international obligations in a specific country's context.

1.2.2 The Significance of the Study

The aim of this study has been to contribute to the body of knowledge by providing appropriate literature for studying the legal framework related to FDI in Pakistan in a broader perspective of global normative developments. Conventional studies on FDI and its legal environment are often conducted in an incomplete way that does not take into account other important aspects of the relationship between laws and FDI. This study is expected to make a meaningful contribution in this connection.

1.2.3 The Structure of the Thesis

Chapter one describes the recent trends of globalization and the growth of FDI flows, in particular, the phenomenon of increasing FDI movements to the developing countries. It analyzes the various reasons justifying foreign investor's desire to involve in operating abroad, and the potential benefits and costs that FDI would deliver to the host country. It has also briefly introduces the national legal regime of Pakistan dealing with foreign investment.

This chapter also provides an overview of the historical development of international law on foreign investment. The early post – war years witnessed the decolonization and a wave of nationalization of foreign property by the newly independent nations. The 1970s was characterized by demands for regulating obligations of multinational enterprises under the general banner of the New International Economic Order, calling for structural changes in the international economic relations by the Third World countries. In the 1980s, a series of national and international developments radically reversed the policy trends. Most bilateral, regional and multilateral instruments on foreign investment actually emerged in this period.

Chapter two is a study of the existing and emerging international regime for foreign direct investment. The first part of this chapter reviews the practice of bilateral investment treaties, with an emphasis on their substantive contents. The comprehensive survey of the main provisions also serves as a theoretical basis upon which further

discussions of the multilateral instruments and some proposed recommendations for a possible multilateral investment framework will be developed.

The next part of this chapter examines the multilateral instruments currently existing. This includes, *inter alia,* the three pertinent agreements under the GATT/WTO framework, especially TRIMS and the MAI envisaged by the OECD. This chapter first discusses the necessity of incorporating FDI rules in the WTO regime. Then, I have made some suggestions on FDI rules in the WTO regime. Finally, I have conducted a preliminary check on the compatibility of the WTO regime with the proposed basic FDI rules. It has also been argued that it cannot be taken for granted that all performance requirements necessarily lead to adverse effects, and they are significant elements of developing countries' economic policies, helping them to achieve certain development objectives.

Chapter three attempts to examine Pakistan's ambivalence between promotion and control of foreign investment and the underlying issues affecting the investment environment in the country. In the first part, I have discussed on the investment review process and post-approved licensing procedures. Legal requirements aimed at policing the operations of foreign enterprises have also been analyzed. The second part highlights promotional aspects of Pakistan's foreign investment framework. The review of these incentives is followed by a discussion of Pakistan's disincentives to foreign investment. It have also dealt with the concept of transparency in foreign investment approvals and this chapter also succinctly discusses the criteria for analyzing transparency in foreign investment approvals. Finally, the last part concentrates on the political risk to doing business in Pakistan, and the country's foreign investment framework with regards to the principle of the rule of law.

Chapter four is the concluding section of the thesis. This chapter summarizes the arguments made by this thesis and concludes the discussion. It attempts to identify the gaps between the international normative framework and the domestic laws and policies and attempts to suggest alternate formulations of law and policy designed to improve the investor confidence and transparency in the foreign investment processes in Pakistan. This part also endeavors to balance the need for transparency in foreign investment approvals with other demands on the approval process including achieving effects, and

they are significant elements of developing countries economic policies, helping them to achieve certain development objectives. The examination also exposes some highly controversial issues in the MAI draft, which have resulted in its abortion in 1998. This chapter also analyzes the substantive provisions that deserve special scrutiny for developing countries like Pakistan. First, this chapter argues that it is realistically unfeasible for developing countries to simply avoid or resist the current trend towards a multilateral investment framework. The fundamental issue appears to be how they could be positively involved in such negotiations, seeking to maintain more flexibility in the proposed agreement to pursue their own economic and political objectives. Having said so, the chapter then identifies some possibly contentious issues and puts forth some comments and recommendations, mainly based on the favorable precedents set by existing instruments,. In this respect, it is important for developing countries in general, and Pakistan in particular, to formulate their own essential objectives on these key issues in order to enhance the prospects of their development concerns being adequately reflected in the proposed framework.

1.3 Foreign Direct Investment and Transnational Corporations

1.3.1 Globalization of the World Economy

The past decade has witnessed an increasingly rapid escalation towards globalization in the world economy. New communication technologies and lower transportation costs have led to a closer international integration of production and markets, a process in which both production and consumption of goods and services have gone beyond a single nation. Facing a sharply intensified international competitiveness, companies are now finding their desire to establish some physical presence in the overseas markets, to take advantage of the low production cost, utilize local inputs and labor, and more importantly, grow closer to their customers.

Globalization is by no means a brand-new phenomenon.' However, the relatively new aspect that makes the surge of the last decade different from previous advances in

the international labor division is the focused attention on the FDI flows.[3] As indicated by the United Nation Conference on Trade and Development (UNCTAD):

> *As soon as FDI becomes a chosen vehicle for establishing crossborder linkages, the character of international economic integration changes from shallow to deep integration. Because FDI, unlike market-based exchange, does not end with initial transaction, it establishes a more lasting linkage between economic agents located in different countries.*[4]

There is no doubt that international trade has contributed enormously to the growth of the world economy, particularly since the dismantling of trade barriers amongst developed countries in the 1950s and 1960.[5] An increasing number of developing countries began to adopt more liberalized trade policy since the 1970s, boosting the average annual growth of international trade to 5.5 per cent.[6] The successful conclusion of the Uruguay Round in 1994 extended liberalization to areas previously exempted, e.g., agriculture and textile, and established the first formal multilateral organization implementing international trade rules.[7] While international trade continues to grow, a significant new trend began to appear, the FDI being recognized as the new engine for the growth of the world economy. In recent years, worldwide FDI flows have grown much more rapidly than international trade, and sales of foreign affiliates also exceed world exports in value.

The traditional view alleges that FDI reduces home country exports and host country imports by conducting production overseas, and therefore FDI and trade are

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[3] World Trade Organization Secretariat, "Trade and Foreign Direct Investment", PRESS/57 (October 9, 1996), available on1ine http://ww.wto.org/wto/archivesltrade-andinvestment.html.

[4] UNCTAD, World Investment Report 1994: Transnational Corporations, Employment and the Workplace (New York, Geneva: United Nations Publication Sales No. E.94.II.A.14, 1994) at p. 118.

[5] Although the GATT 1947 never was a formal international organization, it did serve as the framework for a series of negotiations on trade issues. The initial five rounds of multilateral negotiations achieved great success in terms of multilateral tariff reduction.

[6] UNCTAD, World Investment Report 1999: Foreign Direct Investment and the Challenge of Development (New York and Geneva: United Nations Publication Sales No. E.99.II.D.3, 1999).

[7] Jeffrey S. Thomas & Michael A. Meyer, The New Rules of Global Trade: A Guide to the World Trade Organization (Toronto: Carswell, 1997).

substitutes.[8] However, recent empirical evidence suggests that FDI has a positive impact on world trade. Rather than a substitute for, foreign investment has been viewed as a complement to trade flows.[9] In other words, there is an increasing recognition that greater freedom of investment movements would enhance the benefits derived from international trade liberalization.[10]

1.3.2 The Definition of "Foreign Direct Investment"

According to the WTO, foreign direct investment (FDI) occurs when an investor based in one country (the home country) acquires an asset in another country (the host country) with the intent to manage that asset.[11] This definition stresses that FDI is an asset. The United Nations Conference on Trade and Development (UNCTAD) defines FDI as an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity (the foreign direct investor or parent enterprise) of one country in an enterprise (foreign affiliate) resident in a country other than that of the foreign direct investor.[12] This definition does not tell us what exactly an investment is.

The International Monetary Fund (IMF) defines FDI as capital in any of the following three forms :[13]

1) quity capital. This is the value of a foreign investor's investment in shares of an enterprise in a foreign country. An equity capital stake of 10% or more of the ordinary shares or voting power in an incorporated enterprise, or its equivalent in an unincorporated enterprise, is normally considered as a threshold for the control of assets. This category includes both mergers and acquisitions (M&As) and "Greenfield" investments (the creation of new facilities).

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[8] World Trade Organization Secretariat, "Trade and Foreign Direct Investment", PRESS/57 (October 9, 1996), available on1ine http://ww.wto.org/wto/archivesltrade-andinvestment.htrn.

[9] OECD, "Trade and Investment Interface", TD/TC/WP(96)32 (September 11, 1996), available online http://www.oecd.org/daf/tc.htm.

[10] Ibid. Also see WTO Investment Report, pp. 9-13, for detailed discussion.

[11] WTO Annual Report 1996, p. 46.

[12] UNCTAD, Series on Issues in International Investment Agreement: Foreign Direct Investment and Development, New York, Geneva: United Nations Publications, 1999.

[13] Cited in the WTO Annual Report 1996. .

2) einvested earnings. Reinvested earnings are a transnational corporation's (TNC) share of affiliate earnings not distributed as dividends or remitted to the TNC. Such retained profits by affiliates are assumed to be reinvested in the affiliates. Reinvested earnings can represent up to 60 per cent of total outward FDI from countries such as the United States and the United Kingdom.

3) Other capital. It refers to the short or long-term borrowing and lending of funds between TNCs and their affiliates. The IMF definition emphasizes FDI as capital. In practice, many countries define FDI in both of two ways. For statistical purposes, FDI is defined as foreign capital that a foreign firm or individual intends to bring or actually brings into the host country for a long-term business operation. For legal purposes, FDI is treated broadly as the entire business operation undertaken by a foreign firm or individual in the host country.

According to the IMF and OECD definitions, direct investment reflects the aim of obtaining a lasting interest by a resident entity of one economy (direct investor) in an enterprise that is resident in another economy (the direct investment enterprise). The "lasting interest" implies the existence of a long-term relationship between the direct investor and the direct investment enterprise and a significant degree of influence on the management of the latter.

Based on these authoritative definitions and the common FDI practice, I would define FDI as *assets that are controlled and managed by a foreign firm or individual in a host country for a long-term business operation.*[14] Assets can be categorized into three basic types: current assets, fixed assets and intangible assets. Current assets are cash, accounts receivable, materials and inventories that in the ordinary course of operation are likely to be consumed or converted into cash within twelve months of the last financial year. Fixed assets include items such as buildings and machinery. Intangible assets include patents and goodwill, etc. An asset as FDI can be a foreign asset that is brought into the host country by the foreign firm or individual, or it can be an asset that is borrowed by the foreign firm or individual in the host country. However, host countries

[14] An asset is property or an item controlled by an economic entity as a result of a past transaction or event. See the Australian Financial Review, Dictionary of Investment Terms, 5th Edition, 2000, at http://www.county.com.au/web/webdict.nsf/pages/index?open.

normally require a foreign firm or individual to bring in some assets from foreign source in order to qualify itself or himself as FDI. A long-term business operation must be a production facility, a trading entity, or a service presence.

Portfolio foreign investment, which takes the forms of foreign stocks, bonds and other financial instruments, is distinct from FDI in that there is no intention to manage the invested assets. Since portfolio investment does not serve the function of international production and distribution of goods, it does not have any link with trade. In contrast to "portfolio investment", which is placed through the capital market solely to earn a financial return without an entrepreneurial commitment, FDI involves the cross-border control and management of business and property.[15] FDI is thus considered to be of longer duration and assumes relatively more risks compared to portfolio investment. It was claimed that these factors justify the more favorable treatments for FDI than portfolio investments. FDI should not only be protected by domestic laws of the host country, but also the diplomatic protection of the home country.[16] This view found support from the doctrine of State responsibility for injuries to foreign property in the classical international law rules' and posited that a breach of international Law could arise if a State does not respect the minimum standard with regard to the treatment of aliens. More elaboration on this topic will be set out in the subsequent chapter when customary international law is generally reviewed.

1.3.3 Transnational Corporations

Thanks to the advanced technologies in telecommunications and transportation, more and more medium-sized, or even small enterprises, began to seek opportunities of involving in overseas market. However, the main agent of FDI remains the Transnational Corporations (TNCs).[17] The number of TNCs has grown geometrically since the end of

[15] For a discussion of various definitions of FDI and distinction from other forms of investment, e.g. trans-frontier flows of assets, international financial transactions, see M. Sornarajah, The International Law on Foreign Investment (Cambridge: Cambridge University Press. 1994), at pp. 4-8.

[16] Ibid. at p. 5.

[17] Transnational Enterprises (TNCs) is also called Multinational Corporations (MNCs), or Multinational corporations (MNEs). TNCs is the new name adopted by the United Nations, but it was never caught on outside the UN. A TNC is defined by the Draft United Nations Code of Conduct on Transnational Corporations as "an enterprise, comprising entities in two or more countries, which operates under a system of decision-making, permitting coherent policies and a common strategy through one or more decision-

World War II.[18] Their wealth and influence are now shaping the world economy in various aspects. Indeed, many TNCs are now economically more powerful than sovereign States. For example, Toyota, the Japanese car manufacturer had net sales of over US $94 billion per annum in 1990s, while Ireland had only an average GDP around US $23 billion per annum.

There are a variety of reasons why a foreign investor or a TNC undertakes FDI. In the first place, it may function as a substitute strategy to circumvent the remaining restrictions on trade by host countries. Such so-called "tariff-jumping" FDI and *"quid pro quo"* FDI are used as vehicles to produce within the host countries and thereby avoid either existing or future protectionist tariff.[19] Secondly, for the TNCs in the manufacturing sector, operating internationally is an effective way to minimize production costs. By strategically locating production, the TNCs gain access to cheaper labor and natural resources unavailable at homes.[20] Thirdly, for many service industries, the answer is simple. FDI is the only way for the service provider to have physical presence in a foreign jurisdiction and to be competitive in its market. Fourthly, the TNCs may also undertake foreign operation with a view to internalizing the use of its property assets, particularly intellectual property, in a host country rather than simply licensing the

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making centers, in which the entities are so linked, by ownership or otherwise, that one or more of them may be able to exercise a significant influence over the activities of others, and, in particular, to share knowledge, resources and responsibilities with the others." UNCTC, Draft United Nations Code of Conduct on Transnational Corporations (New York: United Nations Publications Sales No. E.86.11.A. 15, 1986).

[18] Although foreign operation of enterprises can be traced back to the thirteenth century, and by the seventeenth centuries. European colonial powers had established several overseas trading companies such as the British East India Company, the first truly multinational firms did not emerge until the mid-nineteenth century, when advances in manufacturing, communication and transportation technology made possible the international division of the production process.

[19] Olive Morrissey & Yogesh Rai, "The GATT Agreement on Trade Measures: Implication for Developing Countries and Their Relationship Corporations" (1995) 3 1 J. Dev. Stud. 702, at p. 705.

[20] To this end, TNCs take either a vertical or horizontal FDI strategy. In Related Investment with Transnational the case of vertical linkage, TNCs locate different stages of production in different countries seeking the cheapest input and use trade as the agent. The horizontal FDI takes place when similar types of production activities are conducted in different countries to meet the demands of local markets. See generally, John H. Dunning, Multinational Enterprises and the Global Economy (London: Addison-Wesley, 1993) at pp. 34-36.

asset to a host country firm.[21] Nevertheless, in today's internationalized world, the predominant motivation for the TNCs to make presence in a foreign nation is market-seeking.[22] The TNCs are attracted by the size and the growth of the host country's domestic markets, and its openness to international trade. in both the manufacturing and service sectors. The TNCs participate in local research and development (R&D), adapt products to local conditions, and come in closer contact with consumers in host countries.

1.3.4 The Reasons behind FDI Growth

There are many reasons behind the surge of FDI in the past two decades. From a macroeconomic perspective, there are four main reasons for this growth. First, continuing world economic growth in the past decade, notably, the continuing economic expansion in the US and the rapid recovery of Asian and Latin American states from financial crises boosted TNCs confidence in their global strategy. Second, the substantive reduction of trade barriers in tariffs and non-tariff barriers through the multilateral trade liberalization arrangements has significantly reduced transaction costs related to international production and sales, thus raising the efficiency of FDI. Regional free trade arrangements have stimulated intra-regional FDI flows. Third, paralleling trade liberalization efforts, most nations have liberalized their domestic FDI policy regimes towards a more investment- conducive and friendly environment. These FDI liberalization efforts, which resulted from the recognition of the overall benefits of FDI, combined with active endeavors by nations to improve the physical infrastructure for investment, have considerably reduced investment and production costs as well as provided greater security for investment. Fourth, structural reforms and adjustments in many countries, characterized by privatization and deregulation, provided greater opportunities for foreign investors to buy or invest in formally restricted industries.

Deregulation and improved competition policy enhanced FDI in the form of mergers and acquisitions (M&As) in industries such as telecommunication, electricity

[21] World Trade Organization Secretariat, "Trade and Foreign Direct Investment", PRESS/57 (October 9, 1996), available on1ine http://ww.wto.org/wto/archivesltrade-andinvestment.htrn.

[22] Dunning, John H., Multinational Enterprises and the Global Economy (London: Addison-Wesley, 1993), at p. 38.

and financial services. From a microeconomic perspective, there are two main reasons for growth of FDI:

First, intensified competition in domestic and overseas markets forced firms to internationalize their production and sales worldwide so as to seek and maintain competitive advantages. Following the liberalization of domestic trade and investment policies and the integration of world markets, international business undertakings have become imperatives rather than opportunities in consolidated corporate strategies. Accordingly, there is a shift from "Greenfield FDI", which means setting up a new facility, to mergers and acquisitions (M&As) in TNCs global business strategy. It is estimated that between 1985 and 1994, M&As accounted for between 50 and 60 pet cent of all new FDI.[23] As Dunning points out, the driving force behind the increasing use of M&A by TNCs as the primary mode for FDI is not to exploit existing ownership-specific advantages, but rather to protect or augment such advantages, so as to survive global-scale competition.[24]

Second, transport and technology advancements, like cheaper and faster transport methods combined with information technology innovations, have greatly reduced transaction and coordination costs, thereby enhancing the efficiency of cross-border investment and trade. Far-reaching organizational change is taking place as a result of e-business and new technology, which are transforming the value chain for many industries. Vertical integration and ownership of physical assets are becoming less important; co-ordination of intangible assets is becoming crucial.

Among these reasons, trade liberalization endeavors made in the past 50 years, especially since the 1990s, along with investment liberalization efforts in the past two decades in many nations, are two fundamental reasons behind the FDI growth. Trade liberalization through tariff reduction and non-tariff barriers dismantling has dramatically reduced transaction costs and improved trade-related regulatory efficiency, making FDI-related transactions viable and profitable. FDI liberalization through deregulation, privatization and investment protection not only has considerably reduced FDI-related

[23] John Dunning, Forty years on: American Investment in British Manufacturing Industry Revisited, *Transnational Corporations*, vol. *8, no.* 2 (August 1999).

[24] Ibid.

costs, but has also provided both opportunities for and confidence in FDI. The intensified competition among firms is only the secondary reason after trade and FDI liberalization because competition is the norm in business, and firms must respond and adjust to intensified competition by seeking competitive advantages wherever it is possible. Therefore, a liberalized world economy not only offers greater opportunities for international business, but also forces firms to compete with each other at the global level for competitive advantages. Many trade scholars have recognized the essential and fundamental role that trade liberalization has played in stimulating global FDI flows in the past two decades.

1.3.5 The Role of FDI in World Economy

Traditionally and typically, international trade was conducted through arm's-length trade by trading firms located in different countries, which did not involve FDI. However, in recent years, there has been a significant change in this respect. Trade has been increasingly conducted by TNCs in the form of intra-firm trade at the global level. The WTO estimates that intra-firm trade conducted by TNCs at the global level accounts for about one third of annual world trade, and exports by TNCs to non-affiliates account for another third of world trade.[25] Intra-firm trade has become an important international business mode for TNCs to distribute or allocate intermediate goods, materials or final goods around the world for production and/or distribution purposes. To establish an international production or distribution network, a firm must locate one or more production plants or trading entities in foreign countries. Such a move will inevitably involve FDI as a prerequisite. Instinctively, there should exist a close link between FDI, international production and trade, and FDI flows and volumes may directly influence world trade and its patterns.

Along with the growth of trade and FDI and the significant role of FDI in world trade performance, domestic firms are becoming increasingly internationalized. According to UNCTAD World Investment reports,[26] by the early 1990s, there were

[25] This estimate, cited from the WTO annual report (1996), is presented by the UNCTAD based on United States data.

[26] UNCTAD, World Investment Report 1993 and World Investment Report 1998, available online at httw://www.unctad.org/wir/content.

37,000 transnational corporations in the world, with over 170,000 foreign affiliates; however, by 1997, there were some 53,000 TNCs with about 450,000 foreign affiliates around the world. Raymond Vernon estimates that in the United States, the parents and affiliates of TNCs account for two thirds of the country's industrial output and over four fifths of its exports.[27]

1.4 Potential Benefits and Costs of Foreign Direct Investment

1.4.1 Potential Benefits of Foreign Direct Investment for Host Countries

Foreign investors invest in the Third World countries to pursue their "maximum profits" rhetoric. Host developing country governments, on the other hand, seek to foster their national economies in designated directions and exercise their sovereignty over natural resources. In spite of these conflicting interests, potential benefits would still be derived from FDI for host developing countries.[28]

The injection of needed capital for host developing countries is the most obvious and traditional benefit delivered by FDI. In addition, FDI may bring into the host countries resources not accompanied with portfolio investment, *e.g.* advanced technologies, management know-how, established brand names, skilled human resources and improved access to international marketing, distribution and production networks.[29] Empirical studies show that these intangible assets are of particular importance for developing countries to accelerate their economic growth.[30] Through interaction and competition within the host country market, FDI may also exert positive influence on local employment and harness the competitiveness of domestic enterprises. As pointed

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[27] Raymond Vernon, The Harvard Multinational Enterprise Project in historical perspective, *Transnational Corporations*, vol. *8*, no. 2 (August 1999).

[28] Edward M. Graham, Direct Investment and the Future Agenda of the World Trade Organization, in The World Trading System: The Challenges Ahead (Washington, D.C. Institute for International Economics, 1996) 205, at p. 206.

[29] Jeswald W. Salacuse, "Towards a New Treaty Framework for Direct Foreign Investment" (1985) 50 J. Air. L. & Comm. 969, at p. 976.

[30] World Trade Organization Secretariat, "Trade and Foreign Direct Investment", PRESS/57 (October 9, 1996), available online http://www.wto.org/wto/archives/trade_and_investment.htrn, at p. 1.

out by the World Bank, the FDI may encourage an increase in the factor efficiency of the economy as a whole through modernization, a greater use of support industries and services, the provision of opportunities for competition and the exposure to advanced technological, financial, managerial and marketing practices.[31]

1.4.2 Potential Costs of Foreign Direct Investment for Host Countries

While the impact of FDI on the developing countries' economies is predominantly positive, the potential benefits would depend largely on the nature of the FDI undertaken and the initial economic conditions of the host country, as well as the host government policies.[32] Furthermore, it is critical to bear in mind that the potential costs of FDI by the TNCs are numerous, and the above-mentioned benefits may in many cases be outweighed by TNCs' abusive practices.[33] Transfer pricing is a common restrictive business practice. The TNCs may also abuse its dominant position of market power to monopolize the market, thereby hampering domestic competitiveness. Foreign domination of some key industrial sectors of host nation may interfere with developmental policies of host government, or even intimidate its political independence in some cases. Some FDI from industrialized countries may also involve "sunset" or "dirty" industries, with the intention of avoiding environment protection standards imposed by the home country. Such FDI would be environmentally destructive to host developing country's long-term sustainable development. From a political perspective, foreign investors have been engaged in illicit payments, improper interference in internal political affairs and corruption of public officials.[34]

There is no simple answer to the question of the value of FDI to developing countries: indeed, FDI is a mixed blessing for developing countries. Just as FDI can benefit developing countries and contribute to their development, FDI also entails many

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[31] Ibrahim F.I. Shihata, Legal Treatment of Foreign Investment: The World Bank Guidelines (London and Boston: Martinus Nijhoff Publishers, 1993) at p. 1.

[32] Jeswald W. Salacuse, supra note 29, at p. 976.

[33] Ibrahim F.I. Shihata, supra note 31, at p. 7.

[34] Samuel K.B. Asante, "International Law and Foreign Investment: A Reappraisal" (1988) 37 Int'l. Comp. L.Q. 588, at p. 619.

costs for them. The controlling factor in determining the value of FDI to developing countries is, thus, dependent on the manner in which FDI is regulated. Indeed, the regulation of FDI determines the value of FDI to host developing countries. FDI regulation determines, for example, the percentage of local employment that TNCs have to undertake, the amount of profit they are allowed to expatriate, and the percentage of local component parts comprised in the final product they have to achieve.

1.5 Increasing Foreign Direct Investment Flows to Developing Countries

Although the major flows of FDI were between developed countries, in the last two decades an increasing volume of investment has also flowed from developed countries to developing countries, as well between developing countries themselves. In fact, FDI movements to developing countries have grown steadily in response to the more positive attitudes and liberal national statutory regimes adopted by them. The share of all developing countries in total FDI flows has soared since the early 1980s. In 1965, FDI flows to the developing world were only $500 million. In 1998, however, FDI flows to the developing countries reached 149 billion 39 Whilst FDI inflows of developed countries were about 233 billion, developing countries actually account for 37 per cent of the global flows. Asia alone is now receiving nearly a quarter of world FDI flows compared with one-tenth during the 1983-1988 period.[35]

1.6 Foreign Direct Investment in Pakistan

Foreign direct investment (FDI) is a source of promoting capital formation and growth in the Pakistan. When this takes the form of a major investment stake in manufacturing or services, it can lead to a qualitative change in technology, and processes be they related to production, management or marketing. During 1990s, the countries receiving a major share in the world FDI were those which opened their trade and investment regime, maintained macroeconomic stability, had large markets, a predictable institutional environment, markets free from excessive state control and had developed physical and human infrastructure. In the race for attracting FDI, those countries lagged behind which were constrained by macroeconomic instability, inconsistent economic policies,

[35] UNCTAD, WIR 1999, at p. 29.

inadequate infrastructure and excessive bureaucratic controls on the decision making process.

For Pakistan the inflow of FDI increased from a level of $ 354 million in 1993-94 to $1,101 million in 1995-96 but declined again after 1995-96 for a variety of reasons such as the saturation of investment in power sector; the East Asian financial crisis of 1997, economic sanctions, and freezing of foreign currency accounts of May 1998. The situation was compounded by inexperience in handling independent power projects (IPP) such as HUBCO, low levels of foreign exchange reserves in the late 1990s and threat of default on external payments obligations. Since 1998-1999 the FDI, which was at the level of $ 376 million, fell to a level of $ 322 million in 2000-01 but managed to reach a level of $ 798 million in 2002-03 and further increased to $ 1405 million in 2003-04.

In the year 2004-2005 it was $ 1524.2 million. During the fiscal year 2005-2006 Pakistan received $ 3,212 million as FDI. FDI grew at 212% with contrast to previous year. The top investors in this regard are U.A.E with $1357.4 (42.3%), U.S.A with $ 451.4 (14.1%), Saudia Arabia with $275.3 (8.6%), Switzerland with $166.4 (5.2%), U.K, with $166.4 (5.2%), Netherlands with $91.1 (2.8%) and others, with $704.0 (21.9%).

If we have a glimpse of FDI in Pakistan in sector wise distribution, we find the Telecom sector at the top with an investment of $1764.5 million. Power sector attracted $ 315 million, Business and Finance sector availed $ 310 million, Oil and Gas Exploration got the part of $270.5 million, Trade group could attract $ 112.3 million, Construction $82.5 million and others $ 357.2. The flow of foreign investment in Pakistan crossed $3.0 billion in 2005-06. Pakistan has been ranked among top ten reforming countries in the world according to the recent World Bank report. Pakistan is at 60th position in terms of ease of doing business in a survey of 155 countries conducted by international financial corporation (IFC) and surpasses even China and India.

1.7 Development of International Law on Foreign Direct Investment

1.7 .1 Introduction

To understand the current legal approaches towards the regulation of FDI, it would be helpful and necessary to begin with a brief look at the historical evolution of international law on this subject, in the more general context of the rapidly evolving world economy.

Lessons might be drawn in this sense from past practice for the future elaboration as to where the international law would go in the FDI sphere.

Investment of private capital in a foreign country has been a traditional feature of international economic intercourse. Around the end of the nineteenth century the beneficial influence of foreign investment based on liberal economic principles was universally acknowledged by the countries which had then a say in international affairs. Hence the consolidation of principles and rules of customary international law guaranteeing full security to it (non-discriminatory, national, international minimum treatment), both during an investment's productive life and in case of expropriation, as an essential part of the obligations of states as to the treatment of aliens.

Broadly speaking, the development of international law relating to foreign investment has been a checkered one. Customary international law rules and principles evolved over the past century continue to provide the indispensable basis upon which other legal norms could be developed.[36] The competence of States to control the entry and operation of alien individuals and foreign enterprises into their territory flows from these principles. While the principle of territorial sovereignty has always been the foundation of the entire framework, a vast range of economic, political and historical factors have shaped, and continue to shape, the development of international law in this field. As Professor Sornarajah noted in his study:

> *If international law is generated by the eventual resolution of conflicting national interests, the international law of foreign investment provides an illustration of these processes of intense conflicts and their resolution at work. It is an area in which the interests of the capital-exporting states have clashed with those of the capital-importing states and the resultant resolution of the conflict, if any resolution is indeed achieved, indicates how international law is made and how open ended the formulation of its principles are in the face of intensive conflicts of views as to the law among states.*[37]

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[36] Oppenheim stated sovereignty in his international law that: "According to the rule, *quidquid est in territorio est estiam de ferritorio.* all individuals and all property within the territory of a State are under its dominion and sway, and foreign individuals and property fall at once under the territorial supremacy of a State when they cross its frontier." L. Oppenheim, International Law: A Treatise. 7th ed., edited by H. Lauterpacht (London: Longmans. Green and Co. Ltd., 1948), at p. 257. 9th ed. 1996 v.1 p.384

[37] M. Sornarajah, The International Law on Foreign Investment (Cambridge: Cambridge University Press. 1994), at p. 2. ed. R. Jennings and A. Watts, Pearson Education Ltd.

1.7.2 The Early Years after World War II

From the nineteenth century to the middle of twentieth century, there was little need for international principles over FDI to evolve in my significant manner.[38] It was only with the decline of colonialism and the rise of multinational enterprises that the need to regulate FDI came to the fore of the international community. Thus, the development of international investment law from World War II to the present may be divided into three phases, in order to look into the evolving conflicts between the developed and developing countries.

The first decade following the collapse of colonialism witnessed a wave of nationalization of foreign property by the newly independent nations in order to consolidate their political independence.[39] Indeed, China was also actively involved in confiscating foreign businesses since the foundation of the People's Republic of China in 1949, as part of its ideological transformation program that purported to transfer private ownership to collective or State ownership. From the standpoints of these former colonial States, the foreign control of their natural resources and key industries has long deprived them of their political independence and economic development. As a result, hostility and concerns over foreign investment were predominant in the whole process of decolonization. Ideological considerations were also playing an important role in Eastern Europe and some other areas that became part of the Socialist bloc.

Throughout this period of regaining control over natural resources and vital sectors of their economies from the former colonial powers, a series of resolutions were adopted by the United Nations General Assembly (UNGA), including Resolution 1803

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[38] As a feature of the colonial expansion, foreign investment in the colonies before World War II was governed by the legal regimes imposed by the imperial powers. It was only during the latter part of this period that the investment relationship particularly between the United States and the Latin American nations generated a debate concerning the treatment of foreign investors.

[39] The number of cases of nationalisation or expropriation of foreign property, mainly in the natural resources sector kept increasing worldwide until the early of 1970s. See UNCTAD, World Investment Report 1993: Transnational Corporations and Integrated International Production (New York and Geneva: United Nations Publication Sales No. E.93.II.A. 14, 1993) at p. 17.

and Resolution 2158 on Permanent Sovereignty over Natural resources.[40] These UNGA Resolutions recognized the rights of peoples and nations over their natural resources, and the legitimacy of taking foreign property by host nations pursuant to their economic reform or restructuring.[41] The international law principles bearing upon the sovereign right of States over FDI were also reflected in the aborted Havana Charter for An International Trade Organization, which indeed partly led to its failure to enter into force. During this period, the developed countries found themselves mainly on the defensive, as the developing countries had gained a voice to influence the agenda of international economic relations affecting the pursuit of their own economic development within the major international forums, especially the United Nations (UN).

1.7.3 The Decade of the 1970s

i. The New International Economic Order

The second period, which covered the 1970s, was characterized by demands for structural changes in international economic relations by the Third World countries. The energy crisis exerted a profound influence on the international environment for development. Developing countries gained more bargaining power to set the agenda in their favor at the international level, whereas the developed countries were apprehensive over the control of energy resources by some developing nations.

The notion of New International Economic Order (NIEO) and its accompanying programme of action were advocated by the developing countries, that resulted in two important UNGA Resolutions: Declaration on the Establishment of a New International

[40] The United Nations General Assembly Resolution 1803 (XVII) on Permanent Sovereignty over Natural Resources was passed in the form of a declaration at the Seventeenth Session on December 14. 1962, reproduced in Vol.1 1.L.M. 223 (1962); The United Nations General Assembly Resolution 21 58 (XXI) on Permanent Sovereignty over Natural Resources (1966). See generally, Karol N. Gess. "Permanent Sovereignty over Natural Resources: An Analytical Review of the United Nations Declaration and Its Genesis" (1964) 13 Int'I & Comp. L.Q- 398, for an analysis of these resolutions.

[41] The capital-exporting developed countries opposed the adoption of these resolutions and argued for an international legal standard to protect foreign investor and investment. As a major compromise, the Resolutions provided expressly for the payment of appropriate compensation and for the respect of agreements between the foreign investors and host governments. See UNGA Resolution 1803 (XVII), ibid. Article 4.

Economic Order (NIEO Declaration) and Charter of Economic Rights and Duties of States.[42] Article 4 (e) of the NIEO Declaration stresses:

> *Full permanent sovereignty of every State over its natural resources and all economic activities. In order to safeguard these resources, each State is entitled to exercise effective control over them and their exploitation with means suitable to its own situation, including the right to nationalization or transfer of ownership to its nationals, this right being an expression of the full permanent sovereignty of the State. No State may be subjected to economic, political or any other type of coercion to prevent the free and full exercise of this inalienable right.*[43]

The NIEO is relevant for present purposes in that it called for an order which is more responsive to global needs and human dignity, particularly to the needs of development objectives of developing countries. Such efforts have in many respects affected the foundations of international law on which the existing international order has traditionally found its authority.[44] It is precisely against this background that the - 'international development law" was developed by some legal scholars, of course mainly from developing countries.[45]

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[42] The United Nations General Assembly Resolution 3201 (S-VI): Declaration on the Establishment of a New International Economic Order, adopted at Sixth Special Session on May 1. 1974, reproduced in Vol. 13 I.L.M. 715 (1974) [hereinafter NIEO Declaration]; The United Nations General Assembly Resolution 328 1 (XXIX): Charter of Economic Rights and Duties of States, adopted at Twenty-ninth Session on December 12, 1974, reproduced in Vol. 14 I.L.M. *25* 1 (1975). China, as one of those advocating a NIEO, voted in favor of the Charter of Economic Rights and Duties of States. See Sornarajah, supra note 37 at 95. For earlier elaboration of the Charter of Economic Rights and Duties of States, see especially Rober F. Meagher, An International Redistribution of Wealth and Power: A Study of the Charter of Economic Rights and Duties of States (New York: Pergamon Publishers, 1979).

[43] Ibid.

[44] K. Venkata Raman, "Transnational Corporations, International Law, and the New International Economic Order" (1978) 6 Syracuse J. of Int'l L. & Com. 17, at p. 18

[45] International development law aims at establishing a true equality, as contrast to the formal legal equality articulated by the developed countries, whereas the classical international law is proclaimed to be constructed on the foundation of industrial revolution, in response to the need of colonialism and exploitation over developing countries. The FDI issue is, by its nature, at the cote of international development law. The development of international development law reached its peak when "The Declaration on the Progressive Development of Principles of Public International Law relating to a New International Economic Order" (Seoul Declaration) was adopted by the International Law Association in 1986. The Declaration was passed by consensus, including, *inter alia,* the United States. See Milan Bulajic, Principles of International Development Law, 2nd ed. (Dordrecht and Boston: Martinus Nijhoff Publishers, 1993) at pp. 77-78.

ii. The Texaco v. Libya Case

The question of economic independence and the effects of the claims in the debates on NIEO were raised in the case *Texaco Overseas Petroleum Company and California Asiatic Oil Company v. the Government of the Libyan Arab Republic.*[46] The arbitral award is significant and worthwhile discussing insomuch as it constitutes the first direct international response to the general demands for a new economic order represented by the NIEO Declaration. The arbitrator made on the way, albeit somewhat controversial, some far-reaching statements about the significance of the NIEO principles to any claim as evidence of the emerging customary international law. This was done by examining the international characteristic of the Deeds of Concession as contracts, the applicable governing law for their interpretation, and the scope and content of the "appropriate compensation" principle in the light of the NIEO Declaration on permanent sovereignty over natural resources.

The dispute was raised when Libya promulgated, in September 1973 and February, 1974, decrees concerning the nationalization of all the properties, rights, assets and other interests of Texaco Overseas Petroleum Company and California Asiatic Oil Company.[47] The claimants argued that the contractual obligations of the Libyan government under the Deeds of Concession should be frozen against any unilateral changes. They invoked the provisions in the concessions for compulsory arbitration and requested the President of the International Court of Justice to name an arbitrator. What makes the case interesting is that Libya invoked the principles articulated by the NIEO Declaration, in a letter addressed to the Registrar of the Court, to justify its unilateral cancellation of the concessions. Libya contended that its decision was an act of sovereignty over its natural resources, by reference to the specific provisions in the NIEO Declaration recognizing the competence of domestic laws and procedures for resolving

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[46] Award on the Merits in the Dispute Between Texaco Overseas Petroleum Company/ California Asiatic Oil Company and the Government of the Libyan Arab Republic [1978], reproduced in Vol. 17 I.L.M. 1 (1978) [hereinafter *"Texaco* v. *Libya Arbitration*"].

[47] These investment projects were granted under fourteen Deeds of Concession signed by Libyan government. This action is believed to have been taken in response to the foreign investors' refusal to agree to the Libyan demand to curtail the production of their crude oil by approximately half the existing levels, to increase by almost four times the then existing price of crude oil, and also perhaps, to controls over the destination of their resources.

any dispute relating to nationalization.[48] In this regard, there is no doubt that the NIEO aims at making changes in favor of terminating long-term concessionary arrangements regardless of the effect of a stabilization clause.

Professor Rene-Jean Dupuy, acting as the sole arbitrator, rendered the award for the plaintiffs holding that they are entitled to *restitutio in integrum.* In his award, the arbitrator recognized that nationalization, in certain circumstances, can have the effect of placing the nationalizing state "On a level outside of and superior to the contract and also to the international legal order itself', which then "constitutes an 'act of government' . . . which is beyond the scope of any judicial redress or any criticism.[49] However, the pertinent Resolutions of UNGA were characterized, in the view of the arbitrator, as *lex ferenda*[50]. A settlement was eventually reached under which Libya agreed to provide the companies, over a fifteen-month period, $152 million worth of crude oil from its refineries.[51]

Undoubtedly, the *Texaco v. Libya Arbitration* has exerted considerable impact on the attitudes of both developing and developed countries and enriched the doctrine and jurisprudence of customary international law, as well as the authority of United Nations resolutions. As Professor Raman observed:

> The Libya-Oil Companies award amply demonstrated the impermissibility of any arguments that international law is not relevant, even when a municipal legislation seeking nationalization is patently unjust or arbitrary in character. . . . the NIEO documents ... have rejected the applicability of the traditional concepts of international law. ... The aim of the NIEO is to

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[48] The NIEO Declaration, Article 4 *(e)* prescribes, *inter alia,* that: "In order to safeguard these resources, each *State* is entitled to exercise effective control over them and their exploitation with means suitable to its own situation, including the right to nationalization or transfer of ownership to its nationals, this right being an expression of the full permanent sovereignty of the State."

[49] *Texaco v. Libya Arbitration,* supra note 46, at p. 25.

[50] The arbitrator stated that "The conditions under which Resolution 3 17 1 (XXVII), 3201 (SVI) and 3281 (XXIX) were notably different: ... paragraph 2 (c) of Article 2 of the Charter, which limits consideration of the characteristics of compensation to the State and does not refer to international law, was voted by 104 to 16, with 6 abstentions, all of the industrialized countries with market economies having abstained or having voted against it." *Texaco v. Libya Arbitration,* ibid. at p. 29. Such observation deserves more careful consideration since the Resolutions were not asserting a new principle but affirming an already established proposition in international law.

[51] K. Venkata Raman, "Transnational Corporations, International Law, and the New International Economic Order" (1978) 6 Syracuse J. of Int'l L. & Corn. 17, at p. 18.

> bring about fundamental changes in the policies and practices governing the generation, distribution, and enjoyment of global wealth.[52]

iii. The ICSID Tribunals and the Iran-United States Claims Tribunals

The issues relating to proper treatment for foreign investors, expropriation and the standard for compensation did not crystallize at the height of the NIEO, nor did emerge there any confirmative allegation on the applicable governing law for a concession agreement. Ongoing debate has been extended further at both the bilateral and multilateral level, which will bear more discussion in the latter part of this thesis. Yet it might be useful here to have a brief look at some awards rendered by the ICSID tribunals, as well as the Iran-United States Claims Tribunal, which have been seen as an increasingly important source of legal rules in resolving those issues that arise in international investment disputes. In determining the applicable law, both tribunals have come to the somewhat similar conclusion in favor of international law. In the *Amco Asia Corp., Pan American Developrnent Ltd. And P.T. Amco Indonesia v. Republic* of *Indonesia* case, *the* ICSID Tribunal deemed that it is authorized to "apply rules of international law only to fill up lacunae in the applicable domestic law and to ensure precedence to international law norms where the rules of the applicable domestic law are in collision with such norms."[53] Similarly, in the *Oil Field of Texas, Inc. v. The Government of the Islamic Republic of Iran case,* the Iran- United States Claims Tribunal rejected the application of the Iranian law which had actually been agreed to by the parties to the contract, but applied general principles of international law. When dealing with the question of standard of compensation, a significant departure from the traditional "full compensation" standard, however, can be found in both Tribunals' awards. There exists the perception that the establishment of full compensation shall be based on a prior finding of illegality in the government actions of expropriation or nationalization.

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[52] Ibid., at p. 53.

[53] *AmcoA sia Corp., Pan American Developnlenr Ltd And P. T. Amco Indonesia v. Republic of Indonesia* [1986], partially annulled, reproduced in Vol.251 I.L.M. 1439 (1986) [hereinafter *Amco v. Indonesia Arbitration]* at 1445-1446. This view was also explicitly supported by Mr. Shihata, the Secretary-General of ICSID. See Ibrahim F.I. Shihata & Antonio R. Parra, "Applicable Substantive Law in Disputes Between States and Private Foreign Parties: The Case Of Arbitration under the ICSID Convention" (1994) Vol. 9 No. 2 ICSID Review - Foreign Investment Law Journal 183, at p. 192.

Although some Western commentators have argued that all awards support the "full compensation" standard, a deep examination might lead to a different proposition.[54] The Iran-United States Claims Tribunal concluded in its award on the *INA Corporation v. Iran* case that:

> *In the event of such large-scale nationalization of a lawful character. international law has undergone a gradual reappraisal, the effect of which may be to undermine the doctrinal value of any "full" or "adequate" (when used as identical to "full") compensation standard as proposed in this case. Hence, it is evident that the "full compensation" standard no longer represents the only absolute nom applied in all cases of expropriation and nationalization. An interesting distinction is made here between the unlawful expropriation and the lawful expropriation with the purpose of effecting some far-reaching economic reforms, under the latter circumstance of which, appropriate or partial compensation might be justifiable.*

This conventional debate on the issue of the compensation for expropriation appears to have extended much of the NIEO debates to the heart of other claims, issues and relevant problems articulated by the developing countries. These include the sensitive nature of unrestricted foreign investment in the fragile economies of the developing nations, the issues of transfer of technology, and access to world markets of developing countries' products at a proper, equitable and just price.[55] Now these issues, indeed, appear again and again in the current debate, for example, in the OECD and UNCTAD.

iv. Codes of Conducts

Developing countries' efforts to establish an NIEO was paralleled by the successful adoption of some legally none-binding "Codes of Conducts" on TNCs/MNEs. Generally, it is because attitudes of developing countries towards FDI during this period were still

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[54] John A. Westberg, "Applicable Law, Expropriatory Takings and Compensation in Cases of Expropriation: ICSID and Iran-United States Claims Tribunal Case Law Compared (1993) Vol.8 No. 1 ICSID Review - Foreign Investment Law Journal 1, at p. 18. Such conclusion was. however, somewhat paradoxical as the author himself admitted in the same article that there was *"obiter dictum* in one ICSID award and one Hague Tribunal award, however, acknowledging the view of some authorities that a less than full standard might be found applicable in certain cases." Ibid. at p. 15.

[55] K. Venkata Raman, "Strengthening the United Nations on the Eve of the Twenty-first Century: The Imperatives of the Legal Perspective" (1995) 35 Indian J. of Int'l L. 1, at pp. 7-8.

mixed[56]. On one hand, developing countries came to realize that the foreign capital and external resources of TNCs to certain extent may be utilized to promote their economic development. Consequently, they began to conclude bilateral investment treaties with capital-exporting countries in order to enhance the confidence of foreign investors and improve the investment climate. They found that acceptance of certain liberal principles as *lex specialis* between two contracting parties would not deteriorate their position in the international forums. On the other hand, there were still great concerns that abusive practices of MNEs may be costly and detrimental to their political and economic interests.[57] Therefore, in the FDI sphere, efforts concentrated, mainly at the insistence of host developing countries, on regulating obligations of TNCs at the international level.[58]

Developing countries subscribed to the view that so long as their activities could be regulated; TNCs are to play an important role in the NIEO by transferring resources to their economies. In the first place, this trend was reflected in some regional instruments, notably, Decision 24 of the Andean Pact, adopted in 1970, which is characterized by its restrictive control and screening procedures over inward FDI, restraints on repatriation of capital and profits, and particularly a "fade-out" provision, requiring the disinvestment of foreign investors after a number of years.[59] The OECD also played a leading role, adopting a Declaration of International Investment and Multinational Enterprises in 1976. The Guidelines for Multinational Enterprises, as an annex of the Declaration, set out a set of voluntary guidelines for MNEs' conduct.

At the multilateral level, initiatives were taken by developing countries through United Nations. The United Nations Center on Transnational Corporations (UNCTC) was established in November 1975 by the Economic and Social Council of United Nations

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[56] Asante, supra note 34, at pp. 588-589.

[57] Christopher J. Maule & Andrew Vandenval. "International Regulation of Foreign Investment", in International Perspective (November/December 1985) at p. 22.

[58] Article 4 (g) of the NIEO Declaration. provides: "Regulation and supervision of the activities of transnational corporations by taking measures in the interest of the national economies of the countries where such transnational corporations operate on the basis of the full sovereignty of those countries."

[59] Decision No.24 of the Commission of the Cartagena Agreement: Common Regulations Governing Foreign Capital Movement, Trade Marks, Patents, Licences and Royalties, adopted by Andean Group on December 3 1, 1970, reproduced in Vol. 16 I.L.M. 138 (1977).

(UN-ECOSOC), to gather data related to FDI and TNCs and to conduct studies on the role of TNCs. The task to develop "Codes of Conduct" for TNCs activities was set as its highest priority. An inter-governmental working group started to meet in 1977, and an advanced Draft United Nations Code of Conduct of Transnational Corporations emerged five years later. The Code was the most comprehensive one in a host of other similar codes under negotiation in the late-1970s, but it was never formally adopted, even in a non-binding form. Conceptually, the fundamental purpose of the Code of Conduct is to require MNEs, in their business operation, to adhere to the economic goals and developmental objectives, policies and priorities of the host State government.[60] Article 6 of the Draft Code of Conduct restates that "transnational corporations shall respect the national sovereignty of the countries in which they operate and the right of each State to exercise its full permanent sovereignty over its natural resources, wealth and economic activities within its territory. There is also a duty imposed on MNEs not to interfere in the domestic political activities of the host State or to influence their home country to intervene on their behalf.[61]

Other Codes of Conduct emerging over the same period, which generally dealt with more specific issues, include: (i) The Set of Multilaterally Agreed Equitable Rules and Principles for the Control Restrictive Business Practices by UNCTAD, adopted in 1980;[62] (ii) Draft International Code of Conduct on the Transfer of Technology by UNCTAD not adopted;[63] (iii) Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy by ILO adopted in November 1977;[64] (iv)

[60] UNCTC, Draft United Nations Code of Conduct on Transnational Corporations, Article 6.

[61] UNCTC, Draft United Nations Code of Conduct on Transnational Corporations, Articles 17, 18.

[62] The Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices was adopted by the UNGA at its Thirty-fifth Session on December *5,* 1980; reproduced in UNCTAD, The Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices, United Nations Doc. TD/RBP/CONFII O/Rev. 1 (New York: United Nations, 1981).

[63] The Draft International Code of Conduct on the Transfer of Technology was negotiated between 1976 and 1985, but was never adopted. reproduced in UNCTAD, Draft International Code of Conduct on the Transfer of Technology, United Nations Doc. TD/CODE TOT/47 (New York: United Nations, 1985).

[64] International Labour Office, Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy was adopted by the IL0 at its 204"' Session in November 16, 1977, reproduced in ILO, Official Bulletin Vol. LXI, Ser.A, No. I (Geneva: ILO, 1978), at pp. 49-56.

Draft International Agreement on illicit Payment by UN-ECOSOC, not implemented.[65] In essence, these efforts were designed to establish guidelines for the conduct of TNCs vis-à-vis host country governments. Strongly opposed by the developed nations, a major compromise was taken by developing countries in the negotiations by implementing such Codes of Conduct in voluntary- forms rather than legally binding multilateral agreements.

The negotiations over behaviors of foreign investors, MNEs in particular, whether ultimately successful or not, were crucial and contributed to a better understanding of the problems involved. Moreover, some standards postulated in the codes are now becoming established principles of international business."' The issue, in the context of today's increasingly liberalized world economy, acquires particular significance in order to ensure the proper functioning of the market and private economic activities, especially to the Third World countries, which are not yet capable of developing a sophisticated domestic regime to cope with misconducts of MNEs. Thus, it will be further argued in the latter part of this thesis that international rules in this area, dealing with important international private actors such as TNCs/MNEs, should form an indispensable part of the framework at the multilateral level.

1.7.4 The Past Three Decades

The general climate surrounding FDI started to change in the 1980s. It is clearly the most productive and most diffuse period for evolution of the international law on FDI in practice. Prior to this period, the determination of legal environment for FDI was basically, from the viewpoints of customary international law, a matter of policy exclusively left to the discretion of the host State governments. However, the legal regulation of FDI is now increasingly accepted as a matter of international concern. The entire complex of issues has become the object of a variety of bilateral treaties, regional arrangements, multilateral agreements as well as international negotiations, albeit ambiguous and controversial sometimes. This change in the focus of concerns has been responsive to, *inter alia,* radical changes in the world economy as well as political conditions within national governments.

[65] Draft International Agreement on Illicit Payments, not implemented by UN-ECOSOC, reproduced in UNCTAD, International Investment Instruments: A Compendium (New York and Geneva: United Nations Publications Sales No.E.96.II.A. 11, 1996) Vol. 1, at pp. 103- 107.

The emergence of Japan as a major economic power in Asia, and later the rapid industrialization of some developing countries have shifted the balance of the world economy. There have been increasing economic and investment relations among the United States, the European Union, and Japan, who are now called the Triad. The surge of intra-Triad investment flows tremendously accelerated the international production and the globalization process. Developed countries, such as the United States and countries of the European Union are beginning to experience themselves as hosts for external investments.[66] At the same time, with the onset of the debt crisis and subsequent sharp reduction of external sources of development assistance, especially commercial bank loans in the 1980s, the developing countries began to rely more and more on the capital inflows brought by the FDI.[67] More Socialist countries have gradually departed from their ideologically oriented stances and sought to integrate into the world economy by attracting foreign investment.

As mentioned earlier, over the first decades after World War II, most discussions around FDI were primarily concerned with the exploitation of petroleum and other natural resources. However, the industries in which MNEs are active today are not any more the same as those of that time. While the exploitation in natural resources remains important, the focus has turned to investments in manufacturing, services and high technology. At the same time, developing countries also changed their development strategies, from highly protective import substitution models to more outward-looking policies emphasizing export-led growth.[68] Such shift stressed more on the opportunities offered by FDI of establishing linkages with the globally integrated marketing, distribution and production networks. Apart from these, the rehabilitation of FDI as a vehicle for development is also a result of the increasing sophistication of developing

[66] Edward M. Graham & Paul R. Krugman. Foreign Direct Investment in the United States, 3rd ed.. (Washington, D.C.: Institute for International Economics, 1995) at pp. 39-40.

[67] Ibrahim F.I. Shihata, Legal Treatment of Foreign Investment: The World Bank Guidelines (London and Boston: Martinus Nijhoff Publishers, 1993) at p. 1 (noting that the commercial bank loan to developing countries decreased from the 455 million in the beginning of 1980s to the negative 45 million in 1990.). It is easy to understand that FDI would be a more desirable alternative to bank lending insofar as it does not burden the developing countries as much as debt and is more easily available.

[68] R. Kaplinsky, 'The International Context for Industrialization in the Coming Decade" (1984) 20 J. Dev. Stud. 74, at p. 76.

countries. For most third World countries, the process of regaining control over natural resources and key industries has greatly advanced and host governments have acquired sophisticated experience in negotiating with foreign investors for appropriate economic co-operation as well. Therefore, there was an overall perception that liberalization of foreign investment flows will have a positive effect on the global economy, and trends of national policies reversed accordingly. All developing countries now welcome FDI and have liberalized dramatically their domestic regulatory regimes and policies.[69] It was precisely during this period that some 1,700 bilateral investment treaties were concluded, involving about 160 countries in every region of the world.[70] These treaties have become the most widely accepted instrument to provide a stable international legal framework for the regulation of FDI. At the regional level, this period is characterized by the establishment of several important free trade blocs, as well as other regional economic integration arrangements, which fosters liberalization for FDI flows, to name a few, the North America Free Trade Agreement (NAFTA),[71] the European Energy Charter Treaty,[72] the MERCOSUR Protocols,[73] and the APEC Non-Binding Investment Principles.[74] Notably, a characteristic amendment in Decision 291 of the Andean Pact,

[69] According to UNCTAD, the trend towards the liberalization of regulatory regimes for FDI continued in 1998: out of 145 regulatory changes relating to FDI made during 1998 by 60 countries, 136 were in the direction of creating more favourable condition for FDI, Over the period from 199 1 to 1998, some 94 per cent of a total 8 1 O of the FDI regulatory changes were liberalization measures. See UNCTAD, W R 1999, supra, at p. 115.

[70] UNCTAD, Bilateral Investment Treaties in the Mid- 1990s (New York and Geneva: United Nations Publication Sales No. E.98.II D.8. 1998)

[71] North American Free Trade Agreement was signed by Canada, Mexico and the United States of America on September 17. 1992, reproduced in North American Free Trade Agreements, looseleaf collection (New York: Oceana Publications, Inc.. 1999).

[72] The European Energy Charter Treaty was signed in Lisbon on December 17, 1994, reproduced in Vol. 33 I.L.M. 360 (1995).

[73] Protocolo de Colonia Para la Promocion y Proteccion Reciproca de Inversiones en el MERCOSUR (Intrazona) was signed on January 17, 1994. Protocolo sobre Promocion y Proteccion de Inversiones Provenientes de Estados no Partes del MERCOSUR was signed on August 1994. Both are reproduced in UNCTAD, International Investment Instruments: A Compendium (New York and Geneva: United Nations Publications Sales No. E.96.II.A. 10. 1996) Vol. II.

[74] The Asian Pacific Economic Cooperation Non-Binding Investment Principles was endorsed at the Sixth Ministerial Meeting of APEC, and came into effect on November 12, 1994, reproduced in UNCTAD, International Investrnent Instruments: A Compendium (New York and Geneva: United Nations Publications Sales No. E.96.II.A. 10, 1996) Vol. II, at pp. *535*- 537.

that replaced the earlier more restrictive Decision 24, is especially telling how perceptions of the developing countries have changed.[75]

Although economic thinking has changed and foreign direct investment is now welcome in the developing world, a clear consensus on the exact content of customary principles protecting foreign investment has not consolidated yet. Emerging consensus has been helped by non-binding restatements of recognized principles that can be considered as conducive to the development of stability for FDI while taking into account the interest of developing host countries. The World Bank Guidelines of 1992 recommend and advocate the granting by the host state of fair and equitable treatment to established foreign investment, meaning full protection and security to an investor's right regarding ownership, control and substantial benefits over his property as well as operation, management, control and exercise of rights in such an investment. According to the Guidelines treatment will be as favourable as that accorded to national investors in similar circumstances. In matters that are not relevant to national investors, treatment will not discriminate among foreign investors on grounds of nationality. The host state will promptly issue such licenses and permits and grant such concession as may be necessary for the unimpeded operation of admitted investment. The Guidelines include detailed principles on expropriation and compensation which are applicable also " with respect to the conditions under which a state may unilaterally terminate, amend or otherwise disclaim liability under a contract with a foreign private investor for other than commercial reasons, i.e. where the state acts as a sovereign and not as a contracting party".

India - Measures Affecting the Automotive Sector

In December 1997, India announced a new automotive policy that requires manufacturers in the automotive industry and the Ministry of Commerce and Industry to draft and sign a memorandum of understanding (MOU) on new guidelines for the industry. The policy has the following TRIMs Agreement related problems: First, the policy requires that 50

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[75] Decision 291 of the Commission of the Cartagena Agreement: Common Code for the Treatment of Foreign Capital and on Trademarks, Patents, Licences and Royalties, adopted by Andean Group on March 2 1. 1991, reproduced in Vol. 30 I.L.M. 1288 (1991).

percent local content be achieved within three years of the date on which the first imported parts (CKD, SKD) are cleared through customs; the requirement increases to 70 percent within five years of first clearance. Second, the policy requires that export of automobiles or parts begin within three years of start-up; restrictions on the amount of parts (CKD, SKD) that can be imported depend on the degree to which the export requirement is met. This policy amounts to an export/import balancing requirement. Even prior to this policy, India made auto parts import licenses for companies setting up operations within its borders conditional upon signing an MOU containing local content requirements and export/import balancing requirements — despite the lack of any legal basis for doing so. It is clear that the new automotive policy of 1997 is designed to institutionalize the previous administrative guidelines.

In October 1998, the EU requested WTO consultations (in which Japan and the United States participated as third parties). The first consultations were held in December 1998, but were unsuccessful. A WTO panel was established in November 2000 at the request of the EU; Japan participated as a third party. In June 1999, the United States requested separate consultations that were held in July 1999. Japan and the EU participated as third parties. These consultations were also unsuccessful. A panel was subsequently established at the request of the United States in July 2000, and Japan, the EU and the Republic of Korea participated as third parties. At the end of November 2000, the two panels were consolidated into a single panel.

Prior to this dispute, India had already lost before the WTO Appellate Body a complaint brought by the United States over import restrictions on specific items, including automobiles. India reached an agreement with the United States to eliminate import restrictions by April 2001. Consequently, quantitative restrictions on 714 items were eliminated on April 1, 2000, and on a further 715 items on April 1, 2001. Consequently, Department of Commerce and Industry Notice No. 60 was abolished in September 2001. However, the export obligations continued and, thus, the measures cannot be regarded as having been fully eliminated. Indeed, the WTO panel subsequently examined Commerce and Industry Department Notice No. 60 and found that the MOU based on it violated GATT Articles III and XI. India, which was dissatisfied with the Panel Report, appealed to the Appellate Body on January 31, 2002, but withdrew the

appeal on March 14. Subsequently, in August 2002, the Indian Government abolished the export obligations and, accordingly, the automotive policy was fully eliminated.

Multilateral efforts are also underway to create a comprehensive legally binding framework governing the FDI. As already noted, investment issues were brought into the regulatory framework of multilateral trading system - WTO/GATT - in three important aspects: trade-related investment measures, trade in services and intellectual property protection. Among the more recent efforts to draft instruments on investment are the Guidelines on Foreign Investment proposed by a study group of the World Bank and the Multilateral Agreement on Investment (MAI) attempted by the Organization for Economic Co-operation and Development (OECD). The Guidelines were drafted in 1992. They were non-binding as the group felt that the time was not ripe for a multilateral binding code on investments. The MAI was promoted under the auspice of the OECD with the view to strengthening the currently existing instruments in various respects and establishing a dispute settlement mechanism in particular.

The Second Ministerial Conference of the WTO held in Singapore mandated the consideration of an agreement on investment under the auspices of the WTO. The matter was not considered at the Third Ministerial in Seattle where massive demonstrations against the WTO muted consideration of the issue. At the Doha Ministerial, the decision was made to consider the possibility of taking up the subject of investment subject to concerns of development.[76]

Chapter 2 will shed some light on how normative substances have been set out in these significant instruments.

1.8 Development of Customary International Law related to Investment

As the preceding overview has indicated, the customary international law continues to serve as the touchstone of the entire framework, it is thus important and useful to look

[76] At the World Trade Organization (WTO) Ministerial Conference held in Doha in November 2001 Ministers recognized the case for a multilateral framework to secure transparent, stable and predictable conditions for long-term cross-border investment É.Õ (Ministerial Declaration 2001). Paragraph 22 of the Ministerial Declaration set out a number of areas where further work on an investment framework was required.

into the twin foundations in this field before any other international instruments can be examined.

Customary law and international treaties, including bilateral and multilateral treaties, are the two principal sources of international law, among others enumerated in the Statute of the International Court of Justice.[77] It was claimed that there are few customs in the field of foreign investment.[78] Two aspects, however, have been the subject of extensive debate, and significant principles have evolved between the eighteenth and twentieth centuries, albeit often controversial in specific contents. First, it is well established within the international community that a State has the exclusive right to control the entry and activities of aliens and inward foreign investments.

Second, international norms relating to the treatment of aliens and the State responsibility for injuries to aliens and their property on the other hand form another important part of the framework. The international law of foreign investment has teetered between emphasis on each of these two foundations. Capital-exporting countries have argued that a State is entitled to exercise diplomatic protection for its nationals who are injured by another State. They further asserted that a State shall respect the "minimum standard of protection" required by the customary international law and accord to aliens, in particular, foreign investors, treatment in accordance with an objective international law standard.[79]

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[77] In addition to customary law and international treaties, general principles of law, judicial decisions and writings of publicists are considered as the subsidiary sources of international law. See Statute of the International Court of Justice (1945), reproduced in Malcolm D. Evans ed., International Law Documents, 4th ed., (London: Blackstone Press Limited, 1999) at pp. 26-35, Article 38 (1).

[78] Sornarajah. Supra, at p. 74.

[79] American Law Institute. Restatement of the Law: The Foreign Relations Law of the United States (St. Paul, Minn.: American Law Institute Publishers, 1987). Section 712 (State Responsibility for Economic Injury to Nationals of Other States), Vol. II, at 196. This proposition and the postulated international standards were also reflected in Article 19 of the International Law Commission Draft Articles on State Responsibility (1979), reproduced in United Nations International Law Commission, Year Book of the International Law Commission (New York: United Nations, 1979) Vol. 2, at 90. See also generally Richard B. Lillich, "The Current Status of the Law of State Responsibility for Injuries to Aliens", in Richard B. Lillich ed., International Law of State Responsibility for Injuries to Aliens (Cliarlottesville, Virginia: University Press of Virginia, 1983) 1, for a detailed discussion of such minimum international law standard.

Developing countries, on the contrary, have pressed for a "national standard" as articulated by the "Calvo Doctrine.[80] They argued that aliens shall be accorded the same treatment as that of their own nationals under domestic laws, in accordance with the international law.[81] This proposition was reflected in many Latin American constitutions, as well as the "Calvo Clause" incorporated in the contracts with foreign investors. The "Calvo Clause" is an attempt to implement the Calvo Doctrine, which involves the commitment to submit any disputes to the jurisdiction of local courts and provides that the laws of the State in which the contract is executed should be the governing law.[82] Other newly independent nations from Asia and Africa supported the view of Latin American nations on a somewhat different ground that the traditional international legal principles relating to State responsibility were developed by Western Europeans without the participation of the new nations on a reciprocal basis. Thus, such principles reflected merely a relation with apparent colonial characteristics between the exploiter and the exploited and do not respond to the needs of an expanded international community.[83]

Under customary international law, initially at least, the discussion of protection was confined to the physical assets of the foreign investor. This was but natural as it was such assets that were involved in foreign investment. The act against which protection was designed was the taking of the physical assets of the foreigner by the host state. The factual situation in the context of which protection had to be designed was not

[80] In his Le Droit International (Vol.6, 5' ed., t 885), Carlos Calvo asserted that "Aliens who established themselves in a country are certainly entitled to the same rights of protection as nationals, but they cannot claim any greater measure of protection." This has been commonly referred to as "Calvo Doctrine". For further discussion of the Calvo Doctrine and its application, see *e.g.*, Donald R. Shea, The Calvo Clause: A Problem of Inter-American and International Law and Diplomacy (Minnesota: University of Minnesota Press, 1955).

[81] One interesting point involved here concerns the distinctions between property right and right acquired under a contract. Acknowledging such distinctions, measures affecting State contracts with foreign investors, usually in the form of concessions, could then be distinguished from the taking of property of aliens, which should be governed exclusively by domestic laws.

[82] Indeed, such view was also held by Permanent Court of International Justice at that time. See, for example, the Panevezys-Saldutiskis Railway Case (Estonia v. Lithuania) [1939] P.C.I.J. (Ser. A/B) No.76, at p. 16 (stating that "in principle property rights and contractual rights of individuals depend in every State on the municipal law and fall therefore more particularly within the jurisdiction of municipal tribunals.")

[83] Guha-Roy, "Is the Law of Responsibility of State for Injuries to Aliens a Part of Universal International Law?" (1961) 55 Am. J. Int'l. L. 863, at p. 866.

complicated. The industries in which investments were made were usually confined to the exploitation of natural resources, agriculture and less often, manufacturing. The context in which the law was shaped involved capricious takings of physical property by totalitarian regimes or takings by revolutionary regimes in the course of programs associated with the redistribution of property. In the first half of the twentieth century, the law was concerned exclusively with such problems.

The protection of intangible property first became mooted when contracts associated with foreign investment were rescinded by host states. The argument then came to be made that breaches of these contracts would give rise to responsibility without more. The literature suggests an intensive debate on the proposition. It would have been a startling situation from a theoretical standpoint.[84] For such a proposition to be recognized, a foreign investor or a foreign corporation should have personality in international law. Otherwise, the breach of a contract between the foreign investor and the host state, being located in domestic law, could technically have no impact in international law. But, multinational corporations and developed states were interested in ensuring that such a proposition was developed.[85] Progressively, when emphasis came to be placed on the value of intangible property and rights in contracts, protection had to be extended to the types of transactions which created these rights. Contractual rights in concession agreements as well as intellectual property rights which were central to transactions such as technology transfers required protection and the law was progressively extended to cover these transactions. By the time treaty practice took hold, practice in the area had begun to reflect this movement from asset based protection to enterprise and transaction based protection. International law however had not congealed on these points for there was considerable doubt as to the extent of the types of foreign investment that could be protected. Thus, for example, the *Barcelona Traction Case*,[86] which reflected customary international law as understood by the International Court of Justice, stood against the development of an enterprise based system of protection as it undermined the possibility

[84] C.F. Amerasinghe, State Responsibility for Injuries to Aliens (1965), pp.66-95.

[85] For a discussion of the theory of internationalization of foreign investment contracts, M Sornarajah, The Settlement of Foreign Investment Disputes (2000).

[86] [1964] ICJ Rpts 12.

of shareholder protection by the state of nationality of the shareholders. There was a need for change. The change was effected by investment treaties, which, given the doubts that existed in customary international law, sought to establish rules as between the parties by recognizing the protection of shareholder interests.

Overall, while rules and principles of customary international law are important as the foundation of the whole framework, they are often not specific enough, without definite content, thus considerably undermining their practical effectiveness.

Chapter 2

INTERNATIONAL REGIME FOR FOREIGN DIRECT INVESTMENT

2.1 Forms of FDI Regulation

There are primarily three parties whose interests are at stake with respect to the regulation of FDI: the TNC undertaking the investment and its home country on one side, and the host country on the other. Since FDI entails advantages and disadvantages for these parties, each party tries to maximize the advantages it can obtain from FDI and reduce the disadvantages through the regulation of FDI. However, more often than not, the interests of these parties conflict;[1] the desire of a TNC to expatriate its earnings, for example, can conflict with a host country's interest in preserving its balance-of-payments; the interest of a TNC to hire high-skilled foreign labour can conflict with a host country's interest to rise its local employment rate. Accordingly, the regulation of FDI aims at balancing these interests.

The regulation of FDI is a sovereign matter governed by States through the enactment of national and international laws. Thus, the regulation of FDI can be imposed unilaterally, bilaterally, regionally and multilaterally.

A. Unilateral or Domestic Regulation

Unilateral regulation refers to domestic laws enacted by a host country so as to regulate FDI. These regulations are spread over a wide range of laws; they include domestic laws that are enacted specially for regulating FDI as well as any domestic law that governs the

[1] In fact some argue that there is an "inherent conflict" between the TNC and the host *country's* interests. The TNC seeks opportunities where the production costs are lowest and sales where the prices are highest resulting in repatriation of profits to the home country. The host country, on the other hand, seeks to maximize benefits to its economy, which requires the retention of TNC profits within the host economy." See E.M. Burt, "Developing Countries and the Framework for Negotiations on Foreign Direct investment in the World Trade Organization" (1997) *12* Amer. Univ. J. Int'l L. & Policy, p. 1015.

operation of corporations, such as tax law, labour law, corporate law and environmental law. The net effect of this legislation represents a country's policy towards FDI.

Since most countries follow a pragmatic nationalist approach to maximize the advantages of FDI and reduce its disadvantages, they try to regulate FDI in such a way as to achieve this goal.

The formula for host developing countries is thus simple: the more FDI a country can attract and the more regulation it can impose in the direction of its interests, the more advantages it can harness from FDI. The amount of FDI a country can attract is, however, dependent on how strict its regulations are. TNCs prefer to operate on a free market basis and thus try to avoid heavily regulated environment. Therefore, in regulating FDI, host countries try to achieve a balance between the benefits they can harness from regulating FDI and remaining attractive to TNCs as an investment site.

FDI regulation entails imposing entry restrictions and operational requirements to assure that the investment be in line with a host country's policies. Through entry restrictions a country can ensure that FDI is suitable to its development objectives and its interests." A host country can, for instance, require that the investment be located in a particular region, require a certain type of direct investment, such as a joint venture with local partner, or forbid investing in certain industries such as its oil or infrastructure industries. As for operational restrictions, they might include: "local content restrictions, trade balancing requirements, export performance requirements, limitations on imports, foreign exchange and remittance restrictions, minimum local equity restrictions, technology transfer requirements, local employment requirements, personnel entry restrictions, and product licensing requirements". However, unilateral FDI regulation is not carved in Stone. Despite the existence of regulation, there is usually room for negotiation regarding the conditions of investment and the rules applied to them. In fact, some developing countries enact strict investment laws to be used as a bargaining tool in their negotiations with foreign TNCs and their governments.

To give but one example, Mexico enacted a law in 1973 that requires a minimum of 51 percent local ownership in any FDI in Mexico. The practice of the Mexican government has proven that this requirement was not strict and that Mexico was willing to waive this requirement in return for other concessions by foreign TNCs. For instance,

in 1984 IBM sought to establish a plant in order to manufacture computers in Mexico to take advantage of cheap Mexican labour, but did not want to abide by the 51 percent local ownership requirement. IBM's initial proposal included the creation of 880 jobs (80 direct and 800 indirect jobs), $40 million investment ($7 million direct investment and $33 million to be financed from the Mexican capital market), and an annual export of 75,000 computers from Mexico.[2] The Mexican government, however, insisted at the outset on the 51 percent local ownership requirement. Since 100 percent ownership of the investment was crucial to IBM,[3] it agreed to make some concessions in other aspects to the Mexican government. IBM initially came up with a proposal to increase its investment to $91 million to achieve 82 percent local content after four years of operation and to export 92 percent of its production out of Mexico. The Mexican government approved the offer and agreed to 100 percent ownership by IBM.

B. International Regulation

2.2 Bilateral Investment Treaties

2.2.1 Introduction

An international legal framework for FDI has begun to emerge in recent times. In this process, the bilateral investment treaties have played an important role and are to be examined first. They are so far the most common form of investment treaty, and constitute a major element of the current framework for FDI. Many of the issues and provisions discussed here would also be applicable to multilateral agreements. Thus, this chapter also attempts to serve as a theoretical basis upon which the subsequent discussion concerning the current trends at various multilateral forums could be developed. An exhaustive survey of all normative principles and substantive contents embraced by these treaties is certainly neither necessary nor possible for the purpose of this thesis. Instead,

[2] J. Behan & *R.E.* Grosse. *International Business* and Governments: *Issues and Institutions* (Colombia. SC; University of South Carolina Press, 1990).

[3] The reason why 100 percent ownership was crucial for IBM was that IBM wanted to maintain its technological advantage for itself and avoid passing it to potential competitors in Mexico.

emphasis will be placed on some rather contentious issues and the treaties entered into by Pakistan will be particularly looked into.

2.2.2 The Phenomenon of Bilateral Investment Treaties Practice

The practice of entering into Bilateral Investment Treaties (BITs) for developing countries is a relatively new phenomenon in the international law field. As the name implies, they are treaties under which two States agree to protect and promote their investment in each other's territory. The rapid proliferation of these treaties during recent decades signifies the importance of this procedure as a widely accepted instrument to provide a stable international legal framework for the regulation of FDI. As of 1998, over 1700 such treaties have been concluded between developed countries and developing countries, as well as between developing countries inter se.[4]

2.2.3 Bilateral Investment Treaties and Customary International Law

The BITs create international obligations for each treaty party with respect to its treatment of investment from the other party. It is claimed that the BITs stabilize the existing situation and thus contribute to the creation of customary international law in the FDI area as they evidence consistent practice of States in connection with the standards of investment protection.[5] The accumulation of BITs subscribing to the essentially similar standards might strengthen the relevant principles of international law to which it gives expression.[6] Indeed, the normative substance found in the BITs practice has led to the

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[4] Many countries have established their own BITs program and continue to pursue opportunities to negotiate new treaties with a view to facilitating foreign investment and economic co-operation. Apart from BITs other bilateral treaties that have direct relevance to FDI relations include bilateral treaties for the avoidance of double taxation, and more recently, bilateral agreements for Cooperation, notification and information-exchange in the competition policy area.

[5] F.A. Mann, "British Treaties for the Promotion and Protection of Investment" (1981) 52 Brit. Y. B. Int'l L. 24 1, at p. 249.

[6] While some commentators are in favor of the view that BITs support international standards of customary law, some consider them as *lex specialis* created by States in their reciprocal relations in view of the uncertain state of the existing international faw on FDI. See M. Sornarajah, "State Responsibility and Bilateral Investment Treaties" (1986) 20 J. of World Trade L. 79, at 97. The *AAPL* v. *Sri Lanka arbitration* award also refers to the BITs between the United Kingdom and Sri Lanka as *lex specialis.* See *Asian Agricultural Products Ltd. (AAPL) v. Republic of Sri Lanka,* Case No. ARB/87/3, reproduced in Vol. 30 I.L.M. 577 (1991). Given the issue at debate, the widespread belief in their significance among States and

development of several important regional instruments.[7] It is therefore widely acknowledged that BITs may provide the foundation upon which a future multilateral framework can be built. Once an extensive system of BITs is established, standards and principles that generally accepted will enter into the realm of multilateral agreement.[8] Hence, it is necessary at this point to look at the recent BITs practice in the light of the increasing role they play in the FDI sphere, in particular, the Pakistani BITs practice. It is worth noting in this regard that Pakistan has been one of the successful countries to use BITs as an essential instrument, to attract an increasing volume of FDI. The existence of BITs often supplements its domestic legislative regime by providing relevant principles to fill gaps or inadequacies in its context.

2.2.4 Origins and Evolution of Bilateral Investment Treaties

The first modem bilateral investment treaty was entered into between Germany and Pakistan in 1959.[9] An increasing number of BITs were then concluded between European capital-exporting countries and developing countries. However, fewer than a dozen treaties were signed per year during the 1960s and 1970s.[10] It is only since the late 1980s that BITs have come to be the universally adopted instrument for the promotion and legal protection of foreign investments. The number of BITS concluded in the 1990s has risen steadily. in parallel with the rapidly increasing amount of FDI flows to the developing countries during the same period. In fact, more than two-thirds of the treaties signed by

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the fact they have potential for the creation of customary principles are factors underlying the importance of these treaties.

[7] Chapter 11 of NAFTA incorporates many provisions covering much the same grounds as BITs. Similar provisions can also be found in the European Energy Charter Treaty. More recently, some of the high standards followed by industrialized nations have been reconstituted into the MAI envisaged by the OECD.

[8] John M. Kline & Rodney D. Ludema, "Building a Multilateral Framework for Investment: Comparing the Development of Trade and Investment Accords" (1997) Vol. 6 No. 3 Transnational Corporations (December 1997) 1, at p.2

[9] UNCTC, Bilateral Investment Treaties (New York: United Nations Publication Sales No. E.88.II.A. 1. 1988), [hereinafter BITs 1988], at p. 7.

[10] WCTC & ICC, Bilateral Investment Treaties: 1959-1991 (New York: United Nations Publications Sales No. E.92.1I.A.16. 1992) at p. 2. Most of the earliest BITs were between European countries and African countries. Latin American nations, adhering to the Calvo Doctrine, refused to join the trend.

the end of 1998 came into existence in the 1990s.[11] The current network of BITs involves 152 countries and territories from all regions of the world.[12]

The BITs acquired a new significance when developing countries first entered into BITs between themselves, embarking on an era of South-South Co-operation. The number of BITs between developing countries and transition economies has increased from 64 by the end of the 1980s to 508 at the end of 1996.'" Indeed, a lot of them are between countries within the same region such as Southeast Asia and Latin America.

BITs are not the first bilateral treaties to provide protection for FDI. The treaties on Friendship, Commerce and Navigation (FCNs) are the forerunners of BITs, which shaped to a large extent the formulation of BITs. The FCNs was the first step in the evolutionary process of providing protection for FDI, by proposing general obligations to protect the property of the nationals of the treaty Party. In the 1920s and 1930s, international economic relations began to expand and the FCNs became the primary treaty instrument for the United States to protect its direct investment abroad. Yet, for capital-exporting developed countries, FNCs are far from being satisfying to cover all concerns of their risk-taking investors.[13] Provisions pertaining to foreign property in the FCNs were primarily concerned with facilitating trade or shipping, rather than regulating specifically the FDI issue. On the other hand, along with the emergence of some newly independent countries in the post-war time, many old features contained in the FCNs became unacceptable. The unlimited right of entry and unconditional national treatment, in particular, were in direct contradiction with demands of the developing countries to control the inward FDI pursuant to their economic objectives in the new political

[11] UNCTAD, Bilateral Investment Treaties in the Mid- 1990s (New York and Geneva: United Nations Publication Sales No. E.98.II .D.8. 1998)

[12] UNCTAD, WIR 1999.

[13] The case at point is the Case *Concerning Electronica Sicula S. P.A. (ELSI) (the United States v. Italy)* [1989] I.C.J. Rep. 15, reproduced in Vol. 28 I.L.M. 1 IO9 (1989). The United States argued before the international Court of Justice (ICJ) that the Italian government's requisition of ELSI's assets violated its obligations under the U.S.-Italy FCN. The ICJ dismissed the petition by holding that ELSI's financial situation prior to the Italian government's actions was so precarious that the shareholders were incapable of effectively operating the firm.

realities.[14] As already noted, this trend found also its expression in several UNGA resolutions.[15] Therefore, BITs emerged in 1960s as a new bilateral solution to address specifically the issues of foreign investment.

2.2.5 The Advantages of Bilateral investment Treaties

Because of the difficulties in reaching a consensus to create multilaterally acceptable norms, as well as the uncertainties about principles of customary international law, bilateral treaties became the preferable method as the first step in resolving some highly contentious issues in connection with FDI.[16] For their part, developed countries sought to conclude BITs to facilitate the entry of their outward investments by inducing the host developing country to remove various barriers within their national regime. From the perspective of the investors, national regulatory framework of the host countries, particularly the developing states, usually imposing a wide range of restrictions and requirements on FDI, may impede substantially their operation and profitability. Also, they are hesitant to rely merely on the laws of host country for the protection, with the fear that host country government may arbitrarily change its laws after the investment has been made.[17] A legally-binding bilateral treaty is desirable in this context, which creates a *lex specialis* international obligation for the host developing countries. In addition, developed home countries also aimed to establish an effective dispute settlement and enforcement mechanism to remedy the inadequacy of customary international Law.

In some cases, BITs have been utilized in conjunction with other mechanisms also with the purpose of reducing non-commercial risk, such as political risk insurance, investment guarantee agreements. Some capital-exporting countries, *e.g.* Germany and

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[14] For instance, Joseph E. Pattison, "The United States - Egypt Bilateral Investment Treaty: A Prototype for Future Negotiation" (1983) 16 Cornell Int'l L.J. 305, at p. 309.

[15] UNGA Resolution 1803 (XVII) (1962) and UNGA Resolution 2158 (XXI) (1966) on Permanent Sovereignty over Natural Resources.

[16] UNCTC, BITs, p. 1.

[17] Jeswald W. Salacuse, "BIT by BIT: The Growth of Bilateral Investrnent Treaties and Their Impact on Foreign Investment in Developing Countries" (1990) 24 Int'l Law. 655, at p. 662.

France, [18]make the existence of a BIT a pre-condition for granting protection under their national investment insurance schemes.[19] Such tendency was observed in a UNCTC study that "unless the insurer is satisfied that the legal protection of an investment is sufficiently guaranteed under the domestic law of the host State or in some other way, the existence of a treaty may be the condition *sine qua non* for political risk insurance.' As a matter of fact, the MIGA also commits itself to "promote and facilitate the conclusion of agreements, among its members, on the promotion and protection of investments".[20]

The principal reason for developing countries to conclude such treaties is to dispel the impression of political risks associated with the country in the past, thus enhancing confidence of foreign investors and improving the investment climate. Suffice it to say here that the effect of national legal framework on facilitating particular investment and ensuring compensation in the event of expropriation no doubt plays a role in the decision of any potential foreign investor. In this sense, the existence of a BIT is a significant element in creating a stable and predictable investment climate in a particular country. Indeed, the negotiation and conclusion of a BIT by a capital-importing country itself may fulfill an important "signaling function", indicating to the home countries and the international business community that the country not only welcomes FDI but will also facilitate and protect certain foreign enterprises. More recent evidence of how African, Caribbean and Pacific (ACP) countries view the role of BITs may be found in the Fourth Lomé Convention, whereas Article 258 States that the promotion of private investment would need to include binding obligations to: *take measures and actions which help to*

[18] This is partly because Germany and France are among the capital-exporting countries with the most extensive BITs program.

[19] Rudolf Dolzer & Margrete Stevens, Bilateral Investment Treaties (Hague and Boston: Martinus Nijhoff Publishers, 1995) at p. 13. In the case of the United States, Overseas Private Investment Corporation (OPIC), a government-owned corporation, is authorized under the Foreign Assistance Act to provide to U.S. investors insurance against losses due to currency inconvertibility, expropriation, war, revolution, insurrection and civil strife. As a matter of policy, OPIC generally does not offer any of its programs in countries with which there is not any valid bilateral investment agreement or investment guarantee agreement.

[20] The MIGA Convention, Article 23.

create and maintain a predictable and secure investment climate as well as enter into negotiations on agreements which will improve such climate.[21]

As mentioned earlier, developing countries are not yet ready to commit themselves to any binding multilateral treaty in view of the sensitivities of sovereignty and the complexities of internal economic policy issues. That is why the approach of a bilateral treaty is seen preferable. For a pragmatic reason to attract FDI, some relatively liberal principles may be acceptable as *lex specialis,* which are not possible in the context of multilateral fora as *opinio juris.*[22] Moreover, negotiated between two parties, BITs offer the opportunity to be formulated in a manner suitable for their mutual interest.[23] By utilizing a number of negotiation techniques, such as introduction of exceptions and temporal derogation from certain obligations, developing countries would retain a margin of freedom to deal with their specific development concerns.[24] Notwithstanding the fact that it would be empirically un-testable whether the conclusion of a BIT would enhance the total amount of inward FDI in a particular country,'65 die BIT serves also as a diplomatic approach to improve relations with a foreign State. To this end, developing countries may enter into BIT with the hope of securing additional economic advantages, such as increased long-term trade and economic co-operation.

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[21] The Fourth ACP-EEC Convention (Lomé IV) was signed on December 15. 1989 by the Africa-Caribbean-Pacific (ACP) and European Community (EEC) countries, reproduced in Vol. 29 I.L.M 783 (1990), Article 258 (c).

[22] It can be recalled in this regard that developing countries were actively promoting multilateral instruments with the purpose of controlling over MNEs, under the banner of the NIEO. Simultaneously, they began to enter into BITs with home countries, many of which contain principles they strongly opposed at the multilateral level.

[23] See Yao, Meizhen, International Investment Law (Guo Ji Tou Zi Fa) (Beijing: Law Press, 1985), at pp. 275-276.

[24] For example, despite the high standards the United States sought to include in its model BIT concerning the treatment of investment, a majority of its treaty partners have, *inter alia,* specified exceptions covering a broad range of sectors, which almost make the treatment obligation meaningless in the view of many U.S. commentators.

2.2.2 Main Features of Bilateral Investment Treaties

Modern BITs have retained a basic similarity in their provisions. In fact, most countries with active BITs program have developed their own model BIT former negotiation.[25]

These model BITs deserve discussion in that they represent the desirable treaty text and some specific concerns from the perspective of a particular country. The following part does not purport to have a comprehensive survey of all BITs practice worldwide. Rather, attention will be concentrated on the BITs concluded by Pakistan as well as some other most contentious issues arising in the negotiation experiences of the developing countries.

i. Title and Preamble

An examination of the preamble language will show there is a relatively standard pattern, underlying the treaty parties' faith in the private business initiative, stressing mutual desire to enhance economic co-operation to promote investment of the other party in their territory. In spite of the fact that most BITs expressly mention "reciprocal encouragement and protection of investment", which means identical rights and obligations would be granted to both contracting parties, it is argued that only a one-way flow of investments is practically contemplated taking into account the disparities of economic level between two parties. For most developing countries, the paramount goal in signing BITs is to attract and promote the inward FDI, rather than an intention to protect their investment abroad. In this respect, it is important to keep in mind that the existence of BIT is not the only determinant influencing foreign investors' decisions. FDI is a highly sophisticated international transaction, which normally involves a long-term commitment and the engagement of considerable assets abroad. Many other factors, to name a few, the size of potential market, the necessary infrastructure such as transportation, energy supply, and

[25] The United States have developed a rather wordy model BIT, which is unique in many respects compared to its peers. Since the beginning of its BIT programme, the United States has paid much attention to the preparation of a model text which it called "prototype treaty". It continues to revise the model based on its experience of negotiation with other developing countries. The latest version was drafted in April 1994, reproduced in UNCTAD, BITs in the Mid-1990s, Annex II, at pp. 287-295.

the sustainable profitability, will play a decisive role in the process.[26] Furthermore, it is not surprising to note that most BITs do not impose any specific commitment, at least any positive obligation, for home countries to encourage its nationals and companies to invest in its treaty partner.[27] Only within some BITs concluded between developing countries and model BITs prepared by developing countries could such specific obligation be found, representing merely more wish-like expression of the capital-importing countries.[28]

ii. Scope of Application and Definitions

The definition of certain terms used in BITs, particularly "investment" and "investor", would determine the overall scope of the treaty and identify the object to which the treaty will apply. The way in which these terms are defined is thus of some far-reaching implications to a BIT and forms part of the normative substance.

a. Investment

Recent BITs follow the approach to use a broad, comprehensive definition of the "investment", ensuring a great degree of flexibility in the treaty's application. Such definition is asset-based, covering not only the capital that crosses the border with the view to the acquisition of an enterprise, but also other kinds of non-equity arrangements, loans, portfolio transactions. The phrase "every kind of asset" has been most commonly used, followed by an illustrative list of assets that fall within the definition. Typical categories of assets being listed include traditional movable and immovable property,

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[26] UNCTC, The Determinants of Foreign Direct Investment: A Survey of the Evidence (New York: United Nations Publications Sale No. E.92.II.A.2, 1992), for a relevant discussion on this point.

[27] The United States generally refused requests by its BIT partners to include provisions requiring the parties to promote investment by their nationals and companies in the territory of the other party.

[28] Asian-African Legal Consultative Committee (AALCC) Model BIT (Model A), Article 2(i) States that: "Each Contracting Party shall take steps to promote investments in the territory of the other Contracting Party and encourage its nationals, companies and State entities to make such investments through offer of appropriate incentives, wherever possible, which may include such modalities as tax concessions and investment guarantees." Reproduced in UNCTAD, International Investment Instruments: A Compendium (New York and Geneva: United Nations Publications Sales No.E.96.II.A. 11, 1996) Vol. III, at pp. 115-138.

companies and interests in companies, claims to monetary rights, intellectual property rights, as well as concessions and contractual rights.

Some treaties, notably BITS by the United States, define expressly investment as including "rights conferred pursuant to law, such as licenses and permits" with a view to protection of these public law rights acquired under the Law of the host country.[29] It was suggested that the inclusion of Licenses and permits is a recognition of the fact that many of the rights that foreign investor acquires are administrative law rights based on permission to conduct certain activity in the host country. If rights such as the right to export or to repatriate profits upon which the whole course of the investment project may depend, are later unilaterally withdrawn by the host government, the investment will cease to be of any value. The protection of such acquired rights or privileges is thus seen as an important task of the BITs for capital-exporting countries.

From the viewpoint of developing countries, one important issue is that the covered investment shall be made in accordance with the domestic laws of the host country. Many BITS have reflected in the definition of "investment" such concern of the developing countries, for example, the BIT signed by India and the United Kingdom.[30]

As a matter of policy, most host developing countries subject all inward FDI to varying degrees of screening and approval procedure, and only a few maintain an open door policy for all foreign investment. This approach, for developing countries, safeguards their interests by imposing certain screening mechanism and performance requirements on FDI at the entry stage, which can be stipulated in domestic laws and regulations. Where such definition applies, investments that do not conform to local laws, or obtain approval as required would fall outside of the covered investment defined, therefore not to be protected by the BIT.[31] Some BITs make this point explicitly by

[29] U.S. Model BIT, supra, Article I(d) (vi).

[30] Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of India for the Promotion and Protection of Investments, signed in London on March 14, 1994, reproduced in Vol. 34 I.L.M. 935 (1995). It is the first BIT ever to have been singed by India. For an introduction, see Heribert Golsong, "Introductory Note" (1995) Vol. 34 I.L.M. 935. See ibid. Article 1 (b).

[31] The issue of whether an investment qualifies as "approved investment" to be protected by the BIT was raised in a recent ICSID arbitration. The case was settled in 1996. See Philippe Gruslin v. the Government

prescribing that the BIT shall apply only to investment made in accordance with the laws and regulations of the host country.[32] Consequently, developing countries can take advantage of these qualifications to retain flexibility in determining whether an investment should receive treaty protection, thereby identifying a clear set of development priorities in its national laws or policies. This proposition of developing countries is further elaborated in the provisions on admission and establishment of FDI.

b. Investor

Determining which investors will be covered by a BIT is another important issue. The definition of the term "investor" usually includes natural person and company. While there is basically no problem to refer to the contracting parties' domestic laws on citizenship as the criteria to determine an individual's nationality under a BIT,"~the rules governing a company's nationality presents some difficulty. The issue relates to with respect to a company as the investor, the conditions under which such company is deemed to have a sufficient link with a contracting Party. The traditional rule was spelled out in the decision of the Barcelona Traction Case, that a company has the nationality of the State where it is incorporated.[33] Therefore, only treaties concluded by that State shall be applied as to protection of the investment by that company.

Three basic criteria have been employed in the modem BITs practice: the concept of incorporation or constitution, the concept of the seat, and the concept of control, among which the concept of incorporation is most widely accepted. For example, the U.S. BITs use incorporation as the principal test of the nationality of a company, with some limited circumstances under which the other contracting party may deny the benefits of the treaty. Such rights of denial might be performed when the investor is

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of Malaysia (Sole Arbitrator: Sompong Sucharitkul) (ICSID Case No. ARB/94/ 1), available online at http://www.worfdbank.org/icsid/cases/cases.

[32] The BIT between Argentina and Sweden, quoted in UNCTAD, BITs in the Mid-1990s.

[33] Case Concerning Barcelona Traction Light and Power Co. Ltd. (Belgium v. Spain) supra. In the Barcelona Traction case, the Court held that Belgium can not invoke the Belgiurn-Spain BIT to protect the interests of Belgian shareholders in a Canadian company who invested in Spain. In other words, only Canada, the State of the company's nationality, could bring suit for compensation for the injury suffered by the company. This controversial decision received extensive criticism because of its weakness in protecting interests of minor shareholders.

controlled by nationals of a third nation and has no substantial business activities in the contracting party where it is incorporated.[34]

c. Application in Time

Most recent BITs extend protection not only to investments that are made after the conclusion of the treaty but also to investments that are made prior to that time.

This reflects the tendency that today's BIT is not merely viewed as an instrument to create incentives for new investments, but also an instrument to affirm international legal principles on the existing FDI.

ii. General Standards of Treatment

Treatment is a broad term, which in the context of BITs refers to the legal regime that applies to FDI once they are admitted into their territory by the host states.[35] Very often BITs include one or several general principles ("absolute standards"), providing the overall criteria by which it is possible to judge whether the treatment given to an investment is satisfactory.[36] Then some "relative standards" provisions will be applied by reference to the treatment accorded to other investors and investments, requiring essentially non-discrimination in the like situation.

a. Absolute Standards

"Fair and equitable treatment" is the most commonly used absolute standard in many treaties, although there is no general agreement on the precise meaning of this phrase.'09 China adopted this principle in most of its BITs. As to the real use of such a clause, some view the "fair and equitable treatment" as a classic standard in customary international law closely related to the traditional requirement of due diligence. It serves as an

[34] U.S. Model BIT, Article 1 (b) provides: " 'company of a Party' means a company constituted or organized under the laws of that Party."

[35] However, the United States subscribes to a broader view that the standards of treatment shall extend to cover the admission of FDI as well. The U.S. BITs are unique in this respect insomuch as they require the better of either national treatment or most-favored-nation treatment at the entry stage.

[36] Scott K. Gudgeon, "United States Bilateral Investment Treaties: Comments on Their Origin, Purposes and General Treatment Standards" (1986) 4 Int'l Tax & Bus. Law. 105, for an analysis of the purpose of absolute standards of treatment.

auxiliary element for the interpretation of other specific provisions in the treaty, or in order to fill gaps in the treaty and national legislation.'" It is further understood to ensure a prudent and just application of the rule of law.'" The OECD Draft Convention on the Protection of Foreign Property interprets it as "the minimum international standard which forms part of customary international law.[37] But such minimum international standard is again subjective, controversial and with linle authority on its application. In addition to the "fair and equitable treatment", many treaties add explicitly that investment from the other contracting party should be accorded "full protection and security". This standard had been used in some earlier FCNs, which contemplates protecting foreign investment against private as well as public action. On the import and significance of this standard, the award in the *Asian Agricultural Products Ltd (AAPL) v. The Republic of Sri Lanka case* has provided some far-reaching analysis.[38] The AAPL established in Sri Lanka a joint venture with a local Company, which was destroyed as a result of a military action taken by the Sri Lanka armed forces against Tamil insurgents. The AAPL argued that the bilateral treaty has created a higher standard of protection than the customary international law by including the phrase such as "full protection and security". This argument was, however, rejected by the arbitration tribunal.[39]

In addition, some other general standards also appear in the BITs such as "prohibition of arbitrary or discriminatory measures" and "treatment consistent with international law, although it may be arguable that such standards are implicitly included in the "fair and equitable treatment". Moreover, as mentioned earlier, the content of the so-called traditional international law itself is relatively ambivalent, and has been strenuously challenged by developing countries.

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[37] The OECD Draft Convention on the Protection of Foreign Property infra note 426. See also Hermann Abs & Hartley Shawcross, "The Proposed Convention to Protect Private Foreign Investment: A Round Table: Comment on the Draft Convention by Its Authors"(1960) 9 J. of Public L. 1 15, at pp. 125-127.

[38] The *Asian Agricultural Products Lt. (AAPL) v. The Republic of Sri Lanka* case is significant in that it constitutes the first case in which an international tribunal dealt directly with the provisions of a BIT- It has significance not only to the compensation clause, but also to the general application of BITS.

[39] *Asian Agricultural Products Ltd. (AAPL) v. Republic of Sri Lanka,* Case No. ARBl 8713, reproduced in Vol. 30 I.L.M. 577 (1991).

b. Stabilization Clauses

It has been mentioned above that foreign investment is admitted in accordance with the host country's laws and regulations, which is subject to any future changes. In some cases, the entry of foreign investment can also be granted under the State contracts or concession agreements. Foreign investors are concerned that the host government might not observe the commitments or attempt to invalidate such contracts by changing the domestic laws.[40] Consequently, home countries seek to incorporate stabilization clauses into the BIT, requiring the contracting party to respect the obligations of an investment agreement. As a result of such clause, home countries envisage that a breach of contract would constitute a breach of the treaty. Even though, it is still questionable that a stabilization clause may be sufficient to impose a total fetter on the sovereign legislative powers of the host states.

c. Relative Standards non-discriminatory treatment

BITS use two standards for the purpose of protecting discriminatory treatment with respect to different classes of investment: the most-favored-nation treatment (MFN treatment) and the national treatment. As a matter of fact, both of these two standards have their origins in the trade treaties, which define the required treatment by reference to the treatment given to other subjects. Today, MFN and national treatment have become the cornerstone for the entire international economic system, seen as the essential tools for a rapid liberalization in both trade and investment relations.

d. Most-Favored-Nation Treatment Standard

The MFN treatment standard prohibits a country from discriminating among the inward investments from different sources. It assures that investments from the other treaty party are not to be treated less favorable than those from a third country. It also means that any favor, advantage or privilege granted to investments from a third country must be

[40] The stabilization clause was first introduced in the State contract or concession agreement. For example, in the *Texaco v. Libya case*, a stabilization clause can be found in the accords: " The Government of Libya will take all steps necessary to ensure that the Company enjoys all the rights conferred by the concession. The contractual rights expressly created by this concession shall not be altered except by the mutual consent of the parties."

extended automatically and unconditionally to investment originated from the other treaty party.

The application of this principle, nevertheless, is often subject to various restrictions as a result of the inclusion of additional qualifications and exceptions. Exceptions generally include restrictions based on public order or national security, special privileges accorded under a customs union or free trade arrangement, as well as treatment granted by international treaties or domestic legislation pertaining to taxation. Occasionally, a country may not want to extend a favorable treatment guaranteed in an earlier treaty to any other country, so it would include in the subsequent BITs a provision that the early treaty cannot be invoked for the application of the MFN treatment clause. A typical example can be found in the China-Sweden BIT, in which the MFN treatment clause apply only to treatment granted under treaties concluded subsequent to the entry into force of the BIT. Each treaty party is allowed to grant a more favorable treatment to investments from other states so long as it is stipulated under bilateral agreements concluded before the date of the signature of the treaty.

e. National Treatment Standard

While the MFN treatment standard prevents discrimination among other foreign countries, the national treatment standard imposes another type of nondiscriminatory obligation. It guarantees that investment by one contracting party in the territory of the other party will receive from the host country treatment no less favourable than the treatment given to investment by domestic investor of that host country.[41]

Traditionally, developing countries have been reluctant to extend national treatment to foreign investors. From the perspective of developing countries, they wish to reserve the right to discriminate in favor of domestic investors, although the prohibition of discrimination among different foreign investors might be acceptable. It is important to bear in mind in this regard that the generalizing effect of an MFN treatment provision will also apply to the national treatment requirement of a BIT. In essence, the effect of

[41] It is significant to point out here that such non-discriminatory treatment vis-à-vis domestic investors will be applied only after the foreign investment has been admitted into the host country, or in other words, at the post-establishment stage.

the MFN provision is to raise the level of treatment accorded by each BIT concluded by a host country to the level guaranteed by that country's most protective and liberalized BIT.[42] The differences between the BITs concluded by a country may largely become irrelevant given the existence of a MFN treatment provision.

As with the case of MFN treatment, national treatment is subject to a variety of exceptions as well. Reservations concerning measures relating to public order or national security is the most common exception. Development considerations also play an important role in certain exceptions of the national treatment standard so long as such discriminatory measures do not substantially impair investment from the other treaty party. The BIT between Indonesia and Switzerland permits derogation from the national treatment obligation of Swiss investors' in view of the present stage of development of the Indonesian national economy.[43]

Interestingly, a different approach to the application of national treatment adopted by the BIT between Denmark and Indonesia help developing countries rethink the way to balance their developmental needs against the national treatment required by the developed home countries. The Treaty provides that:

> *Neither Contracting Party shall in its territory impose on the activities of enterprises in which such approved investments are made by nationals or corporations of the other Contracting Party conditions which are less favorable than those imposed in its territory on activities in connection with any similar enterprise owned by national or corporations of the other Contracting Party or national or corporations of third countries.*

By referring to "imposition of conditions" instead of a general "treatment", the language implies that the national treatment will not apply to the benefits and advantages granted to the domestic investors. In other words, the host country government can not subject foreign investment from the treaty party to any performance requirements or other conditions in the event that it does not impose the similar requirements on the domestic investment. However, it might grant subsidies or other preferential treatments to domestic

[42] UNCTAD, BITs in the Mid-1990s, at p. 61.

[43] Ibid., at p. 64.

investment according to its own development priority without giving such treatments to foreign investment.

In BITs practice, national treatment is very often used in combination with the MFN treatment standard. In this manner, host country must apply the treatment whichever is more favorable under the circumstances.

It was claimed that national treatment had, on the other hand, been utilized in another dimension, which was traditionally supported and applied by developing countries. In this context, national treatment refers to concept close to the "Calvo Doctrine" that aliens are entitled to no greater rights and privileges than those available to nationals. However, this notion of national treatment is not what to be applied in BITs practice.

iv. Admission and Establishment

Admission and establishment provisions are at the heart of a BIT as they determine the degree to which the host country government can control over the inward FDI, as well as the policy flexibility of developing country to support certain indigenous industries. It has already been reiterated that, in accordance with the customary international law, the ability of foreign investor to make an investment in a host country is subject exclusively to the territorial sovereignty of the host states. This principle has found its formal expression in various international instruments, including the bilateral treaties. For developing countries, the admission provisions in a BIT are amongst the most important from a developmental point of view. The bitter memory with the former colonial powers reminds capital-importing countries of the importance of control over some vital industries and natural resources. Moreover, entry restrictions and conditions for admission are the most efficient way through which developing countries give expression to their developmental priority in certain sectors. Some developed countries might also be concerned about foreign ownership over industries of special importance to national security, or even cultural reservation.

Most BITs leave the host country the discretion to regulate the admission of foreign investment into its territory and the freedom to prohibit the entry of foreign investment in specific industries or activities.' The U.S. BITs have followed a different

approach, which generally deals with the issue of admission and establishment in the treatment provisions.[44]

v. Transfer of Funds

The provisions on transfer of funds are considered one of the most important aspects of a BIT by both sides of the treaty. For host countries, developing ones in particular, the sudden repatriation of large amount of foreign currency as profits or other funds can have an unexpected adverse effect on their balance of payments situation, thereby hindering their economic development. In contrast, foreign investors regard the timely transfer of income, capital and other payments as the fundamental requirement to operate and benefit from their investment projects. In this connection it is necessary to have a brief look at the Articles of Agreement of the International Monetary Fund, which is the most important multilateral instrument regulating the conduct of monetary matters. Article VI11 (2) of the IMF Articles prohibits in principle any restriction imposed by member countries on current international transaction.[45] However, controls over currency exchanges for capital transactions are normally allowed. Hence, relatively little protection has been afforded to foreign investors under the IMF Articles, in the view of home countries, which in part resulted in their insistence on the inclusion of the right of free transfer in the BITs.

Normally, three categories of funds are covered by the provision: (i) the repatriation of the capital invested; (ii) transfer of returns generated by an investment and dividends to the shareholders; and (iii) current payments made in relation to an investment. Two approaches have been adopted in the BITs practice. The first is to

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[44] The United States seeks to impose the host country an obligation to accord to foreign investor either MFN treatment or national treatment, whichever is more favorable, both at the pre- and post- establishment stage.

[45] A current international transaction is any transaction other than the transfer of capital, which involve: (i) any payment in connection with foreign trade, other current business, including services, and normal short-term banking and credit facilities; (ii) any payment due as interest on loans and as net income from other investments; (iii) any payment of moderate amounts for amortization of loans or for depreciation of direct investments; and (iv) moderate remittances for family living expenses. Articles of Agreement of International Monetary Fund, reproduced in Stephen Zamora & Ronald A. Brand eds., Basic Documents of International Economic Law (Chicago: Commerce Clearing House, Inc.. 1990), at 321-382. Article XXX(iii).

guarantee the free transfer of all payments related to an investment, usually followed by a non-exhaustive list. This approach is preferred by home countries and foreign investors because of its breadth and flexibility, while host countries are concerned with the uncertainty of the types of payment covered. The second approach is simply listing the types of payments that are allowed for free transfer.

vi. Expropriation and Compensation

One of the primary reasons that many developed countries initiated BITs was to secure protection of their investments abroad against the risk of expropriation and nationalization. In the ambit of foreign investment law, this has been the most contentious issue affecting the development of customary international law. Consequently, all BITs have prescribed the conditions under which an expropriation action may be undertaken and the standards for determining the quantum of compensation.

Most BITs do not define the terms "expropriation" and "nationalization" and regard them as synonymous with each other.[46] However, many BITs commonly include expropriation and nationalization, as well as a reference to other indirect measures that constitute de facto acts of expropriation. As a result, expropriation provisions are also to be applied to measures "tantamount" or "equivalent" to expropriation and nationalization. Some BITs concluded by the United States specify explicitly that such measures include also "the levying of taxation, the compulsory sale of all or part of the investment, or impairments of the management, control or economic value of a company.[47]

Notwithstanding the positions taken by host developing countries in various multilateral fora, virtually all BITs have adopted the traditional rule of international law that a State shall not expropriate the property of foreign investors except for (i) a public purpose, (ii) in a non-discriminatory manner, (iii) upon payment of compensation and (iv)

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[46] In the legal sense, a distinction may be made between expropriation and nationalization. While nationalization refers to taking of foreign property for a radical economic restructuring purpose affecting all economic sectors or a whole industrial branch, the expropriation is used when the disruption of a specific investment is caused a particular governmental action. For more on this topic, see generally UNCTC, BITs 1988, supra, at p. 49.

[47] US.-Zaire BIT, Article III.

in accordance with due process of law. That is to say, so long as all the four conditions are satisfied, an act of expropriation is to be considered as lawful.[48]

"Public purpose" or "public interest" is a commonly accepted ground for expropriation and nationalization by a State despite its lack of certain and precise meaning. Host governments have been in the light of general government policy considerations, granted a very wide margin to determine what is for its public purpose.[49] The requirement of "non-discrimination" was traditionally directed at the singling-out of aliens on a racial basis. However, it is now generally more widely applied to prevent any arbitrary or discriminatory action with regard to due process and payment compensation, as well as other procedural measures. The "due process" requires that an expropriation or nationalization action should abide by the domestic substantive and procedural legislation pertaining to expropriation, and should be reviewed by an independent host country judicial body or administrative authority. But again, such requirement is essentially a matter of domestic law and there is little authority concerning the meaning of this term.

While as a matter of principle, all BITs require the payment of compensation for expropriation, the standards for determining the amount of compensation have been the subject of extensive contentions. Developed countries adhere to the "Hull formula" for a "prompt, adequate and effective" compensation.[50] The U.S. Model BIT provides the explanation what is to be understood as "prompt, adequate and effective." Prompt payment means payment within a reasonable time without delay.

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[48] In earliest time, an extreme form of the international minimum standard was formulated to prohibit per se the expropriation of foreign property, and imposed the sanction of restitution up the expropriating country. See Chorzow Factory Case, [1927] P.C.I.J. (Ser. A) No.13.

[49] There is little authority in international law establishing any definite criteria by which a State's own determination of public purpose can be questioned. It was pointed out in the Foreign Relations Law of the United States that: "public purpose is broad and not subject to effective reexamination other States." American Law Institute, The Restatement of the Law: The Foreign Relations Law of the United States, at p. 200.

[50] The issue was raised in the diplomatic correspondence between the United States and Mexico over the Mexican nationalization of land and petroleum holdings of the United States nationals. In 1938, U.S. Secretary of State, Cordell Hull, first put forth this standard in one correspondence to the Government of Mexico that "under every rule of law and equity, no government is entitled to expropriate private property, for whatever purpose without provision for prompt, adequate and effective payment therefore." See Josef L. Kunz, "The Mexican Expropriations" (1940) 17 N.Y.U. L. Q. R. 327, at p. 347.

Adequate compensation means payment of the fair market value of the property immediately before the expropriation. Effective compensation is that compensation shall be paid in a freely-convertible currency at the prevailing market exchange rate calculated on the date of expropriation.[51]

As previously noted, such standard was questioned by developing countries in various international forums. Instead, they proposed standards such as "appropriate" compensation, which essentially gave the host country more flexibility in determining the exact amount of compensation to be paid, while taking into consideration the specific circumstances of each case. Furthermore, developing countries held the standpoint that any issue pertaining to compensation should be determined by reference to domestic laws, and domestic courts have the exclusive jurisdiction over any dispute concerning the expropriation and compensation. This view was evidently reflected, for instance, in Article 2 (2) (c) of the Charter of Economic Rights and Duties of States:

> *Each State has the right to nationalize, expropriate or transfer ownership of foreign property, in which case appropriate compensation [emphasis added] should be paid by the State adopting such measures, taking into account its relevant laws and regulations and all circumstances that the State considers pertinent. In any case where the question of compensation gives rise to a controversy, it shall be settled under the domestic law of the nationalizing state and by its tribunals, unless it is freely and mutually agreed by all States concerned that other peaceful means be sought on the basis of sovereign equality of States and in accordance with the principle of free choice of means.*[52]

Although some developing countries yielded to pressure from their developed treaty partner and accepted formulations close to the Hull formula as a matter of *lex specialis*, more preferred to use more flexible formulation of the compensation standard other than "prompt, adequate and effective". For example, the treaty between

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[51] U.S. Model BIT, supra note 177, Article 111 2. The meaning of "prompt, adequate and effective" was also elaborated in the Anglo-Iranian Oil Co. Case (United Kingdom v. Iran), in International Court of Justice Pleadings, Vol. 1952, at 105. The plaintiff stated that: "By "adequate" compensation is meant "the value of the undertaking at the moment of dispossession, plus interest to the day of judgment" . . . Second, the requirement for prompt compensation means immediate payment in cash ... The third requirement is summed up in the word "effective" and means that the recipient of the compensation must be able to make use of it . . . Monetary compensation which is in blocked currency is not effective...".

[52] UNGA Resolution Charter of Economic Rights and Duties of State, Article 2 (2) (c).

India and the United Kingdom has used -'fair and equitable compensation'. In other cases, "appropriate" or the adjective "reasonable" has been used before "compensation".

vii. Settlement of Disputes

For foreign investors and home country governments, one principal weakness of the customary international law is that it does not afford any effective and binding mechanism for dispute settlement, which is indeed vitally significant in terms of implementing and enforcing treaty obligations. To remedy the inadequacy of international law, virtually all BITs contain provisions calling for the settlement by international arbitration of disputes between the contracting parties over the interpretation or the application of the treaty. In addition, there is a tendency that more recent BITs contain provisions dealing with disputes between the host country government and the private foreign investors. This form of dispute settlement is unusual in treaty practice insofar as it provides private investors the right to bring directly claims against a state.

Investment disputes might involve disputes between private investors, between one State and private foreign investors, and between two treaty parties. Disputes between private parties fall, of course, into the scope of international private law rules. Depending on the existence of contractual arrangement reached by two parties, the disputes are normally resolved through either recourse to the courts of the State that has jurisdiction, or to a commercial arbitration. Such disputes are not covered by the dispute settlement provisions of a BIT.

a. *State to State Dispute Resolution*

The State-to-State dispute settlement mechanism usually applies to disputes between the treaty parties concerning the interpretation and application of the BIT.

7zTwo procedural stages are foreseen in virtually all BITs: settlement through negotiations and ad hoc arbitration.

b. *Diplomatic Negotiations*

%Most BITs generally stipulate that the contracting parties shall undertake diplomatic negotia%tions before a formal arbitration proceeding can be initiated. It reflects the

general obligation imposed by customary international law for countries to seek an amicable resolution of disputes and to negotiate in good faith.[53] It is common to limit the time period required for negotiation to six months or simply stipulates that a reasonable lapse of time shall have passed.[54]

c. *Ad hoc Arbitration Proceeding*

Any State-to-State dispute that cannot be resolved through negotiations will then be submitted at the request of either treaty party to an ad hoc tribunal, rather than an institutional or pre-existing arbitration tribunal. A survey of the relevant provisions in BITs finds little variation as to the way in which such tribunal is constituted. The normal procedure provides for each party to appoint one arbitrator and then the third arbitrator is to be appointed by agreement of the parties or by the two arbitrators appointed. The third arbitrator usually serves as the presiding arbitrator or chairman.

Where agreement on the third arbitrator cannot be reached within a limited period of time, an alternate appointing authority, e.g., the President of the International Court of Justice or the Secretary-General of the United Nations, is entrusted by the treaty with responsibility of making the necessary appointment. Because the disputes are referred to an ad hoc arbitration, the procedural rules are not automatically in existence. Most BITs explicitly authorize the tribunal to determine its own procedure; while a few specify that a particular set of rules should be used.[55] With respect to the applicable law, very few BITs specify the substantive law that is to be applied by the tribunal, with the assumption that international law will govern arbitration between States unless the parties agree otherwise. Some, however, call for the law of the host country to be taken into account in adjudicating the disputes.

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[53] Vienna Convention on Diplomatic Relations (1961).

[54] A typical provision can be found in the China-France BIT, which set outs that a dispute could be submitted for arbitration if it can not be settled through diplomatic channel within six months. See China-France BIT, Article 8 (2).

[55] The U.S. BITs have incorporated a reference to the UNCITRAL Rules. See U.S. Model BIT. Article X (1). United Nations Commission on International Trade Law, The United Nations Commission on International Trade Law (UNCITRAL) Arbitration Rules, adopted by the Commission on April28, 1976, reproduced in Vol. 1 5 I.L.M. 70 1 (1976).

d. Consultations between the Parties

Some BITs provide for the contracting parties generally to undertake consultations on matters relating to the treaty. Such consultation differs from the negotiation process in a State-to-State dispute settlement as it may involve any matters that are not yet disputes, and thereby preventing a situation from evolving into a serious dispute. More importantly, it may also serve as the monitoring mechanism over the implementation of the BIT.

ii. Investor-to-State Dispute Settlement

The earlier BITs were concerned only with dispute settlement between the contracting parties. As already repeated, developing countries insisted that the domestic court have the exclusive jurisdiction over all disputes arising from the foreign investments admitted into its territory.

In the absence of specific investor-to-State dispute settlement provisions, an investor would have two remedies when its investment is injured. First, investors could bring a claim against the host country government in a domestic court. Second, investors could request that their home country espouse the claim against the host country a process generally known as exercising diplomatic protection. The present tendency of incorporating an investor-to-State dispute settlement provision was, *inter alia*, inspired by the successful conclusion of the ICSID Convention in 1965. The existence of such a provision has been viewed by developed home countries as a major improvement in terms of FDI protection, by affording the private investors direct access to an arbitral mechanism.

To begin with, the investor-to-State dispute settlement provision typically defines the types of disputes to which the provision will apply. A widely accepted approach prescribes that such provision should apply to any disputes "in connection with" or 'related to" investment.' This formulation is very broad to include actually any dispute arising out of the investment relationship, no matter whether such dispute involves a violation of the BIT obligations or not. An apparently narrower formulation limits the application of the investor-to-State dispute settlement provision only to any disputes that

have direct relevance to the BIT, either concerning the interpretation or application of the treaty or the obligations of the host State under the treaty.

Negotiation and Arbitral Tribunal

Like the case of State-to-State dispute settlement, two procedural stages are usually afforded for parties to settle the dispute. In most treaties, a specified minimum period of time must have elapsed for the amicable negotiation before the dispute could be submitted for the arbitration.[56]

In contrast to the ad hoc arbitration used in the State-to-State dispute settlement, most investor-to-State dispute settlement provisions refer to institutional or other pre-existing arbitration. Although more recent BITs provide to the parties an option in respect of the arbitration tribunal, the vast majority of treaties contain a reference to ICSID.

ICSID Clause and Choice of Non-ICSID Arbitration

The Convention on the Settlement of Investment Disputes between States and Nationals of Other States was opened for signature in 1965. The Convention created the International Centre for Settlement of Investment Disputes (ICSID). The jurisdiction of the ICSID extends to:

> *any legal dispute arising directly out of an investment, between a Contracting State (or any constituent subdivision or agency of a Contracting State designated to the Centre by that State) and a national of another Contracting State, which the parties to the dispute consent in writing to submit to the It is further prescribed that once "the parties have given their consent, no party may withdraw its consent unilaterally.*[57]

Thus, the consent of the host country constitutes important prerequisite enabling private investors to resort to the arbitration under the ICSID's auspice. Such consent can

[56] China-France BIT, Article 8: "Any dispute concerning investment between investors of one Contracting Party and the other Contracting Party shall be settled amicably as far as possible by the two parties concerned."

[57] ICSID Convention, Article 25(1).

be granted either under the national legislation,[58] or in most cases, in the context of BITs. The investor-to-State dispute settlement provision refemng to the ICSID contained in the BITs is perceived to represent such consent of the host country.'95 A number of treaties, however, do not qualify the reference to ICSID arbitration as an advance consent but subject it to later agreement between the host country and investor, although unreasonable refusal to consent might violate the BIT obligation and give effect to an enforcement proceeding.[59]

Most earlier investor-to-State dispute settlement provisions contained only reference to ICSID arbitration. More recent treaties, however, afford the opportunity for disputing parties to choose some other institutions other than the ICSID or its Additional Facility, including the International Chamber of Commerce or the Stockholm Chamber of Commerce. A few BITs refer also to ad hoc arbitration as a choice.

Applicable Law for Arbitration

In principle, international arbitration respects the choice of law in an investment agreement between the investor and the host country. In the absence of such contractual arrangement, arbitral tribunal may apply national or international law to decide the case. ICSID tribunals are governed by Article 42(1) of the ICSID Convention, which reads as follows:

> *The Tribunal shall decide a dispute in accordance with such rules of law as may be agreed by the parties. In the absence of such agreement, the Tribunal shall apply the law of the Contracting State party (including its rules on the conflict of laws) and such rules of international law as may be applicable.*[60]

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[58] Antonio R. Parra, "Principles Governing Foreign Investments, as Reflected in National Investment Codes" (1992) Vol. 7 No. 2 ICSID Review - Foreign Investment Law Journal 428, at p. 446. (noting that some 20 States have incorporated an unilateral submission to ICSID arbitration into their domestic investment laws.)

[59] The Malaysia-Sweden BIT provides: " . . . it shall upon the agreement by both parties to the dispute be submitted for arbitration to the International Centre for Settlement of Investment Disputes.".

[60] ICSID Convention, Article 42(I).

Some BITs include a choice of law clause in the investor-to-State dispute provision. For example, the China-Vietnam BIT States that: "The tribunal shall adjudicate in accordance with the law of the Contracting State to the dispute accepting the investment".[61] It also provides the possibility that general principle of international law may apply, but again only to the extent those principles are "accepted by both Contracting parties".[62]

Enforcement of Arbitral Awards

The ICSID Convention requires all parties to enforce any award issued by an ICSID tribunal.[63] As a result, if an investor chooses ICSID arbitration according to the ICSID clause in the BIT, the award is automatically enforceable in the host country that is a member of the Convention. Many BITs use the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards,[64] often referred to as the New York Convention, to enforce arbitral awards that are not issued by the ICSID tribunal.

2.3 The OECD Multilateral Agreement on Investment

2.3.1 Negotiating Background of the Multilateral Agreement on Investment

Outside the WTO/GATT system, current efforts towards a multilateral investment regime are mainly undertaken by the Organization of Economic Cooperation and Development (OECD).[65] In May 1995, Ministers of the OECD launched a negotiation for a Multilateral

[61] China-Vietnam BIT, Article 8 (7).

[62] Ibid.

[63] ICSID Convention, Article 54.

[64] United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, signed at New York on June 19, 1958, reproduced in Stephen Zamora & Ronald A. Brand eds. Basic Documents of International Economic Law (Chicago: Commerce Clearing House, Inc., 1990) at pp. 979-984.

[65] The Organization of Economic Cooperation and Development (OECD) was established in 1961 as a forum for the discussion and coordination of economic policies of industrialized nations. Joined by Mexico and Korea in 1995, the current member countries of the OECD include Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece. Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

Agreement on Investment (MAI).[66] The MAI negotiations aimed at reaching a comprehensive set of d e s which would:

> *provide a broad multilateral framework for international investment with high standards for the liberalization of investment regimes and investment protection and with effective dispute settlement procedures;*
>
> *be a free-standing international treaty open to all OECD Members and the European Communities, and to accession by non-OECD Member countries, which will be consulted as the negotiation progress.*[67]

Essentially, it is clear that the purpose of the negotiations is to establish a "GATT" for international investment, and in words of its proponents, "to remedy the weaknesses of the WTO Agreement, which still leaves ample scope for restricting access to foreign investors and for negotiation of a wide series of performance requirements not directly related to trade.[68]

2.3.2 Early Attempts of the OECD to Regulate Foreign Direct Investment

As a matter of policy, the MAI proposal followed a long history of the OECD's attempts to develop a comprehensive legal framework for the protection of foreign investment. Since its foundation in 1960's, OECD sought to reduce obstacles to trade and to liberalize international capital movement. However, the first proposal for a binding investment agreement did not come to fruition.[69] The first successful results were the Code of Liberalization of Capital Movements and the Code of Liberalization of Current Invisible Operations adopted in 1961 Both of these two Codes require OECD members to commit

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[66] OECD "A Multilateral Agreement on Investment: Report by the Committee on International Investment and Multinational Enterprises (CIME) and the Committee on Capital Movements and Invisible Transactions (CMIT)" (May 25, 1995), in Towards Multilateral Investment Rules (Paris: OECD Documents, 1996) 9, at p. 9.

[67] Ibid. at p. 11.

[68] Dr. William H. Witherell, "Towards an International Set of Rules for Investment", in Towards Multilateral Investment Rules (Paris: OECD Documents. 1996) 17, at p. 20.

[69] OCED, Draft Convention on the Protection of Foreign Property and Resolution of the Council of the OECD on the Draft Convention (Paris: OECD Documents, 1967). The Draft Convention on the Protection of Foreign Property was completed by the OECD in 1967, but was never opened for signature. However, it did serve later on as a model text for the BITS practice. See A.A. Fatouros, "An International Code to Protect Private Investment – Proposals and Perspectives" (1961) 14 U. Toronto L.J. 77.

to liberalize the entry of FDI and the transfer of currency associated with general business. While the two Codes are legally binding, members are permitted to lodge reservations and exceptions on a non-discriminatory basis.

Perhaps the better-known achievement of OECD in the investment sphere is the OECD Declaration of International Investment and Multinational Enterprises adopted in 1976.[70] The Declaration is of a non-binding character, being claimed to merely have "the force of moral suasion and little more.[71] The Declaration comprises of five parts: (i) The Guidelines for Multinational Enterprises; (ii) National Treatment; (iii) International Investrnent Incentives and Disincentives; (iv) Consultation Procedures; and (v) Review.[72] The Guidelines for Multinational Enterprises, an Annex of the Declaration, though on a voluntary basis, represent a serious effort to formulate some recommendations addressed to MNEs. The guidelines describe the norms in a wide range of areas, such as competitive practices, information disclosure, financing, taxation, employment, environment protection, and technology transfer, by which MNEs shall operate in order to be in harmony with host countries' national policies.[73] Two other decisions, National Treatment and International Investment Incentives and Disincentives, involve recommendations to host country governments. The National Treatment instrument requires a post-establishment national treatment for any foreign investor and investment from other member countries,'~~ whereas the instrument on Investment Incentives and Disincentives recognizes the need to make investment measures transparent and that due regards should be given to the interests of other member countries.[74]

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[70] OECD, Declaration on International Investment and Multinational Enterprises, reproduced in The OECD Declaration and Decision on International Investment and Multinational Enterprises: 1991 Review (Paris: OECD Documents, 1992), Annex 1 and II, at 10 1 - 120 [hereinafter OECD Declaration]. A brief introduction of the OECD Declaration is available online at http://www.oecd.org/daf/cmis/codes/declarat.htm.

[71] Michael Hart, "A Multilateral Agreement on Foreign Direct Investment: Why Now?", in Pierre Sauve & Daniel Schwanen eds., Investment Rules for the Global Economy: Enhancing Access to Markets (Toronto: C.D. Howe Institute, 1996) 36, at p. 70.

[72] OECD Declaration, supra note 156.

[73] Ibid., Annex 1 "Guidelines for Multinational Enterprises".

[74] Ibid. Article II (National Treatment).

The Codes and Declaration have been successful in encouraging the elimination of restrictions on FDI flows within the OECD members, and meanwhile helping understand the issues in this. However, many argued that they are lack of formal dispute settlement mechanism and limited to a small number of members, which has largely undermined their function as the basis for international investment regulation.[75] More importantly, the underlying philosophy of industrialized countries to seek for an international investment regime has, more or less, shifted from the emphasis to regulate MNEs' practices as envisaged by the Guidelines for Multinational Enterprises, to a desire of inducing developing host countries to liberalize their regulatory regime and market access. This ultimate goal is anticipated to be achieved through an aggressive liberalization mechanism, such as the standstill and rollback requirements, on the one hand, and some effective investment protection commitments, on the other, such as a promise of prompt, adequate and effective compensation. As a consequence, at the 1994 OECD Ministerial Conference, the Ministers received a feasibility study on a possible new instrument, and a formal proposal was set forth to "enter a new phase of work aimed at elaborating a multilateral agreement.

2.3.3 The Failure of Negotiations on the Multilateral Agreement on Investment

After three years of negotiations, the MAI appeared to be at a standstill.[76] The self-imposed deadline to complete the work had to be postponed for two times.[77] Although there are several reasons for the failure of the negotiations, a major factor is the very

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[75] Alister Smith, "The Development of a Multilateral Agreement on Investment at the OECD: A Preview", in Towards Multilateral Investment Rules (Paris: OECD Documents, 1996) 3 1, at p. 32, positing that "it is easy to point to limitations of OECD codes - for example, the inadequacy of existing provisions to deal with many foreign investment protection issues and the absence of enforceable dispute settlement procedures."

[76] In April 1998, the MAI negotiations were formally suspended for "a period of assessment and further consultation between the negotiating parties and with interested parts of their societies." See OECD, "Ministerial Statement on the Multilateral Agreement on Investment (MAI)", (April 28, 1998), available online at http://www.oecd.org/news-andeventsl release/nw9850a.htm; Then, in December 1998, negotiators announced the cessation of the formal negotiation. See OECD, "International Investment Report to Ministers" (May 26, 1999), available online at http://www.oecd.org//daf/cmis/fdi/ sgrep.htm.

[77] It was originally expected that the agreement would be concluded for ratification in May, 1997 OECD Ministerial Council Meeting, following two years of negotiations. The deadline was, however, then extended to May, 1998.

vocal opposition from the developing countries and the NGO groups, as well as the controversial views advocated in the debates among negotiating partners themselves.[78] The substantive norms envisaged by the MAI have some particular implications for developing countries, especially from a development perspective. These implications will be mentioned throughout the following examination of the MAI provisions. The main sticking points frustrating negotiators appeared to be the issue of the United States' Helms-Burton Act, the proposal relating to environment and labor standards, the request by France and Canada on cultural exceptions, and the insistence by the EU on an exception for regional integration agreements. To a large extent, these issues reveal the existing difficulties and ambivalence surrounding the efforts for a multilateral regime, even in the context of the OECD.

2.3.4 The Scope and Key Features of the Multilateral Agreement on Investment

i. Definition of Investment

The scope of the MAI includes all forms of investment. The OECD has followed the approach of most BITs and the NAFTA by incorporating a broad "asset-based" definition of investment, extending beyond traditional FDI to cover portfolio investment, all non-equity arrangements and intangible assets, to name a few, bonds, loans, intellectual property rights, as well as public rights acquired under the law of host country such as concessions, licenses and permits.[79] In view of the recent Asian financial crisis resulting from the instability of some short-term and speculative capital flows. Such an overly broad definition poses particular questions for developing Countries.

ii. Non-discriminatory Treatment

The starting point of the MAI is a broad non-discrimination obligation, including both national treatment and MFN treatment. The key principles of national treatment and

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[78] Jeffrey Lang, "The International Regulation of Foreign Direct Investment: Obstacles and Evolution, Keynote Address" (1998) 3 1 Cornell Int'l L.J. 455, at p. 461.

[79] OECD, MAI Negotiating Text (as of 24 April 1998), available online at http://www.oecd.org/daf/investment/fdi/mai/negtext.htm [hereinafter MAI Negotiating Text], Article II (Scope and Application): 2 (Investment).

MFN treatment have been proclaimed to be the philosophical and legal touchstone of the agreement.[80]

It has already been discussed in the BITs practice, that national treatment requires host countries to treat foreign investors and investments no less favorably vis-à-vis domestic ones. As a result of this standard, countries could not impose special restrictions or conditions on foreign investors, or grant any subsidy, privilege, or other forms of economic assistance that solely benefit domestic enterprises, or require foreign investment enterprises to achieve a designated degree of performance. In essence, any domestic laws, regulations and policies *per* se that have a discriminatory effect on foreign investors and investments would be prohibited. The MFN treatment provision then requires host country governments to treat all foreign investors from different sources equally.

Unlike the majority of BITs, with the notable exception of the American ones, the striking feature of the MAI lies in, for the first time at a multilateral level, its application of national treatment and MFN treatment provisions to both the pre- and post-establishment stages of investment. The national treatment clause, which is undisputedly at the core of an investment agreement, thus deserves quoting in full here:

> *Each Contracting Party shall accord to investors of another Contracting Party and to their investments, treatment no less favorable than the treatment it accords in like circumstances to its own investors and their investments with respect to the establishment, acquisition, expansion, operation, management, maintenance, use, enjoyment and sale or other disposition of investments.*[81]

As indicated earlier in the overview of the BITS provisions, application of national treatment in the post-establishment stage has become gradually acceptable to many developing countries. However, to apply national treatment at the pre-establishment or the entry stage, foreign investors are to be granted an absolute right of establishment equal to that of domestic enterprises, either in the manner of establishing a

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[80] Don Wallace, Jr. & David B. Bailey, 'The Inevitability of National Treatment of Foreign Direct Investment with Increasingly Few and Narrow Exceptions" (1998) 3 I Cornell Int'l L.J. 615, at p. 619.

[81] MAI Negotiating Text, supra note 15, Article III (Treatment of Investors and Investment): National Treatment and Most Favored Nation Treatment (1).

new legal entity or acquiring an existing one. This open-ended national treatment clause has been seen one of the most liberalizing measures, but also the most controversial one, within the MAI. The right of establishment creates a general "open door" principle for all inward FDI, thus restraining considerably the autonomy of host country governments to pursue their own economic and development objectives.

The traditional assumption that the host country is most likely to favor its own nationals has been by and large not true since in some instances, foreign investments may be granted privileges that local investors do not have. Accordingly, the MAI has combined the two non-discriminatory treatments by requiring the host country to is more favorable.[82] A deeper look at the provision will reveal that, however, the non-discriminatory obligations do not require exactly the same treatment for foreign investors, because it allows, or might even encourage, advantageous treatment of foreign investors vis-à-vis domestic ones. Therefore, it fails to set forth a minimum standard in connection with government actions competing for FDI. Such minimum standard preventing a regulatory "race to the bottom" effect is actually one important aspect of a multilateral framework from which the developing world might benefit.

iii. Standstill and Rollback

The non-discriminatory treatment provisions are reinforced by a mechanism corn bining the "standstill" and "roll back clauses. The standstill clause requires national, as well as sub-national governments of Contracting Parties to refrain from adopting any the laws and policies that violates the MAI obligations. As a result, standstill freezes the standards of national treatment and MFN treatment at their current level. Contracting Parties are obliged to list all their existing non-conforming measures in the most precise terms possible, to impose no new non-conforming measures, and to make no amendments to existing measures that have the effect of increasing the degree of non-conformity to the MAI obligations.[83]

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[82] Ibid. Article III (Treatment of Investors and Investments): National Treatment and Most Favored Nation Treatment (3).

[83] Ibid. Article IX (Country Specific Exceptions): Lodging of Country Specific Exceptions.

The rollback clause is designed to ensure that any existing regulatory measures or policies of Contracting Parties that do not conform to the principles and obligations of the MAI would be reduced, either immediately or over a period of time, and accord to investors of another Contracting Party the better of the treatment, whichever eventually be eliminated. Rollback has been viewed as a dynamic liberalization process linked closely with standstill. Utilized in conjunction with standstill, it would produce a "ratchet effect", by which any new liberalization measures would be locked in so they could not be rescinded or nullified later on. The MAI envisions a number of ways for achieving rollback. Successive rounds of negotiations have been foreseen where rollback could be resulted from the trade-offs or exchange of concession. An institutional "Parties Group" is also expected to play the role of monitoring the adjustment of country specific reservations, conducting periodic examination of non-conforming measures, on either a country to country basis or a sectoral basis, which will lead to recommendations in favor of the removal or reduction of specific measures.[84] Rollback process has also been designed through liberalization commitments by the Contracting Parties effective on the date of entry into force of the MAI. First, it implies that not all restrictions currently maintained would be included in the list of exceptions. Secondly, rollback commitments are expected to be inscribed in schedules of commitments or list of reservations, by means of a "phase-out" or a "sunset" clause specifying a future date when the non-conforming measures would be eliminated or made more limited in the future.[85] Once any new liberalization measures have been taken, the reservation list of Contracting Parties will be adjusted to reflect the new situation and the standstill will then apply.[86]

iv. Privatization

The MAI also describes briefly specific stipulation as to the issue of privatization. Although Contracting Parties are not mandated to privatize any of their public institutions or services, it is suggested that once a State does decide to privatize a State-owned

[84] Ibid. Article XI (Implementation and Operation): The Parties Group.

[85] Ibid. Article IX (Country Specific Exceptions): Lodging of Country Specific Exceptions.

[86] Ibid.

enterprise, then the national and MFN treatment applies and foreign investors must be given the same rights as domestic investors to acquire the privatized enterprise and any other government held assets.[87] For developing countries, this might have some significant implications. Many countries, particularly those former Socialist countries, are in the course of a general process of privatizing public enterprises. They normally retain specific policies of giving preference to domestic investors, or reserving a certain percentage of shares for them. These policies have been designed to maintain significant local participation in what are often regarded as key industries or sectors, but under the MAI, it is clearly a violation of the treaty obligations.

v. Performance Requirements

The performance requirements provision appears to be part of the "absolute" standards, according to which foreign investors must not be subject to any performance requirements, even such requirements are equally imposed on domestic enterprises. To this end, the standards go beyond the national and MFN treatment, and again, host States are required to accord a "supranational" treatment to foreign investors. The MAI prohibits the host country to impose any performance requirements or other conditions in connection with the establishment, acquisition, operation, sale or other disposition of an investment.[88] To name a few, prohibited measures include requirements for foreign investor to export or import at a certain level, to purchase domestic goods and services, to take on a local partner, to hire a certain number of local management personnel or employees,[89] to transfer technology or achieve a certain level of Research and Development.[90] The clause has implied that performance requirements would not be allowed even they are linked to the granting of advantages or incentives since in no case could any of such commitments or undertakings be enforced. Even though, it was still

[87] Ibid. Article III (Treatment of Investors and Investments): Privatization.

[88] Ibid. Article III (Treatment of Investors and Investments): Performance Requirements.

[89] Ibid. Article III (Treatment of Investors and Investments): Nationality Requirements for Executives, Managers arid Members of Boards of Directors, Employment Requirements. These two clauses are in addition to the prohibition of performance requirements.

[90] Ibid. Article III (Treatment of Investors and Investments): Performance Requirements.

proclaimed that the language is not clear enough, and needs to be improved by adding "or condition the receipt or continued receipt of an advantage" at the end of the paragraph.[91] It is evident that the MAI goes far beyond the TRIMs Agreement and the NAFTA, seeking to ban not only the trade-related measures, but also all other measures that possibly have some degree of impact on the establishment and operation of foreign investment enterprises.[92]

vi. Absolute Standards of Treatment

As with the case of BITs, the non-discrimination principles are further reinforced by some so-called "absolute" treatment requirements, which foresee a special or minimum level of treatment for foreign investors and foreign investments.

These standards are essentially borrowed from most existing BITs of the United States and the NAFTA. The introductory article prescribes that the MAI will require "fair and equitable treatment" and "full and constant protection and security", at least as favorable as required by customary international law.[93] Apart from these, a Contracting Party shall not impair foreign investments by any unreasonable or discriminatory measures. Again, it is arguable that all these standards are lack of certain and clear definition, and the application of customary international law has little authority.

The transparency obligation is also in place. Each Contracting Party is required to publish or make publicly available all its laws, regulations, policies, as well as international agreements in connection with foreign investment, and upon request, to respond to specific questions from other Contracting parties.[94] However, while the

State governments are obliged to be transparent in its legislation and regulation process, the foreign investors are protected against any request for access to their

[91] Ibid. Article III (Treatment of Investors and Investments): Footnote 19.

[92] The TRIMs Agreement bans merely measures that have direct effects on trade in goods. The NAFTA provides for a shorter list of prohibited performance requirements. For example, the requirements to locate headquarter of an investment for a specific region, to achieve a certain level of R&D, to hire a certain number of nationals, and to establish a joint venture all are not prohibited under the NAFTA. See NAFTA, supra note 1 18, Article 1 106: Performance Requirements.

[93] MAI Negotiating Text, supra note 15, Article IV (Investment Protection): 1. General Treatment.

[94] Ibid. Article III (Treatment of Investors and Investments): Transparency (1) (2).

proprietary or other relevant information because of its nature of confidentiality.[95] Such obviously unbalanced approach poses again difficulties for participating countries.

vii. Expropriation and Compensation

The expropriation and compensation provisions are firmly established in the MAI, pursuant to the so-believed traditional international law principles articulated by the industrialized home countries. Expropriation will be prohibited except if it is "for a purpose which is in the public interest, on a non-discriminatory basis, in accordance with due process of Law, and accompanied by payment of prompt, adequate and effective compensation."[96] The notion of prompt, adequate and effective compensation is further elaborated to be as "paid without delay, equivalent to the fair market value of the expropriated investment immediately before the expropriation occurred, and be fully realizable and freely transferable.[97]

The first controversy deals with the "due process of law" requirement envisaged by the expropriation provisions, which is prescribed as "prompt review of its case, including the valuation of its investment and the payment of compensation of compensation in accordance with the provisions of this article, by a judicial authority or another competent and independent authority".[98] As universally acknowledged in traditional international law, due process of law is a matter of domestic law. Involving judicial, or in some cases, administrative review in the procedural, as well as the substantive issues of an expropriation action in accordance with the national laws of host country. However, the MAI requires such review to be based on the provisions of the Agreement rather than the national laws, which is obviously an interference with the sovereignty of host States.

In spite of the lack of definition, the prohibited expropriation no doubt goes beyond the explicit acts of nationalization and direct expropriation, since it includes

[95] Ibid. Article III (Treatment of Investors and Investments): Transparency (3).

[96] Ibid. Article IV (Investment Protection): *2.* Expropriation and Compensation (2.1).

[97] Ibid. Article IV (Investment Protection): 2. Expropriation and Compensation *(2.2)* (2.3) (2.4).

[98] Ibid. Article IV (Investment Protection): 2. Expropriation and Compensation (2.6).

"measures having equivalent effect".[99] Indeed, the MAI provisions have implied that foreign investors would have a clear advantage in that they could challenge a legislative measure of the host country under the MAI, while domestic enterprises under the similar circumstances would have no case in domestic courts and no recourse to any international arrangements. Notably, under the classical international law, expropriation is viewed merely as the physical taking of property by the State, but not any change in the property value or future profitability due to a regulatory or policy change. However, the overly broad notion employed by the MAI and the ambiguous inclusion of "measures of equal effect" would confer considerable power to private investors to challenge actions of a sovereign government. In this connection, it is worthwhile to recognize that any regulatory or policy changes, or more broadly, any governmental measures, adopted by the host country, would more or less interfere in the business of private enterprises and affect their economic situation such as the potential cost and profitability, including both foreign and domestic ones for the majority of cases. During the negotiation of the MAI, it goes even far as to propose that certain corporate tax measure that do not conform with the basic principles and obligations of the Agreement could be identified as "creeping expropriation" for which private investors could claim for compensation from governments.[100] More analysis and some possible solutions relating to the question of indirect expropriation would be addressed in the subsequent chapter. Here, it is useful to look into an interesting case under the NAFTA dispute. The MAI expropriation provisions are extremely similar to those found in the Chapter 11 of the NAFTA. An analysis of the case under the NAFTA expropriation provisions will, therefore, expose some of the MAI'S potential effects.

viii. Indirect Expropriation and the Ethyl Case

This concrete example at point is the $350 million lawsuit filed against the Canadian government by the Ethyl Corporation, an American Chemical Company, regarding Canada's ban on the import and inter-provincial transport of the gasoline additive MMT.

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[99] Ibid. Article IV (Investment Protection): 2. Expropriation and Compensation (2.1).

[100] OECD, "The Multilateral Agreement on Investment: Commentary to the MAI Negotiations Text' (modified on December 14, 1 *W8),* available online <http://www.oecd.org/daf/cmis/negtext.htm>.

In 1997, Canada banned the importation and inter-provincial transport of the MMT, a manganese fuel additive which has been found not only to have serious health effects as a dangerous neuro-toxin, but also interfere with the diagnostic system in cars that control anti-pollution devices.[101] In fact, this additive has been banned in the United States by the Environmental Protection Agency for 17 years, but is only used in Canada. Ethyl argued that the ban constitutes an illegitimate expropriation of its assets under Chapter 11 of the NAFTA, which justifies the compensation for actual and any future earnings losses, as well as damage to its reputation. Interestingly, the claim was pursued under the Investor-to-State mechanism right after the refusal by the United States Trade Representatives (USTR) office to espouse for an inter-governmental dispute settlement." In the end, the case was settled, and the Canadian government agreed to repeal its trade ban and pay Ethyl $19.3 million for legal costs and lost profits. For many legal scholars, the settlement of the case cut short the opportunity to clarify the strengths and limitations of the rules and principles relating to the "indirect" expropriation.[102] However, suffice it to say here that the controversy arising from the NAFTA has given rise to the effect of fettering, to an unexpected degree, the hands of governments to regulate FDI in some very legitimate ways. It is not an exaggeration to say that the incorporation of such provisions in the *MAI* at the multilateral level will definitely deteriorate the situation.

An effective dispute settlement mechanism has been seen by developed home country and foreign investors as one of the most important factors in ensuring the enforceability of an international agreement. The most distinguished, but also most controversial, aspect of the MAI is the dispute settlement mechanism it has envisaged, in particular, the Investor-to-State dispute settlement.

The MAI largely follows the precedent set forth by the WTO in the State-to-State dispute settlement procedure, which consists of several separate but inter-related procedures: consultation, conciliation and mediation, and arbitration, The State-to-State mechanism will apply to the disputes regarding the interpretation or application of the

[101] Scott Feschuk, "Reputation Hurt, MMT Maker Says Ethyl Corp. to File $201 Million Claim against Ottawa over Moves to Ban Fuel Additive', in The Global and Mail (September 11. *1996).*

[102] Sylvia Ostry and Julie Soloway, "The MMT Case Ended Too Soon: Taking It to Arbitration Would Have Helped Settle Some Crucial Questions", in *The Global and Mail* (July 24. 1998).

Agreement.[103] The first phase requires parties to resolve their dispute through consultation, conciliation or mediation.[104] Consultations are without prejudice and are confidential.[105] Assuming that consultations or the other alternatives have failed to settle the dispute within 60 days, the next phase is the initiation of an ad hoc arbitration.[106] The formation of the tribunal and the proceedings envisaged by the MAI are essentially the same as the BITs practice, while a roster of experienced arbitrators is maintained by the Parties Group.[107] Scientific and technical expertise is in place and expected to help out with some factual issues whenever necessary.[108] Unlike the BITs, some of which call for the law of the host State to be taken into account while others keep silent with the assumption that international law will be applied, the MAI makes it clear that the dispute will be adjudicated in accordance with the Agreement, and the rules of international law will be applied with respect of the interpretation and application.[109] One might contend at this point that the so-called "international law" is subjective, controversial and with little authority on its application, and more importantly, what rules would be applied in the case of discrepancy between the MAI and the customary international law.

In the context of BITs, the consultation and arbitration procedures are generally sufficient to settle the bilateral disagreement. However, under the multilateral treaty, the resolution of a dispute between two States will very likely affect interests of other States, especially with regards to interpretive issues. A clause offering a third party's involvement is thus provided.[110] Another distinguishing aspect of the MAI from the BITs is its elaborate prescription on the enforcement of the arbitral award. A Contracting Party is required to comply with its obligations as determined in the award. If it fails to do so

[103] MAI Negotiating Text, supra note, Article V (Dispute Settlement): State-State Procedures (A. 1).

[104] Ibid. Article V (Dispute Settlement): State-State Procedures (B. 1).

[105] Ibid. Article V (Dispute Settlement): State-State Procedures (B.4).

[106] Ibid. Article V (Dispute Settlement): State-State Procedures (C. 1).

[107] Ibid. Article V (Dispute Settlement): State-State Procedures (C.2).

[108] Ibid. Article V (Dispute Settlement): State-State Procedures *(C.5).*

[109] Ibid. Article V (Dispute Settlement): State-State Procedures (C.6).

[110] Ibid. Article V (Dispute Settlement): State-State Procedures (C.4).

within a reasonable period of time, the other party could request for consultations with a view to reaching a mutually acceptable solution. In the event a solution still cannot be reached, the party in whose favor the award was rendered is entitled to take measures in response or simply suspend the application of its obligations to the other party, provided it should submit a notification to the Parties Group and such responsive measures do not involve expropriation or other actions prohibited by the General Treatment requirements.[111]

ix. Investor-to-State Dispute Settlement

With respect to investor-to-State dispute settlement, again, the MAI provisions are broadly derived from the approach of the NAFTA. This mechanism enables private investors to sue a sovereign government, and seek monetary compensation through international arbitration. Essentially, the investor-to-state dispute settlement has conferred the private investors the same rights and legal standing as sovereign governments, which goes far beyond the traditional notion envisaged by the customary international law.

The scope of the dispute covered has been defined very broad. Any violation of the MAI principles and obligations "which causes or is likely to cause loss or damage to the investor or its investment" would constitute grounds for legal action by private investors. Then, the theory of internationalization of concessions and State contracts postulated by some Western jurists is realized. The foreign investors are also entitled to bring any dispute concerning an alleged breach of a specific contractual obligation under "an investment authorization" or "a written agreement granting rights" to the fore of an international arbitration.[112]

Reflecting the preference of investors and developed home countries for a litigious approach, only a brief one-sentence clause is referred to the negotiation and consultation of the disputes, in contrast to the BITs practice.[113] Most emphasis has been posed on the arbitration procedures. Under the MAI, the investor-to-State dispute

[111] Ibid. Article V (Dispute Settlement): State-State Procedures (C.9.).

[112] MAI Negotiating Text, supra note 440. Article V (Dispute Settlement): Investor-State Procedures (D.1).

[113] Ibid. Article V (Dispute Settlement): Investor-State Procedures (D.2).

settlement procedure will be handled by an institutional or pre-existing arbitration, but not an ad hoc tribunal. Any dispute can be submitted under: (1) the ICSID Convention, provided that both the disputing party and the party of the investors are members of the Convention; (2) the Additional Facility Rules of ICSID, provided that either the disputing party or the party of the investor, but not both, is a party to the ICSID Convention; (3) the UNCITRAL Arbitration Rules; or (4) the ICC Arbitration rules.[114] Once acceding to the MAI, the host country has automatically given its "unconditional consent" to the submission of a dispute to international arbitration, and cannot withdraw its consent unilaterally.[115]

An arbitration tribunal is composed of three individuals, two of whom are selected by the opposing parties, and the third presiding arbitrator is appointed by agreement of the disputing parties.[116] If the disputing parties cannot decide on a presiding arbitrator within ninety days after a claim is submitted to arbitration, the Secretary-General in case of the ICSID arbitration, or the International Court of Arbitration in case of the ICC will appoint a presiding arbitrator from a roster of previously approved arbitrators. Generally, a judgment would not be based on the laws of the host country but on the norms and principles of the MAI itself.[117] However, if the dispute arises out of a state contract or concessions, the choice of law according to the contractual arrangement will be applied. In the absence of such choice of law, host country laws and rules of international law will be taken into account.[118] Nonetheless, no elaboration is made on the situation where there is a discrepancy between the host country laws and the international law.

The investor-to-State arbitration is required to be held in a state that is a party of the New York Convention so that the arbitral award will be automatically enforceable. Given the growing concerns over the problem of the sovereign legislative power of the

[114] Ibid. Article V (Dispute Settlement): Investor-State Procedures (D.2).

[115] Ibid. ArticIe V (Dispute Settlement): Investor-State Procedures (D.3), (D.5).

[116] Ibid. Article V (Dispute Settlement): Investor-State Procedures (D.7).

[117] Ibid. Article V (Dispute Settlement): Investor-State Procedures (D. 14:a).

[118] Ibid. Article V (Dispute Settlement): Investor-State Procedures (D. 14:b).

host governments, the Contracting Party is obliged to provide for only the enforcement of the pecuniary obligations imposed by the award, but not mandated to compromise on its regulatory or policy change.[119]

x. Investor-to-State Dispute Settlement and the Metalclad Case

The controversy surrounding the overly broad coverage of the investor-to-state procedure poses the question whether such mechanism should be limited to only some foreseeable situation where the foreign investor has the legitimate reason to challenge the abusive utilization of the host country's legislative power. The MAI negotiators seem to have not been constrained by these concerns. It has even been proposed expressly that "a lost opportunity to profit from a planned investment would be a type of loss sufficient to give an investor standing to bring an establishment dispute.[120] That is to say, a foreign investor who wants to establish in a host country but is not allowed access will be entitled to challenge that decision, and the compensation might be eventually justified for such rejection of access.

The case at point is another example of Chapter 11 of NAFTA being used by private investors to retaliate a sovereign government. Metalclad Corporation, a California based Company, sued a state government of Mexico at the ICSID tribunal in 1997, claiming compensation for the Governor's refusal to approve a hazardous waste disposal plant. Metalclad's $90 million claim for damages includes the fair-market value of the plant, as well as the lost revenue since being blocked in 1995.[121]

Metalclad alleged that, by including a landfill in a protected ecological zone, the state government has prevented it from establishing operation there. Such prohibition violated the relevant provisions under the chapter 11 of the NAFTA, specifically the

[119] Ibid. Article V (Dispute Settlement): Investor-State Procedures (D.18).

[120] OECD, "The Multilateral Agreement on Investment: Commentary to the MAI Negotiations Text", supra.

[121] Rosella Brevetti, NAFTA: First Chapter 11 Requests for Arbitration with Mexico Filed, in Int'l Trade Daily (March 26, 1997), available in Westlaw, BNA-BTD Database.

Articles 1102, 1103, 1104, 1105 and 1110.[122] Aside from the national treatment and the MFN treatment, Metalclad cited the expropriation provisions as its strongest argument.[123]

xi. Obligations of Private Foreign Investors

The OECD anticipates that the MAI will annex the Guidelines to the MAI.[124] However, they appear to be purely voluntary recommendations for MNEs as they will not share the legally-binding character of the MAI. Apparently, such an approach does not represent a serious effort to regulate obligations of foreign investors, and can hardly alleviate the unbalanced nature of the Agreement. To achieve a fair balance, any multilateral treaty in the FDI sphere should spell out foreign investors' obligations, legally binding wherever possible. Suffice it to say here, a one-sided agreement like the MAI, emphasizing only liberalization and protection of foreign investments but ignoring the needs to fetter distorting behaviors of private investors, would certainly be unacceptable for developing countries and in no interest of either Party.

xii. Other Issues

One aspect usually not covered by the BITs is the issue relating to entry and sojourn of foreign nationals. Under the MAI, subject to national laws of the Contracting Parties, an investor or an employee generally shall not be rejected temporary entry, stay or authorization to work in the host country.[125] The monopolies and State enterprises issue is also considered by the MAI. Contracting Parties are not forbidden from maintaining, or designating a monopoly, but they shall endeavor to accord non-discriminatory treatment when doing so, and a monopoly and State enterprise must operate based on normal commercial considerations, and not to discriminate in favor of domestic enterprises when supplying or purchasing goods and services.[126]

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[122] Ibid.
[123] Ibid.
[124] MAI Negotiating Text, supra, Article X (Relationship to other International Agreements): The OECD Guidelines for Multinational Enterprises.

[125] Ibid. Article III (Treatment of Investors and Investments): Temporary entry, stay and work of Investors and Key Personnel.

[126] Ibid. Article III (Treatment of Investors and Investment): Monopolies/State Enterprises/Concessions.

One last significant point concerns the problem of accession and withdrawal. The MAI envisages that a Contracting Party could withdraw from the Agreement only after five years, on six months' notice, but all the provisions of the Agreement would continue to apply for another fifteen years.[127] This arrangement is innovative in a multilateral treaty practice. Once acceding to the *MAI,* a Contracting Party would then be prevented for such a long span of time from derogating from the obligations in order to safeguard its interests, even it becomes to realize that the Agreement may have severe adverse effects on its national economy or political situation.

2.4 The Outstanding Issues: Helms-Burton, Exceptions, Carve-outs and REIOs,

2.4.1 The Helms-Burton Act

In March 1996, the United States adopted the U-S Cuban Liberty and Democratic Solidarity Act, commonly referred to as Helms-Burton Act,[128] which aimed at tightening the economic noose around Cuba. Under the Act, Title III allows U.S. nationals and corporations to sue any "person" who "traffics" in the confiscated property before the U.S. federal court. Title IV excludes aliens who "traffics" in the confiscated property, as well as their families. The Helms-Burton Act has given effects to greater tension between the United States and its trade partners, particularly the EU, Mexico and Canada, because of its aggressive intention of extraterritorial enforcement of the U.S. laws.[129] Blocking and clawback legislation has been passed by the EU,[130] Mexico[131] and Canada.[132] The EU even brought the issue *to* the dispute settlement of the WTO on the ground that Helms-Burton violated the WTO Agreement obligations by creating an extraterritorial

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[127] Ibid. Article XII (Final Provisions): Withdrawal.

[128] U.S. Cuban Liberty and Democratic Solidarity Act, 22 U.S.C., S s. 6031-6040 (1996).

[129] Natalie Maniaci, "The Helms-Burton Act: 1s the U.S. Shooting Itself in the Foot?" *(1998) 35* San Diego L. Rev. *897,* at pp. 893-895.

[130] The European Union, Council Regulation No. *2271196,* reproduced in Vol. 36 I.L.M. 125 *(1997).*

[131] Mexico, Act to Protect Trade and Investment from Foreign Norms that Contravene International Law, reproduced in Vol. *36* I.L.M. *111 (1997).*

[132] Canada, Foreign Extraterritorial Measures Act Incorporating the Amendments Countering the U.S. Helm-Burton Act, reproduced in Vol. 36 I.L.M. 111 (1997).

enforcement effect.[133] In fact, the issue of extraterritoriality, in terms of principles pertaining to jurisdiction, particularly in the field of anti-trust and trade controls, has for a long time brought the United States into conflict with many European states.[134] The same friction seems to have played a significant role in the MAI negotiations.

2.4.2 Exceptions. Carve-outs and Regional Economic Integration Organizations

While the development of a legal text providing the basic Framework turns out to be rather easy, the identification and negotiation of country specific exceptions and carve-outs has been proved to present much more difficulties. On the one hand, the

United States remains unsatisfied with the ambiguous and broad exceptions and carve-outs proposed by some European countries. France and Canada have also sought a total carve-out for culture without specifying what would constitute cultural measures.[135] On the other hand, the United States, Canada and Mexico are not to fully accept the "standstill" and "rollback" approach preferred by most European countries, all of which are actually members of the NAFTA. Under the NAFTA, while some of the exceptions are subject to standstill, many remain basically to be open-ended, which can be trade-off through future negotiations and achieve a balance of benefits.

The proposal from the European Commission for an exception for a Regional Economic Integration Organization (REIOs) defined in terms that essentially applies only to the EU, has further complicated the issue.[136] In principle, the REIOs exception would enable the European Commission to discriminate in favor of its members not only at the current level, but also could new harmonized measure be adopted increasing the degree of discrimination. The United States strongly opposed to the incorporation of such a

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[133] The case was finally settled based on a mutual understanding that relevant principles would be developed in parallel with the negotiations on the MAI. See John R. Schmertz Jr., "EU Ends its WTO Challenge to U.S. Cuban Sanctions Act" (1998) 4 Int'l L. Update 67. See also European Union - United States: Memorandum of Understanding Concerning the US. Helms-Burton Act and the U.S. Iran and Libya Sanctions Act, (April *1 1 , 1997)* reproduced in Vol. 36 I.L.M. *529* (1997).

[134] For a detailed discussion, see *e.g.* Alan Derrett Neale & Mel L. Stephens. International Business and National Jurisdiction (Oxford: Clarendon Press, *1988).*

[135] MAI Negotiating Text, supra, Annex 1 "Country Specific Proposals for Draft Texts: Culture".

[136] MA1 Negotiating Text, supra, Annex 1 "Country Specific Proposals for Draft Texts: Clause for Regional Economic Integration Organizations".

carve-out.[137] From the viewpoints of the United States and Canada, the REIOs exception, on the other hand, is of relevance with respect to the question of sub-national measures.[138]

2.5 The Multilateral Agreement on Investment: An Unbalanced Approach

As the preceding examination of the substantive contents of the MAI has evidently indicated, the negotiation of the MAI itself has turned out to be highly problematic. One thing is clear from the perspective of developing countries. The fundamental premise on which the edifice of the MAI has been erected is considerably flawed and one-sided. As poignantly described by one commentator, the MAI is "a charter of rights for transnational corporations which will limit the role of democratic governments in important ways".[139] It expands the rights and powers of foreign investors without imposing any corresponding obligations on them. The experience of the NAFTA has revealed that such unbalanced approach is most likely to give rise to the effect of fettering the sovereign legislative powers of the host country government. On the other end of the spectrum, the Agreement says, however, nothing about the rules and principles that the foreign investor must fallow in order to be in harmony with the national policy objectives of host countries.

2.6 Key Issues and Recommendations for Developing Countries with Respect to Substantive Provisions

There are, of course, some issues that have been widely employed in most BITs practice, or more or less guaranteed in the context of regional arrangements, and thereby their reconstitution into a multilateral treaty might not pose serious problems for the developing countries. For example, recent approaches in bilateral and regional

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[137] For further discussion on the REIOs clause, see Joachim Karl, "Multi lateral Investment Agreements and Regional Economic Integration" (1996) Vol. 5 No. 2 Transnational Corporations (August 1996) 19.

[138] MAI Negotiating Text, supra, Annex 1 "Country Specific Proposals for Draft Texts: Sub-national Measures".

[139] Bob White, "What the MAI Means for Canadians", in Andrew Jackson & Matthew Sanger eds., Dismantling Democracy: The Multilateral Agreement on Investment (MAI) and Its Impact (Ottawa: The Canadian Centre for Policy Alternatives, *1998)* 1, at p. 1.

agreements in respect of the scope of the instruments appear to favor a broader definition of investment. The "assets based" definition of investment is thus generally acceptable from developing countries' viewpoints for the purpose of an international investment treaty. Also, the fair and equitable treatment, as well as the MFN treatment standard, appears by and large to be adopted in virtually all BITs and regional arrangements. A comprehensive examination of all normative substance of an investment agreement would be practically impossible, and goes beyond the purpose of the current study. Rather, the subsequent discussion on substantive provisions will be limited to those that are, by their very nature, likely to be subject of controversial debate where conflicting interests of developing countries and developed ones will be involved. The discussion is, of course, merely exploratory and does not purport to analyze any systematic approach to the issues.

So far as the developing countries are concerned, the development issues need to be built into the MIF through various substantive provisions, which inextricably constitutes conflicts with developed countries, who are indeed seeking for a highly liberalized regime on FDI. Generally speaking, two dimensions could be identified, in this sense, from a development perspective: one part would be how to allow a sufficient margin of flexibility for developing countries to pursue their own objectives with respect to FDI, while the other part would be how to spell out the obligations for foreign investors in a multilateral context.

2.7 Regulating Investment in the GATT/WTO Framework

2.7.1 The Necessity of Integrating Investment Rules into the WTO

A. FDI Bas Become An Underpinning of World Trade.

As discussed in Chapter One, trade patterns have significantly changed in the past twenty years, with trade increasingly dependent on intra-firm trade. From the observation in Chapter Two, we know that FDI as capital flow directly supports international production and independent intra-firm trade. Without FDI, international production and independent intra-firm trade cannot take place. FDI in international production and independent intra-firm trade strongly supports and contributes to trade. Without FDI, trade would have

occurred much less. In other words, FDI has become an important underpinning for modern world trade.

B. Imperative to Recognize the Contribution of FDI to Trade and Economic Development in the World Trading System.

As we know, after 50 more years of development, the WTO has become the predominant multilateral system for regulating international economic relations. Trade liberalization through the GATT has brought about a profound change in the world economy. The magnitude of FDI flows in the movement of production factors not only has shaped trade relations among nations, but also has also substantially changed the fundamentals of international economic relations. A recent study by UNCTAD defines the movement of production factors as the "deep" integration of world economy, compared with the "shallow" integration under the condition of arm's-length trade. Three points can explain the profound change of the world economy:

1) First, the aggregated huge stock of FDI and the magnified intra-firm trade flows have entailed the mass movement of production factors such as capital, raw materials or intermediate products, labor, and technology. This fundamental change, which is driven by TNCs seeking international production and distribution efficiency, has promoted the rational allocation and efficient use of world resources, thus benefiting consumers worldwide and promoting economic development in every nation.

2) The second point is that the diversified FDI flows suggest that more and more countries rely on FDI to sustain their economic growth. Or in other words, more and more nations have a substantial stake in the free movement of capital and the security of capital.

3) Third, FDI flows have shown a strong two-way development as more countries have become both home and host countries to FDI. For example, the USA is not only the largest home country for outward FDI flows but also the largest host country in absolute terms. Another spectacular example is Canada.[140] The two-way phenomenon of FDI flows and the ensuing cross-border business activities conducted by TNCs further reflect the deep connection of

[140] Edward Safarian, Host Country Policies towards Inward Foreign Direct Investment in the 1950s and 1990s, *Transnational Corporations,* Vol. 8, *No.* 2 (August *1999),* p. 99.

> national markets. Consequently, FDI plays an increasingly important role in host countries' capital formation and economic development. Such close relationships make domestic markets increasingly integrated and interdependent. As a consequence, the domestic economic policy of a home country not only affects its own domestic economy, but also has effects on the host country's economy through the investments of TNCs from the home country.

Although the world economy has fundamentally changed, the basic concepts directing international economic relations have not changed greatly. The conventional trade concepts of comparative advantage and free trade, which constitute the theoretical foundation of the world trading system, still dominate and direct international economic relations. However, many scholars have begun to question the adequacy of these trade theories in explaining the new trends in trade and in dealing with issues regarding economic development in the globalized world economy. Porter argues that merely using the resources available or assembling more resources based on the theory of comparative advantage is not enough for prosperity.[141] He argues that the failure to understand the distinction between comparative advantage and the new competitive advantage of nations is the root cause of problems in economic development. Braga supplements Porter's point by asserting that many developing countries have not gained a fair share of the benefits from the trading system because old concepts, i.e., free trade, comparative advantage and interrelated concepts, do not capture the driving forces for economic development in today's global economy.[142] He argues that developed countries have gained more than developing countries from the world trading system mainly because their firms have adopted effective outward-oriented international business strategies that stress key abilities such as technology creation and outward FDI so as to exploit resources and markets world-wide.[143] He suggests that developing countries should encourage and support their enterprises to emulate such business strategies in the global economy.

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[141] Michael E. Porter, The Competitive Advantage Of Nations, The Free Press, 1998, p. 640.

[142] Rubens Lopes Braga, Expanding Developing Countries' Exports In a Global Economy: The Need to Emulate the Strategies used by Transnational Corporations for International Business Development, *UNCTAD D*iscussion Paper No. 133, March 1998. http:/www.unctad.org/en/pub/a133-98.htm

[143] Ibid.

Therefore, in the new era where FDI plays an important role in economic growth and development of many nations and contributes significantly to world trade, beyond the conventional wisdom of trade theories, we need to recognize the importance of FDI in the world trading system, and to incorporate FDI theories as a theoretical foundation into the world trading system.

2.7.2 Pre-Uruguay Round FDI Regulation

Prior to the Uruguay Round, the GATT framework barely contained any provisions regulating FDI. The General Agreement on Tariffs and Trade (GATT) was a pure trade-oriented agreement that did not include any sort of FDI regulation. The Charter of the International Trade Organization (ITO),[144] however, included provisions regulating some aspects of FDI.[145] These provisions, however, were so rudimentary and were considered to be a codification of the existing international law at that time. Furthermore, since the ITO never came into existence, it can be correctly stated that prior to the Uruguay Round, the GATT framework did not include any investment regulation whatsoever.[146]

Due to the growing importance of FDI and its correlation with international trade, the GATT framework had to evolve to include some investment-oriented provisions. This need was clearly illustrated in the 1982 FIRA dispute between the US and Canada, which helped trigger the TRIMS Agreement.[147]

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[144] *Charter of the International Trade Organization, 24* Mach 1948, Final Act and Related Documents. UN. Code on Trade and Employment U.N. Doc. ICITO/1/4, (1948).

[145] The main articles touching upon investment in the ITO Charter were Article 11 entitled "Means of Promoting Economic Development and Reconstruction" and Article 12, entitled "International Investment for Economic Development and Reconstruction". "The ITO investment provisions, however, were not demanding in their liberalization requirements. They required States to only "give due regard to the desirability of avoiding discrimination as between foreign investments". There was no obligation for national treatment or right of establishment in the ITO provisions, and the provisions did not cover investment incentives or performance requirements.

[146] Some commentators believe that part of the reason behind the failure of the ITO was its investment provisions, which were considered to be too protective of MNEs by developing countries and too protective of host countries by developed countries.

[147] *Canada Administration of the Foreign Investment Review Act,* 7 February 1984. GATT B.I.S.D. (30th Supp.) at p. 140 (1984) (*FIRA Dispute)*..

In the FIRA dispute, the US alleged that Canada's administration of its F*oreign Investment Review Act (FIRA)* was inconsistent with GATT principles. The FIRA adopted a case by case approach in accepting FDI proposals. As a condition to entry, all FDI proposals had to be deemed of "significant benefit to Canada" in a review by the Canadian government.[148] It is worth noting that the FIRA did not include provisions imposing local content requirements or any other trade-related investment measures (TRIMS). It was through the negotiations with the Canadian government, however, that foreign investors were pushed to accept performance requirements or undertakings, as the FIRA terms them. For example, when the American Apple Company wanted to invest in Canada, it was pressured to accept a number of undertakings. Resultantly, Apple undertook to purchase component parts of Canadian origin and to promote Canadian-made peripheral equipment to its dealers all around the world.

The FIRA case panel reviewed the validity of two types of undertakings under the FIRA: (1) undertakings that require investors to purchase goods of certain origins (purchase undertakings), and (2) undertakings that require foreign investors to export a certain percentage of their production (export undertakings). Regarding purchase undertakings, the panel found such requirements to be inconsistent with GATT Article III:4, "National Treatment on Internal Taxation and Regulation". The panel concluded that undertakings to purchase goods of Canadian origin without any qualification exclude the possibility of purchasing available imported products *so* that the latter are clearly treated less favourably than domestic products and that such requirements are therefore not consistent with Article III). Nonetheless, in order to avoid applying GATT principles to FDI, the FIRA decision had to be based "on the discriminatory effects on those countries that would lose the opportunity *to* export goods to the investor" instead of "the discriminatory treatment to the foreign investor p*er se.*[149]

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[148] FIRA adopted general criteria to assist in determining the benefits of the investment for Canada, for example, Article 2(2) (a) included the following criteria: "The effect of the acquisition or establishment on the level and nature of economic activity in Canada, including, without limiting the generality of the foregoing, the effect on unemployment, on resource processing, on the utilization of parts, components and services produced in Canada, and on exports from Canada."

[149] E.M. Burt, "Developing Countries and the Framework for Negotiations on Foreign Direct Investment in the World Trade Organization" (1997) *11* Amer. Univ. J. Int'l L. & Policy, p. 1015.

Although the US claimed that export undertakings infringe GATT Article XVII: l(c) because they deprive investors from operating on a commercial basis,[150] the panel did not find export undertaking to be inconsistent with any of the GATT provisions.

It should be noted that the findings of the panel do not necessarily apply in the case of developing countries. Since the FIRA dispute was between two developed countries, Argentina argued that "the provisions and arguments invoked against Canada were not necessarily those which could legitimately be invoked against developing countries, considering the protection which those countries have the right to grant under the General Agreement to their developing industries".[151] The panel confirmed this point and noted that "in disputes involving less-developed Contracting Parties full account should be taken of the special provisions in the General Agreement relating to these countries, such as Article XVIII:C".[152]

Some commentators argue, however, that a strict application of the GATT would lead to the prohibition of all performance requirements. Edwards asserts that:

> *Although no single Article of GATT is applicable to all forms of [performance requirements], all [performance requirements] arguably violate one Article or another. Some [performance requirements] clearly nui afoul of specific provisions while the case against other forms is weaker, given a strict construction of treaty obligations. Nonetheless, where obligations do not appear, on their face, to prohibit certain [performance requirements], the general intent and context of the GATT-MTN system should be considered. The system is intended to foster free trade, while [performance requirement] are protectionist measures. The presumption should therefore, be against considering any [performance requirement] valid under GATT.*[153]

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[150] Article XVII: I(a-c) provides that the Contracting Parties shall not prevent enterprises from acting in accordance with commercial considerations or in a manner consistent with the general principles of nondiscriminatory treatment set out in the GATT. See GATT, *art.* XVII: I(a-c).

[151] *FIRA Dispute, supra,* at p. 157.

[152] Ibid. at p. 158. Although the panel asserted developing countries' right to have a different treatment than developed countries regarding trade-related investment measures {TRIMS) did not elaborate on how this treatment would differ.

[153] R.H. Edwards. "Towards a More Comprehensive World Trade Organization Agreement on Trade Related Investment Measures" [Summer 1997) 33 Stan. J Int'l L. 169 at pp. 190-191.

Even though Edwards admits that this argument for broad applicability did not prevail in the Uruguay Round, he argues that "its reasoning should be used as a central guideline in the development of a new TRIMS agreement.[154]

2.7.3 Post-Uruguay Round FDI Regulation

The Uruguay Round negotiations Focused on the so-called "new issues", which included trade in services, trade-related investment measures. and intellectual property rights. The negotiations on these issues produced three agreements that regulate these matters respectively, the GATS, the TRIMS and the TRIPS Agreements. Although it might appear that the only investment oriented agreement of the Uruguay Round is the TRIMS Agreement, the GATS and the TRIPS Agreement do regulate certain aspects of FDI.

i. The General Agreement on Trade in Services

Due to the importance of trade in services in the world economy and to the large number of provisions relating to FDI in the GATS, many commentators believe that the GATS is the "true investment agreement of the Uruguay round".[155] The following paragraphs analyze GATS rules as they relate to FDI.

Scope of Application

The GATS's scope of application as defined in Article I (1) extends to measures by member States that affect trade in services. Paragraph (2) of Article I defines trade in services as encompassing the supply of a service:

(a) from the territory of one Member into the territory of any other Member,

(b) in the territory of one Member to the service consumer of any other Member;

(c) by a service supplier of one Member, through commercial presence in the territory of any other Member;

(d) by a service supplier of one Member, through presence of natural persons of a Member in the territory of any other Member.

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[154] Ibid.

[155] OECD Trade Directorate, "Investment and the Final Act of the Uruguay Round: A Preliminary Stocktaking." OECD Doc. COM/TD/DAFFE/IME(94)56/REV 1 (1994), at p. 5.

Thus, although the GATS does not use the term FDI or even investment, its coverage of FDI is clearly derived from subparagraph (c), which extends to the supply of service through the establishment of a commercial presence in the territory of another GATS member. Article XXVIII (2) (d) defines commercial presence as "any type of business or professional establishment, including through (i) the constitution, acquisition or maintenance of a juridical person, or (ii) the creation or maintenance of a branch or a representative office within the territory of a Member for the purpose of supplying a service". [156]

Conditions for Entry

As with most developing countries' BITS, the GATS does not confer an absolute right of entry to foreign investor of other contracting States. In fact, the GATS does not grant any right of entry, but rather leaves the issue of market entry to a large extent to States' prudence.

According to GATS Article XVI, the states have full discretion to decide if they want to enter into market access obligations or not: and if they decide to enter into such commitments, they can specify, in their national schedules, the service sectors in which these obligations will be undertaken and the terms, limitations and conditions which will apply to the commitments. In other words, the GATS takes a positive list approach with respect to market access obligations and leaves the determination of this list to States' discretion.

Once market access commitments are, however, undertaken regarding certain sectors, Article XVI (7) provides a list of measures that member States are forbidden to maintain or adopt on the basis of either a regional subdivision or its entire territory. These measures are:

> limitations on the number of service suppliers whether in the form of numerical quotas, monopolies, exclusive service supplies or the requirements of an economic needs test; limitations on the total value of service transactions or assets in the form of numerical quotas or the

[156] GATS, Article XXVIII(2)(d). It should be noted however, that the definition of investment in the GATS is narrower than the asset based definition of investment in the Organization for Economic Cooperation and Development (OECD) multilateral Agreement on Investment (MAI).

> requirement of an economic needs test: limitations on the total number of service operations or on the total quantity of service output expressed in terms of depicted numerical units in the form of quotas or the requirement of an economic needs test; limitations on the total number of natural persons that may be employed in a particular service sector or that a service supplier may employ and who are necessary for. and directly related to, the supply of a specific service in the tom of numerical quotas or the requirement of an economic needs test: measures which restrict or require specific types of legal entity or joint venture through which a service supplier may supply a service; and limitations on the participation of foreign capital in terms of maximum percentage limit on Foreign shareholding or the total value of individual or aggregate Foreign investment.[157]

Obviously, these measures are not obligatory for States even with regard to service sector in which States undertake market access commitments as the wording of Article XVI(7) clearly allows States to deviate from these measures by specifying so in their national schedules. However, the GATS subjects the regulation of market entry to the principle of MFN treatment."' Article XVI, titled Market Access, provides that: "With respect to market access through the modes of supply identified in Article 1, each member shall accord services and service supplies of any other Member treatment no less favourable than that provided for under the terms, limitations and conditions agreed and specified in its national schedule".[158]

Treatment

The main treatment commitments under the GATS are the MFN treatment, National treatment and transparency.

The GATS employs different approaches regarding the application of these obligations. While MFN treatment and transparency are considered to be general obligations that are imposed on all members in all service sectors, national treatment

[157] GATS, Art. XVI (2), footnote.

[158]The GATS notes: If a Member undertakes a market-access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph 2(a) of Article 1 and if the cross-border movement of capital is an essential part of the service itself, that Member is thereby committed to allow such movement of capital. If a Member undertakes a market-access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph *I(c)* of Article 1, it is thereby committed to allow related transfer of capital into its territory. GATS, *A*rt. XVI, footnote.

obligations are regarded as specific commitments that are limited to the sectors and modes of supply a State chooses to record in its national schedule.

The GATS adopts a negative list approach regarding the MFN treatment principle; Article II (2) permits member States to maintain measures inconsistent with their MFN treatment obligations provided that such measures are "listed in, and [meet] the conditions of, the Annex on Article II Exemptions".[159] This means that the MM treatment commitment is obligatory for all members and in all sectors, except for cases where a State files an exemption. As for national treatment commitments, the opposite approach is employed; GATS Article XVII (1) adopts a positive list approach with regard to national treatment obligations and leaves the determination of this list to States' discretion. Accordingly, a State is obliged to respect the national treatment principle only for the sectors it chooses to include in its national schedule and subject to any conditions and limitations it wishes to apply thereto.

Beside the country specific exemptions, the GATS includes general and security exceptions too. Members are exempted from their GATS obligations, in regard to measures adopted to *inter alia,* preserve public order and human, animal and plant well-being, provided that such measures are applied in a nondiscriminatory fashion and do not constitute a disguised restriction on trade in services.[160]

The approaches that the GATS employs regarding its entry and treatment obligations, along with its general exceptions, considerably limit its extent of liberalization. Although this limited liberalization might appear to be in line with the interests of developing countries only, the GATS contains a very reasonable balance of interests that accommodates the interests of both developed and developing countries. Indeed, although the GATS adopts this limited liberalization, it clearly States that its objective is to progressively achieve higher levels of liberalization through its progressive liberalization mechanism. Thus, the narrow liberalization of the GATS is balanced by its progressive liberalization mechanism, which requires member States to enter into

[159] Furthermore, Article II (3) allows members to confer or accord "advantages to adjacent countries in order to facilitate exchanges limited to contiguous frontier zones of services that are both locally produced and consumed".

[160] GATS, Article XIV.

successive and periodical rounds of negotiations with the intention to achieve progressively higher levels of liberalization.[161] These negotiations, which should "take place with a view to promoting the interests of all participants on a mutually advantageous basis", must "be directed to the reduction or elimination of the adverse effects on trade in services of measures as a means of providing effective market access".

Monetary Transfers

As a general rule, the GATS guarantees the right of service providers to unrestricted international monetary transfers and payments.[162] However, as in most BITs with developing countries, the GATS includes an exception that allows countries to deviate from this obligation in cases of "serious [balance-of-payments] and external financial difficulties".[163] Nonetheless, this exception is not without limitations. Article XII (2) States that restrictions adopted under this exception on monetary transfers and payments:

(a) shall not discriminate among Members;

(b) shall be consistent with the Articles of Agreement of the International Monetary Fund;

(c) shall avoid unnecessary damage to the commercial, economic and financial interests of any other Member;

(d) shall not exceed those necessary to deal with the circumstances described in paragraph 1;

(e) shall be temporary and be phased out progressively as the situation specified in paragraph 1 improves.

Paragraph (3) of Article XII allows Members, in determining the incidence of such restrictions, to "give priority to the supply of services which are more essential to

[161] Article XIX of GATS, however, qualifies the liberalization expectations for developing countries by stating that subsequent liberalization shall give due respect to national policy objectives and development levels. Further. it accepts the likelihood that developing country members will undertake liberalization commitments only commensurate with their level of development.

[162] Article XI (1) provides that "a Member shall not apply restrictions on international transfers and payments for current transactions relating to its specific commitments". Paragraph (2) of Article XI, however, provides that nothing in the GATS shall affect the rights and obligations of the member of the International Monetary Fund under the Articles of Agreement of the Fund including the use of exchange actions which are in conformity with the Articles of Agreement provided that a member shall not impose restrictions on any capital transactions inconsistently with its specific commitments regarding such transactions, except under Article XI1 or at the request of the Fund.

[163] GATS, Article XII (1).

their economic or development programmes". However, paragraph (3) prohibits such restrictions to "be adopted or maintained for the purpose of protecting a particular service sector".

Paragraph (4) of Article XII obliges States to promptly notify the General Council of the adoption or maintenance of such restrictions. Members are also required to promptly consult with the Committee on Balance of Payments Restrictions regarding restrictions adopted under Article XII. Paragraph *5* (b) of Article XII gives the Ministerial Conference the jurisdiction to "establish procedure"[164] for periodic consultations with the objective of enabling such recommendations to be made to the Member concerned as it may deem appropriate".

Settlement of Disputes

The GATS only regulates State-State disputes. Thus, the GATS dispute settlement mechanism can be employed whenever a member claims that another member's failure to fulfill its GATS obligations results in the nullification or impairment of a benefit (or even just a reasonable expectation of a benefit),[165] accruing to it under the GATS.

GATS Articles XXII and XXIII incorporate the Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU). According to GATS Article XXII, consultations is the first approach to solving disputes between members. Paragraph (l) of Article XXII provides that member states "shall accord sympathetic consideration to, and shall afford adequate opportunity for, consultation regarding such representations as may be made by any other Member with respect to any matter affecting the operation of [the GATS]". The paragraph then declares that the "Dispute Settlement Understanding (DSU) shall apply to such consultations". According to the DSU, the member requesting

[164] For the procedure under this paragraph, the GATS incorporates the same procedures of the GATT 1994. See GATS, *A*rticle. XII, footnote.

[165] GATS Article XXIII(3) provides that: "If any member considers that any benefit it could reasonably have expected to accrue to it under a specific commitment of another Member under Part III of this Agreement is being nullified or impaired as a result of the application of any measure which does not conflict with the provisions of this Agreement it may have recourse to the DSU [Dispute Settlement Understanding]. If the measure is determined by the DSB [Dispute Settlement Body] to have nullified or impaired such a benefit the Member affected shall be entitled to a mutually satisfactory adjustment on the basis of paragraph 2 of Article XXI, which may include the modification or withdrawal of the measure. In the event an agreement cannot be reached between the Members concerned Article 22 of the DSU shall apply."

consultation should make a written request to the other member in dispute, to which the latter should reply within 10 days after the date of its receipt and should enter into consultations in good faith within a period of no more than 30 days after the date of receipt of the request, with a view to reaching a mutually satisfactory solution.[166] If the consultations, however, prove unsuccessful within 60 days after the date of receipt of the request for consultations, the member seeking consultations may request the establishment of a dispute settlement panel.[167]

Upon the request of the complaining party, the Dispute Settlement Body (DSB) must establish such a panel in a very short period of time (at the latest at the DSB meeting following that at which the request fiat appears as an item on the DSB's agenda), in order to "examine, in the light of the relevant provisions.. . . the matter referred to the DSB by [the complaining party] and to make such findings as will assist the DSB in making the recommendations...."[168]

After the establishment of the panel, the dispute is subjected to a fast and effective process and deadlines; the panel should conduct its examination of the dispute and circulate its final report to the disputing parties within 6 months from the date of its composition; and the report of the panel should be adopted by the DSB within 60 days after its circulation to the member in dispute, "unless a party to the dispute formally notifies the DSB of its decision to appeal or the DSB decides by consensus not to adopt the report". In this case, a standing Appellate Body should be established by the DSB to view the appeal. The Appellant Body should submit its final report to the DSB for adoption within "60 days from the date a party to the dispute formally notifies its decision

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[166] If the Member does not respond within 10 days after date of receipt of the request or does not enter into consultations within a period of no more than 30 days, or a period otherwise mutually agreed after the date of receipt of the request then the Member chat requested the holding of consultations may proceed directly to request the establishment of a panel. See DSU, Art. *4 (3)* .

[167] Furthermore, the complaining party "may request a panel during the 60-day period if the consulting parties jointly consider that consultations have failed to settle the dispute". Art. 4(7). Article 5 of the DSU permits the contracting parties to have recourse to "Good offices, conciliation and mediation". According to paragraph (3) of Article 5, "Good offices, conciliation or mediation may be requested at any time by any party to a dispute [andl ... may be terminated at any time. Once procedures for good offices, conciliation or mediation are terminated a complaining party may then proceed with a request for the establishment of a panel."

[168] DSU, Article 7(1).

to appeal to the date the Appellate Body circulates its report".[169] In any case, a dispute settlement decision should be rendered by the DSB within a maximum of 9 months (or 12 months where the report is appealed) from the date of the establishment of the panel.

2.7.4 The Agreement on Trade-Related Investment Measures and Developing Countries

The Uruguay Round negotiations leading to the conclusion of the TRIMS Agreement demonstrated the inherent conflict between developed and developing countries regarding FDI regulation. Developed countries, led by the US, were of the opinion that TRIMS are 'a barrier to a liberal trade regime.'[170] Their initial negotiation agenda aimed at establishing a "GATT for investment". Developing countries, on the other hand asserted that the use of TRIMS is justified as a means to encounter abusive MNEs practices and to channel FDI towards their development objective. [171] Accordingly, developing countries aimed at limiting the scope of TRIMS negotiations to measures "with direct and significantly adverse trade effects only. An examination of the TRIMS Agreement reveals developing countries' success in narrowing its scope.

The scope of application of the TRIMS Agreement is defined in its Article I which States that it "applies to investment measures related to trade in goods only". "'TRIMS are basically investment restrictions imposed by host countries that directly affect trade flows by either restricting imports or exports or requiring imports or exports.[172] Thus, by definition, the TRIMS Agreement has a very narrow scope.

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[169] However, "when the Appellate Body considers that it cannot provide its report within 60 days it shall inform the DSB in writing of the reasons for the delay together with an estimate of the period within which it will submit its report. In no case shall the proceedings exceed 90 days." DSU, Article 17(5).

[170] The US proposed a comprehensive list of TRIMS that it considered to be trade-distorting. The list included: local content requirements, export performance requirements, trade balancing requirements, product mandating requirements, domestic sales restrictions, foreign exchange and remittance restrictions, local equity requirements, technology transfer and licensing requirements, and investment incentives. The European Union supported the United States in all but technology transfer requirements and local equity restrictions. Japan supported all but local equity restrictions.

[171] P. Low & A. Subramanian, "Beyond TRIMS: A Case for Multilateral Action on Investment Rules and Competition Policy?" in W. Martin & L. A. Winters, eds, *the Uruguay Round and the Developing Countries* (New York: Cambridge University, 1996), 380-408 at p. 380.

[172] Low and Subramanian describe TRIMS as "measures employed usually, but not exclusively, by developing countries to compel or induce multinational enterprises to meet certain yardsticks of

According to its Article 1, the TRIMS Agreement applies only to investment measures, leaving several other important aspects of FDI unregulated; the TRIMS Agreement does not, for example, cover FDI screening, establishment rights, profit repatriation, expropriation and compensation issues. Moreover, the TRIMS Agreement does not even cover all investment measures: the TRIMS Agreement only deals with trade-related investment measures. These include local content requirements, trade balancing requirements, general import restrictions, trade balancing restrictions, foreign exchange balancing restrictions on imports, domestic sales requirements (export restrictions). Investment measures that are not trade-related and thus not covered by the TRIMS Agreement include: local equity requirements, technology transfer and licensing requirements, local manufacturing requirements, personnel entry restrictions, local employment requirements, remittance restrictions, and export performance requirements, among others.

TRIMS are dealt with in the TRIMS Agreement by simply applying the existing GATT Articles to them. Article 2(1) of the TRIMS Agreement proscribes trade-distorting investment measures that are inconsistent with GATT Articles III (national treatment) and XI (prohibition on quantitative restrictions).[173] The Annex to the TRIMS Agreement provides an illustrative line of such measures. According to the Annex, investment measures which are inconsistent with the GATT's national treatment obligation and the GATT's obligation of general elimination of quantitative restrictions "include those which are mandatory or enforceable under domestic law or under administrative rulings, or compliance with which is necessary to obtain an advantage". Investment measures which are violative of GATT's national treatment obligation include those that require:

(a) the purchase or use by an enterprise of products of domestic origin or from any domestic source, whether specified in terms of particular products, in terms of volume or value of products, or in terms of a proportion of volume or value of its local production: or

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performance. They tend to be concentrated in specific industries: automotive, chemical and petrochemical, and computer/informatics." Low & Subramanian, ibid., at pp. 380-381.

[173] Article 2 (1) states: "Without prejudice to other rights and obligations under GATT 1994, no Member shall apply any TRIM that is inconsistent with the provisions of Article III or Article XI of GATT 1994." *TRIMS Agreement, A*rticle 2(1).

(b) that an enterprise's purchases or use of imported products be limited to an amount related to the volume or value of local products that it exports.[174]

TRIMS inconsistent with the GATT's obligation of general elimination of quantitative restrictions include those which restrict:

(a) the importation by an enterprise of products used in or related to its local production, generally or to an amount related to the volume or value of local production that it exports;

(b) the importation by an enterprise of products used in or related to its local production by restricting its access to foreign exchange to an amount related to the foreign exchange inflows attributable to the enterprise: or

(c) the exportation or sale for export by an enterprise of products, whether specified in tens of particular products, in terms of volume or value of products, or in terms of a proportion of volume or value of its local production.[175]

The extent of liberalization of the TRIMS Agreement is further narrowed by the important exceptions it introduces. First of all, Article 3 explicitly provides that all exceptions under GATT 1994 are applied, as appropriate, to the provisions of the TRIMS agreement. Article 4 grants developing countries the right to deviate from their obligations under Article 2 of the TRIMS Agreement in cases of balance-of payments difficulties, in accordance with GATT Article XVILI. Moreover, Article 5(2) gives countries a transition period before eliminating all TRIMS inconsistent with the TRIMS Agreement. This period was two yean for developed countries, five years for developing countries, and seven years for the least-developed countries. Nonetheless, Article 9 requires a review of the TRIMS Agreement at the turn of the century by the Council for

[174] Article 2(2) states: "A*n* illustrative list of TRIMS that are inconsistent with the obligation of national treatment provided for in paragraph 4 of Article III of GATT 1994 and the obligation of general elimination of quantitative restrictions provided for in paragraph 1 of Article XI of GATT 1994 is contained in the annex to this Agreement."

[175] It should be noted that the transparency article of the TRIMS Agreement obliges member to notify the WTO Secretariat of existing TRIMS and to provide additional information to member States in that regard upon request. See TRIMS Agreement, Article 6.

Trade in Goods.[176] After reviewing the operation of the TRIMS Agreement, the Council for Trade in Goods must make proposals for textual amendments to the Ministerial Conference. The review by the Council for Trade in Goods must consider the need to complement the TRMS Agreement "with provisions on investment policy and competition policy".

As for the settlement of disputes, the TRIMS Agreement takes a similar approach to that of the GATS: the TRIMS Agreement incorporates the GATT settlement of dispute mechanism and the DSU. Article 8 of the TRIMS Agreement clearly states that the provisions of Articles XXII and XXIII of GATT 1994, as elaborated and applied by the Dispute Settlement Understanding shall apply to consultations and the settlement of disputes under the TRIMS Agreement.

The TRIMs Agreement and Developing Countries

Developing countries consider regulating investment policies a sovereign right necessitated by national economic considerations. Their opposition in the WTO has lead to a moderately restricted and narrow regulation of FDI. An examination of the WTO framework for regulating FDI reveals the developing countries' success in limiting its degree of liberalization and narrowing its scope.

Just as the TRIPS Agreement is limited to trade-related aspects of intellectual property rights, the GATS is also by definition limited to investments related to trade in services and furthermore, allows several general and country specific exceptions to deviate from the obligations it imposes. The TRIMS Agreement, moreover, is also limited in scope; it deals only with investment measures, leaving other important aspects of FDI unregulated, such as FDI screening, establishment rights, profit repatriation, expropriation and compensation issues. Additionally, the TRIMS Agreement does not even cover all investment measures as it only deals with trade-related investment

[176] Article 9 states:
Not later than five years after the date of entry into force of the WTO Agreement, the Council For Trade in Goods shall review the operation of this Agreement and as appropriate and propose to the Ministerial Conference amendments to its text. In the course of this review, the Council for Trade in Goods shall consider whether the Agreement should be complemented with provisions on investment policy and competition policy.

measures and, further, gives space to important exceptions to the application of its provisions.

Although most developing countries regard the balance of interests of the WTO FDI framework considerably fair, developed countries view it as only a moderate first step towards a more comprehensive and liberal FDI regulation.

2.7.5. The Agreement on Trade-Related Aspects of Intellectual Property Rights

The TRIPS Agreement complements the WTO framework regarding FDI regulation. The TRIPS Agreement provides the necessary protection for the transfer of technology through FDI operations. Article 7 of the TRIPS Agreement clearly states that the objective of the Agreement is to facilitate and provide adequate protection for technology transfer.[177]

This is believed to be advantageous for both MNEs and host developing countries as it provides crucial protection for FDI by MNEs with intellectual property as their core competence, and, at the same time, gives incentives for MNEs to undertake technological transfers to host countries. Although it is generally believed that there is a positive relation between the level of protection in a country's intellectual property rights laws and its attractiveness *to* FDI as an investment site. Some commentators believe that "the magnitude of the impact of weak protection on FDI decisions is debatable".[178] One commentator argues as follows:

> *First, evidence based on surveys of foreign investors that identified IPRs [intellectual property rights] as a relevant variable for FDI decisions tend also to point out that other considerations -in essence, the overall investment climate of the country- are more important (Frischtak 1989). Second, FDI may replace trade flows as firms try to maintain control of proprietary information in countries with weak IPR protection. In this*

[177] Article 7 states: "The protection and enforcement of intellectual property rights should contribute to the promotion of technological innovation and to the transfer and dissemination of technology, to the mutual advantage of producers and users of technological knowledge and in a manner conducive to social and economic welfare, and to a balance of rights and obligations." TRIPS *Agreement, A*rticle 7.

[178] A.Z. Hertz "Proceedings of the Canada-United States Law Institute Conference: NAFTA Revisited: Shaping the Trident: Intellectual Property Under NAFTA. Investment Protection Agreements and At the World Trade Organization" (1997) 23 *Can.-U.S.* L.J. *16* 1 at p. 280.

case, the impact of TRIPS would be to diminish the incentives of R&D-intensive industries for FDI at the margin ....[179]

Nonetheless, the fact that the effect of intellectual property rights (IPRs) protection on the location decision of FDI is limited does not render IPRs protection unrelated *to* FDI regulation On the contrary, any complete regulation of FDI should address the matter of IPRs protection since IPRs policies certainly affect FDI operation. Like the GATT, the GATS and the TRIMS Agreement, the TRIPS Agreement is based on the foundations of the MFN treatment, national treatment and transparency principles.[180]

Article 3 of the TRIPS stipulates that a member "shall accord to the nationals of other Member treatment no less favourable than that it accords to its own nationals with regard to the protection"' of intellectual property". Article 4 provides that "any advantage, favour, privilege or immunity granted by a Member to the nationals of any other country shall be accorded immediately and unconditionally to the nationals of all other Members".

The transparency principle, introduced in Article 63 (1) obliges member States to publish their laws and regulations, along with any final judicial decisions and administrative rulings related to the TRIPS Agreement. Developing and least-developed countries get a slightly more favourable treatment than developed countries under the TRIPS Agreement. Article 65 grants developing countries an extra four-year delay in applying the TRIPS Agreement, except for Articles 3 and 4 (national treatment and MFN treatment); and Article 66 relieves least-developed country members of applying the provisions of the TRIPS Agreement, other than Articles 3.4 and *5,* for a period of 10 years from the date of its application. Moreover, Article 66 allows the Council for TRIPS to extend this period for least-developed member countries upon their request. Paragraph

[179] C.A. Primo Braga, "Trade-related Intellectual Property Issues: The Uruguay Round Agreement and its Economic Impact" in W. Martin & L. A. Winters, eds., The *Uruguay Round and the Developing Countries* (New York: Cambridge University, 1996) at pp. 341-379. See also UN *Conference on Trade and Dev,.* The TRIPS Agreement and Developing Countries (UN. Sales No. E.96.11.D.IO) (1996).

[180] It may be noted, however, that the TRIPS Agreement includes several other detailed and substantive obligations regarding the standards concerning the availability, scope, use, enforcement, acquisition and maintenance of intellectual property rights. See *TRIPS Agreement, P*arts II-IV.

(2) of Article 66 calls on developed member countries to "provide incentives to enterprises and institutions in their territories for the purpose of promoting and encouraging technology transfer to least-developed country Member in order to enable them to create a sound and viable technological base".[181]

As for the settlement of disputes, the TRIPS Agreement uses the same approach as that of the TRIMS Agreement: it incorporates the GATT's dispute settlement mechanism and the DSU. As stated in Article 61(1), the "provisions of Articles XXII and XIII of GATT 1994 as elaborated and applied by the Dispute Settlement Understanding ... apply to consultations and the settlement of disputes under [the *TRIPS* Agreement] except as otherwise specifically provided [in it]".

2.7.6 Inadequacy of the Investment-related Rules in the WTO

In fact, some investment-related rules have been established in the WTO regime. Some investment-related principal concepts have been incorporated into the preambles of Agreement Establishing the World Trade Organization and the General Agreement on Tariffs and Trade (GATT). Both agreements in their preambles call for parties to take into account the full use of the resources of the world and the expansion of the production and exchange of goods when they conduct their relations in the field of trade and economic endeavor.[182] We can see that the expansion of the production of goods (which should be understood as including international production) and the expansion of the exchange of goods (which should include independent intra-firm trade) are basic objectives of the world trading system. The two agreements in their preambles further state that, in order to contribute to that objective, all parties are committed to substantially reduce tariffs and other barriers to trade and to eliminate discriminatory treatment in

[181] Moreover, Article 67, titled *Technical Cooperation* provides that: "Developed country Members shall provide, on request and on mutually agreed terms and conditions, technical and financial cooperation in favour of developing and least-developed country Members. Such cooperation shall include assistance in the preparation of laws and regulations on the protection and enforcement of intellectual property rights as well as on the prevention of their abuse, and shall include support regarding the establishment or enforcement of domestic offices and agencies relevant to these matters, including the training of personnel."

[182] WTO, Agreement Establishing the World Trade Organization and General Agreement On Tariffs And Trade, http://www.wto.org/english/docs_e/legal_e/final_e.htm.

international trade relations through multilateral arrangements. Since international expansion of the production and exchange of goods in the mode of independent intra-firm trade are based on FDI, arguably, the two agreements in fact link FDI with trade, and recognize the negative effects of restrictive trade measures on international production and distribution of goods.

The WTO TRIMs Agreement in its preamble expresses the desire to promote the expansion and progressive liberalization of world trade and the desire to facilitate investment across international frontiers so as to increase the economic growth for all trading partners, while ensuring free competition. It is the first time that the WTO has recognized trade and FDI as two primary means to achieving economic growth. Moreover, the preamble stresses the importance of maintaining free market competition in economic growth - which suggests that the WTO members should refrain from using market-distorting trade and FDI measures to achieve economic growth. More importantly, the preamble explicitly recognizes that certain investment measures can cause trade-restrictive and distorting effects.'" Arguably, the applicable scope of the TRIMs Agreement can be so wide as to encompass all restrictive and incentive trade or investment related agreements, because every such restrictive or incentive agreement can produce some "trade-restrictive or distorting effect". Thus, the statement in the preamble leaves it open for including more such arrangements into the TRIMs Agreement. Nevertheless, the related WTO agreements do not explicitly recognize the contribution of FDI to world trade and the contribution of trade to FDI, nor do they fully recognize the importance of free capital movement or capital liberalization in economic growth.

Although the TRIMs agreement proscribes certain FDI measures that restrict or distort trade, like local content requirements, trade-balancing requirements, and balance of payments requirements, many other FDI measures that impede or distort trade, mainly incentive trade or investment related agreements, are left undisciplined. The Agreement on Subsidies and Countervailing Measures (ASCM) has prohibited certain trade or investment related agreements in the form of subsidies. Nevertheless, many arrangements that distort or impede FDI, which are mainly in the form of incentives, have not been disciplined in the WTO. Other discriminatory and restrictive FDI measures and the issue of FDI protection are even not on the agenda of the WTO. As one WTO member has

commented, FDI-related provisions in the WTO agreements such as the TRIMs Agreement, the GATS and the ASCM are limited in scope and lack coherence, therefore, members should strengthen FDI rules in the WTO to ensure that the benefits of trade liberalization will not be eroded by distortive investment measures.[183]

Despite the lack of effectiveness of the WTO in dealing with TRIMs, many countries are not committed to negotiating an MAI in the WTO system. The main reasons given are: they cannot see any direct or additional benefits fiom an MAI; they insist that FDI is not a trade issue; and finally, they consider autonomous FDI liberalization and bilateral FDI treaties enough to promote and protect.[184]

For some countries, this reluctance may be due to the lack an adequate recognition of the importance of FDI in world trade and domestic economic development. If it is only a recognition problem, it c m be solved once these counties realize the positive link between trade and FDI and the negative impacts of TRIMs on trade and economic development. However, some countries reject an MAI simply for the sake of domestic "policy flexibility". In such a case, it is difficult to persuade these countries to commit to an MAI, because most often, the real motive behind the ostensible reason is to serve either domestic political interests or the interests of special groups at the expense of consumers and economic development. Any international agreement necessarily involves a loss of a measure of policy flexibility, but this would be compensated by a gain in terms of greater predictability and stability of rules. Besides, an MAI in the WTO would have the scope and flexibility desired by its Members. The GATS is such an example regarding a particular kind of FDI which fully takes into account the specific situation of each country and the differences in level of development between Members.

Countries favoring autonomous liberalization and bilateral treaties over an MAI argue that, in the current context of closer global economic integration in which the importance of FDI to development is generally recognized, countries are likely to make

[183] See the discussions in the WTO Report (2000) Of The Working Group on The Relationship between Trade and Investment to the General Council, 27 November 2000, WT/WGTI/4, http://docsonline.wto.org/gen_search.asp

[184] The WTO , Agreement Establishing the World Trade Organization and General Agreement On Tariffs And Trade, http://www.wto.org/english/docs e/legal e/final e.htm.

every effort through legislation or best practices to compete successfully for FDI. They also argue that the recent increase in FDI flows have occurred in the absence of a multilateral frame work.[185] This argument is unconvincing in many ways. Firstly, the functions of autonomous liberalization and bilateral treaties are different from the function of an MAI, and they cannot fully replace each other. The approach of autonomous liberalization stresses the controlling and maneuvering power of the host government while bilateral investment treaties concentrate on the protection of investment. Although both to some extent promote and protect FDI, they are by no means satisfactory. They do not target many FDI barriers and distorting measures. As well, they cannot deal with many problems such as transparency, government competition, and discrimination. An MAI should have the scope to deal with these problems and issues. Secondly, although developing countries have begun to liberalize their investment regimes, this liberalization has been only partial.[186] Furthermore, without an underlying standstill or rollback obligation of a multilateral investment agreement, this modest liberalization can be easily reversed. An MAI in the WTO, therefore, would at a minimum lock in the current levels of liberalization. Thirdly, possible gaps and conflicts among existing international investment instruments may restrict market contestability, distort investment flows, reduce economic efficiency, and thus frustrate the objective of such instruments.[187] Although there is a large degree of commonality between existing instruments in terms of basic principles, specific rights and obligations vary. Therefore, there may be potential for conflicts arising from investment agreements that are designed to address the priorities and concerns of the parties involved without proper regard to the potential negative impacts on third parties. Lastly, arguably, an MAI in the WTO will generate more FDI flows and thus produce more benefits to host countries. An MAI can play a special role in promoting FDI flow and world welfare which autonomous or bilateral liberalization cannot substitute for.

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[185] The discussions in the WTO Report (2000) Of The Working Group on The Relationship between Trade and Investment to the General Council, 27 November 2000, WT/WGTI/4, http://docsonline.wto.org/gen_search.asp

[186] Eric M. Burt, Developing countries *and* the Framework for Negotiations on Foreign Direct Investment in the World Trade Organization, American University Journal of International Law and Policy, 1997.

[187] Ibid.

Many developed countries are not fully committed to an MAI in the WTO, mainly due to the political pressure from anti-free trade or anti-globalization movements in these countries. The anti-free trade movement mainly targets the free movement of goods and capital - the most tangible manifestation of globalization. The extensive and substantial reservations to the MAI draft made by each member state were obviously the result of a strong anti-free trade or anti-globalization sentiment arising from the civil society in those developed countries. These reservations had rendered an MAI less than compelling. However, most of the criticisms currently directed against free trade in general, and the WTO in particular, are either false, incoherent, or fatuous.[188] The same is true with respect to the anti-capital sentiment. Although most motives behind the anti-free trade or anti-globalization movement are either trade protectionism or unjustifiable concerns, they nevertheless constitute a major obstacle for developed countries to commit to a MAI in the WTO.

[188] Michael J. Trebilcock, Mostly Smoke And Mirrors: NGOs And The WTO, U.S. Library of Congress and New York University Law School Conference, New York University Law School, March 10, 2000.

Chapter 3

LEGAL AND REGULATORY ENVIRONMENT FOR FDI IN PAKISTAN: AN EVALAUATION

In the first part of this chapter, we will turn our attention to issues affecting the general investment climate in Pakistan. We will first review the investment guarantees found in the foreign investment legislation. Such guarantees, along with other advantages form part of the wider incentive package designed to attract foreign investment. After having examined these investment incentives, we will then bring our attention to the major regulatory disincentives to investing in Pakistan. We will study the Independent Power Producers' disputes, analyzing the Hubco affair and three other disputes as illustrative cases that demonstrate the various risks and the legislative and judicial inadequacies in contractual and investment protection issues.

3.1 Investment Climate in Pakistan

The overall political climate in any country is bound to have an impact on FDI inflows as it affects the long-term investment strategies of multinational corporations (MNCs). Three distinct government investment liberalization initiatives begun in 1992, 1997, 2000 and 2005 have progressively opened Pakistan to foreign investment, offering broad arrays of incentives to attract new capital inflows. A number of barriers to the flow of capital and international direct investment have been removed. Foreign investors do not face any restrictions on the inflow of capital, and investment of up to 100% of equity participation is allowed in most sectors (local partners must be brought in within 5 years and contribute up to 40% of the equity in the services and agriculture sectors). Unlimited remittance of profits, dividends, service fees or capital is now the rule. Business regulations are now among the most liberal in the region. On these grounds, Pakistan appears much more investor friendly than its larger neighbour, India. However, implementation of business regulations especially by the lower level bureaucracy could still be improved.

The fact that Pakistan imposes no limit on the percentage of foreign ownership in enterprises operating within its borders has often been cited as an indication of its receptiveness to foreign investment. However, one must not forget that although wholly foreign-owned enterprises are indeed owned in Pakistan, they are not necessarily Pakistani authorities' favorite form of investment. Approval for 100% foreign-owned businesses is, in practice, harder to obtain than for joint venture enterprises and it is only granted in certain sectors of the economy while other sectors remain simply off-bits to wholly foreign-owned enterprises.

Tariffs have been reduced to an average rate of 16%, with a maximum of 25% (except for the car industry). The privatization process, which started in the early 1990s, has gained momentum, with most of the banking system privately owned, and the oil sector targeted to be the next big privatization operation. It is worth noting, however, that very few OECD investors have shown an interest in privatization: Most investors come from the Middle East and China.

A foreign company can have its representation in Pakistan established through various legal forms such as (i) a partnership, (ii) a privately or closely held limited liability company or (iii) a public limited company which may or may not be quoted on the stock exchange. A variation in the form of limited companies is that of Companies Limited by Guarantee.[1] In case a foreign investment is in a noncommercial or charitable venture then choice of a Foundation or a Trust is also available. Though the Pakistani law recognizes the formal presence rule like most of the Common law jurisdictions, the legal and regulatory framework of Pakistan does not operaste fully to extend equal benefits to all kinds of vehicles for FDI. For instance, a foreign company can establish a place of business in Pakistan (which includes a branch, share transfer or registration office, factory, mine or other fixed place of business) without formally creating a separate legal entity. A liaison office can be established by a foreign company for the purpose of marketing activities in Pakistan and to acquire contracts from Government and private sector. A liaison office is converted into a branch office whenever the foreign company

[1] The main legislation governing incorporated companies is the Companies Ordinance of 1984 and the Companies Rules of 1985. These two statutes provide the law and regulation which deals with private or public limited companies including foreign controlled companies. Partnerships and proprietorships are governed by the Partnership Act of 1932.

gets a contract in Pakistan in any field of economy.[2] Experience indicates that banking facilities and recourse to local lending that can be crucial for saving foreign currency reserves is not fully available to the branch or liaison offices

3.1.1 Equitization and Privitization

Despite frequent changes in the governments, there has been consensus on the continuation of privatization policy and as such it is expected to be cornerstone of all the future government policies, at least in the near future. Divestiture of assets is not new to Pakistan though the motivation for divestiture has not been the same in different time periods. During the 50s and the 60s, public sector used to invest in non-traditional activities especially where the gestation period was long and private sector was reluctant to invest. While a large number of private sector units were nationalized and public sector expanded at a rapid rate in the 70s, an effort to divest public sector enterprises were made during the mid-eighties. However, the efforts to divest shares worth Rs 2 billion of various profit making public enterprises in the mid-eighties and 14 loss making industrial units for divestiture in 1988 did not succeed. Similarly, out of the six profit-making corporations identified for partial divestiture in 1990, only 10 per cent shares of Pakistan International Airlines could be divested.

The Government promulgated Privatisation Commission Ordinance, 2000 with the aims to ensure level playing field for existing and future entrants, protecting

[2] Permission for opening of branch/ liaison office may be granted by the BOI for a period of 3 to 5 years. Further extension will be granted by the BOI after reviewing and examining the past performance of foreign companies. Request for renewal or extension will be processed by the BOI with two weeks provided the requests are supported with complete documentation. Companies who wish to open their branch / liaison or representative offices in Pakistan may apply to BOI for permission on prescribed forms. The BOI will process and decide such cases within 2 to 3 weeks. Once the permission is granted by BOI, the foreign entities are required to register with the Securities and Exchange Commission of Pakistan under the Companies Ordinance 1984. The following documents must be submitted with the BOI and SECP for permission and registration of Branch/Liaison Offices of a foreign company in Pakistan: i. Application on a prescribed form duly completed and signed by the Principal Officer of the proposed branch/liaison office in Pakistan. ii. Minutes of the meeting of the Board of Directors of company regarding the opening of office in Pakistan. iii. Article of Association of Company iv. Certificate of Incorporation of the Company in the country of origin. v. Letter of appointment of Branch Manager/Principal Officer of Company for Pakistan Office. vi. Letter of acceptance by Branch Manager/Principal Officer for accepting his position as Branch Manager/ Principal Officer of Pakistan Office of foreign company. vii. Power of attorney in favour of an individual or firm to act as consultant for providing such professional services. viii. Copy of the contract awarded (in case of Branch/Project Office)

consumer and taxpayer interests and dealing with public employees in a fair manner. The Ordinance strives, *inter alia* to:

- Ensure that the Government policies and objectives are met;
- Ensure widest possible participation in privatization;
- Ensure that monopolies are not created in the process of privatization; and
- Strengthening of regulatory framework for independent and fair regulation.

The modes of privatization that commission can opt for have been prescribed in the Ordinance as follows:

- Sale of assets and business;
- Sale of shares through public auction or tender or public offering of shares through a stock exchange;
- Management or employees buyouts by the management or the employees of a state owned enterprise;
- Lease, management or concession contracts; or
- Any other method as may be prescribed.

A total of 147 entities had been privatized fully or in part until end of 2006, with proceed of Rs 176.48 billions. The number of privatized units up to June 2003 was 132, while process on 14 more units was completed between July 2003 and May 2005. It takes roughly 18 months for the process of handing over to new owners. Privatization Commission has been also instrumental in the restructuring and revitalization of various units and liquidation of non-viable and sick units in order to curtail losses and stop financial hemorrhaging in the public sector. In the financial year 2005-06 Privatization Commission achieved unprecedented success on the privatization front as it was able to take strides on the strategic sale of mega projects like KESC, Pak Arab Fertilizers, Mustehkam Cement, Javedan Cement, CTI, PTCL, and Pak American Fertilizer Limited. For the first time the sale moved beyond the favorite banking and financial sectors. The upfront payment of US$1.4 million by Etisalat and transfer of management control of the PTCL has already taken place.

For many major transactions, the ability to privatize and the amount of proceeds realizable depend critically on the level of regulated prices for the public enterprise's inputs or outputs and other sectoral or regulatory policies. For many monopolies or quasi-monopolies, the "rules of the game" specifying the competition framework post

privatization, the manner and type of regulation, and the institutions regulating them are key to investor interest. In addition to rules determining prices or tariffs, there may be rules determining standards, penalties for noncompliance, the extent, form and timing of any proposed deregulation, and the evolving structure of the market following liberalization. Clarification of these rules and passage of needed laws and regulations will often be necessary before taking the transaction to market.

Privatization and other incentives offered are expected to increase the investment levels. As a matter of fact the investment had started rising but political instability and the problems with IPPs may tend to set-off levels of investment.

3.2 Investment Protection

Investment guarantees offered by the host country are meant as tools to bolster foreign investment.[3] Understandably, foreign investors want to be reassured that their investment will be protected as far as possible against state action. Thus, Pakistani governments have taken pains to enact certain investment guarantees in the country's foreign investment legislation. In addition, Pakistan has entered into double taxation agreements with 51 countries and has committed to the principle for equal treatment under its investment laws. It has also entered into bilateral agreements on promotion and protection of investment with 40 countries. Even more so than the investment guarantees under its foreign investment legislation, the BITs Pakistan has concluded demonstrate a genuine commitment to protect the interests of foreign investors. Indeed, BITs present a much more reliable protection because they are binding upon the parties under international law and cannot be unilaterally modified as is the case with the investment protections granted under domestic laws.

The Foreign Private Investment (Promotion & Protection) Act of 1976 (FPIA) was enacted to promote and protect foreign private investments in the country. FPIA provides protection to foreign investors with respect to their industrial establishments in Pakistan, precludes the Government from acquiring foreign capital or foreign investments

[3] "Such guarantees are usually given by high risk countries in the hope that risk perceptions arising from past nationalisations will be counteracted by the guarantees. Low risk states obviously have little need to issue such guarantees." M. Sornarajah, *The International Law on Foreign Investment* (Cambridge: Cambridge University Press, 1994).

in an industrial undertaking except under due process of law with adequate compensation.[4] It upholds the principle of equal treatment to foreign owned industrial undertakings with regard to laws, rules and regulations.[5] Furthermore, Section 6 of the Act confirms the availability of permission for repatriation of capital and profits in foreign exchange as well as remittance by foreign employees for maintenance of their dependents abroad.

The Protection of Rights in Industrial Property Order (President Order No.5), 1979 provides that no person shall be deprived of his industrial property save in accordance with law. It further declares that no industrial property shall be compulsorily acquired or taken possession of save for a public purpose and save by the authority of law which provides for adequate compensation being given therefore within a reasonable time specified therein either fixes the amount of compensation specifies the principles on and the manner in which compensation is to be determined and given.

The Protection of Economic Reforms Act, 1992, was subsequently enacted mainly to provide legal cover for economic reforms related to privatization and deregulation and other fiscal incentives introduced on and after 07 November 1990, through various policies, programmes and regulations of the Government. Contrary to the FPIA, which allows the federal Government a take-over under due process of law, this law clearly lays down that no industrial or commercial enterprise or any equity investment in a company or financial institution shall be compulsorily acquired or taken over by the Government.

Section 8 of the Act declares that no foreign, industrial or commercial enterprise established or owned in any form by a foreign or Pakistani investor for private gain in accordance with law, and no investment in share or equity of any company, firm, or enterprise and no commercial bank or financial institution established, owned or acquired by any foreign or Pakistani investor, shall be compulsorily acquired or taken over by the Government. Section 8 of the Protection of Economic Reforms Act, 1992 gives an all-out guarantee that the assets and capital of foreign investors will not be nationalized or otherwise expropriated by the state thereby granting a much better protection than the

[4] The Foreign Private Investment (Promotion and Protection) Act, 1976, Section 5.

[5] Ibid. Section 9.

Hull formula of "prompt, adequate and effective" compensation in case of expropriation." However, while Section 8 grants complete protection against state requisition of foreign assets and capital, other provisions are hardly reconcilable with such unequivocal wording. Also, it is important to bear in mind that land rights are not protected against expropriation by the state.

Foreign currency account holders in Pakistan are assured that no restrictions will be placed on their deposits by the central bank.[6] The law assures the investors that the fiscal incentives allowed to them through rules and regulations shall continue for the term specified therein and shall not be altered to their disadvantage.[7] The Act also allows all Pakistani and foreign nationals to bring in and take out of the country foreign exchange without any restrictions.[8] However, this provision is neutralized by Section 2 of the Foreign Exchange (Temporary Restrictions) Act, 1998, that declares that notwithstanding anything contained in the Protection of Economic Reforms Act, 1992 (XII of 1992) or in any other law for the time being in force, or in any agreement or contract, it is hereby provided that the right to hold, sell, withdraw, transfer, pay or take out foreign exchange held by any person in Pakistan as on the twenty-eighth day of May 1998 without the prior permission of the State Bank of Pakistan shall remain suspended.

Understandably, foreigners doing business in evolving legal environments harbor particular concerns over potential changes in the legal frameworks of the host states. Thus, Pakistan has not taken steps to address such worries by granting foreign investors a protection against adverse legislative changes.

3.3 The IPPs and Other Cases involving Investment Disputes

Faced with chronic power shortages, the Government of Pakistan in 1994 initiated a study of Pakistan's future needs up to the year 2020. The report highlighted that additional generation capacity of about 9,800 MW was urgently needed by the year 2020. Of this recommended additional capacity, 4,600 MW was under construction, or in the early stage of planning and the balance of 5,200 MW was recommended to be implemented by the private sector.

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[6] The Protection of Economic Reforms Act, 1992, Section 5.
[7] Ibid. Section 6.
[8] Ibid. Section 4.

The Government formulated the 1994 power policy and invited for the first time, Independent Power Producers (IPPs) to invest in the power sector in Pakistan. To attract the first private investment of the IPPs, the Government offered generous tariffs. Construction started on Hub Power Plant (HUBCO) in 1993, with a capacity of 1,292 MW and a negotiated tariff based on a "cost plus" approach. Because of the very attractive Government incentives offered, 19 IPP projects arose and brought over $3 billion to install about 3,500 MW capacity. This excluded funding for HUBCO and WAPDA's Kot Addu Plant, which later was established as Kot Addu Power Company (KAPCO). The advantages of the 1994 power policy included quick implementation, and access to global capacity and technology resources. The drawbacks related to the absence of international competitive bidding procedures, un-staggered timing of the plant's commissioning, poor planning of the location of the power plants, and the inappropriate choice of imported furnace oil for the IPPs power plants. The poor physical location of IPPs power plants had the impact of putting severe strain on Pakistan's physical infrastructure, including the electricity transmission system.

With the commissioning of some IPP power plants in 1997, WAPDA and KESC purchased electricity from these IPPS. From 1998, Pakistan had excess capacity with the utilities contracted to purchase expensive IPP electricity while their own plants were underutilized.

Faced with the problem of having to purchase power from the IPPs and the two private sector operators - HUBCO and KAPCO at an expensive rate, the Government's financing of other public enterprises in the power sector was adversely affected. The Government contended that the $0.065/kWh rate of the IPPs, as per their agreement with the previous Government, is unaffordable for a country like Pakistan. In 1996-1997, WAPDA and KESC faced serious liquidity problems and defaulted on some of their financial commitments.

Pressure by the previous Government on the IPPs to lower their tariffs and to coerce a confession of corrupt practices in securing their approvals of their projects resulted in lengthy and complicated legal actions. ADB and other funding agencies advised the Government that it should delink the corruption issue from the tariff structure and resolve the IPP issue in an amicable and business-like environment and within the

framework of contractual agreements. The Government since than have resolved the HUBCO case and also implemented an orderly framework for resolving the IPP issue. Of the nineteen IPPs, three IPPs are operating under the original power purchasing agreements, one IPP was cancelled, and two others have opted out. As a result of the renegotiations, the purchase prices from IPPs were reduced by nine percent.

3.3.1 The HUBCO Affair

The Hub Power Project is owned by a public company incorporated in Pakistan whose shares are listed on the stock exchanges in Pakistan and in GDR form in Luxembourg. The Government of Pakistan provides Hubco a sovereign guarantee of the financial obligations of certain of the state entities involved, including WAPDA's, as the power purchaser, under a 30-year power purchase agreement (PPA).

Once the plant began supplying energy, WAPDA found that it had to pay, on the nail, monthly capacity payments because of the "take or pay" arrangements under the PPA, payments that it could not sustain without itself collapsing. The situation was compounded by the power policy of the Benazir Government which had led to an unsustainable investment in the thermal power sector amidst a drastic falling away of the demand for power, on which the policy's economic projections were based, caused by an ever-worsening macroeconomic situation and a contracting economy. Exacerbating all this was a massive devaluation of the Pakistani Rupee: under the PPA, WAPDA was obligated to pay for power in Rupees and must index certain elements of the capacity payments for dollar devaluation to ensure the investors a real dollar IRR of 18%. Payments to Hubco (and other IPPs as they came on line) burgeoned until they constituted a dangerously high proportion of WAPDA's revenues.

Eradication of Corrupt Business Practices Ordinance, 1998

On 18 April 1998, the Government of Pakistan promulgated the Eradication of Corrupt Business Practices Ordinance. This Ordinance was targeted only at the power sector. It required a sworn statement from the chief executive of any company which had entered into a power sector contract with any government entities that neither the Company nor its directors, officers or sponsors had committed any corrupt business practice in

obtaining such contract. If, on investigation by a person appointed by the Government, the declaration was found to be false, the Government was empowered to declare such a contract void without any adjudication by an impartial tribunal. Hubco and the other IPPs filed the required declarations on time.

The Writ Petition

On 8 May 1998 a constitutional petition under Article 199 of the Constitution of Pakistan, purportedly *pro bono publico*, was filed in the Lahore High Court (LHC) against the Company. The Petitioner, Mr Qureshi, challenged the decision of the GOP and WAPDA to enter into the PPA with Hubco on the grounds that the tariff was discriminatory in favour of the Company. The petition also accused the GOP, WAPDA of acting in bad faith and of having fixed a tariff, which was unjustifiable. Curiously, the Accountability Bureau was also made a party although no relief was sought against it. Equally curiously, the Company's capacity purchase price (CPP) invoice to WAPDA, dated as recently as 1 May 1998, barely a week before the Petition, was attached as an exhibit to the petition.

At the behest of Mr Qureshi, the LHC issued interim orders on 11 May 1998 which prohibited the Company from making any repatriation of funds outside Pakistan, although he only sought to prevent the Company from utilising or distributing a certain sum representing profit in the Company's accounts at the previous year end, the bulk of which had in any event been paid out the previous month as dividend. The Accountability Bureau also wrote to the State Bank of Pakistan (the central bank, monetary and exchange authority and banking regulator) the same day, shortly after the order was made, quoting the order and directing the State Bank to ensure its compliance by all banks and financial institutions. It also separately required the Company to disclose immediately the balances in all its bank accounts. The very next day the Accountability Bureau, claiming to investigate the truth of the Company's declaration under the Eradication of Corrupt Business Practices Ordinance, demanded that all the major documents of the Company be produced before the Bureau in Islamabad.

A week later, Mr Qureshi, the Petitioner, invoked the LHC requesting that the CPP paid by WAPDA be reduced to Rs. 845 million per month on the basis of a

comparison with another allegedly similar power project. The court did not grant the relief sought but instead passed an order that a unitary tariff of Rs. 1.50 per unit be paid by WAPDA to the Company. The Company applied to vacate these orders but was unable to obtain a suitably early date for hearing. Meanwhile WAPDA filed its response, in which the amendments to the PPA, which had occurred during Benazir Bhutto's government, were attacked for having been obtained fraudulently; it was alleged that the persons who agreed the final tariff with Hubco were coerced by higher officials, whose influence had been corruptly procured, into agreeing an exorbitant tariff. It was also stated that the WAPDA official signing the second amendment agreement had no authority to do so. This laid the ground for the dispute between Hubco and WAPDA.

When it could not get an early hearing, the Company appealed directly to the Supreme Court of Pakistan. The Supreme Court amended the High Court's orders so as to grant no more than what the petitioner had in fact sought. WAPDA was therefore directed not to pay more than Rs. 845 million per month for the capacity charge plus energy charges and Hubco was restrained from distributing its profits as shown in the accounts for 1997. In the event this provided the Company sufficient funds to continue running the company and not to default on payments to its lenders but there was not enough to pay the shareholders any more dividends.

In the course of the hearings, the Supreme Court of Pakistan had expressed the view that the matter should be resolved through negotiations. Meetings were therefore held from 11 June 1998 with the Accountability Bureau and WAPDA to resolve the dispute. At one of those hearings, the court required WAPDA to take a clear stand; in response, WAPDA filed a statement that Amendment No. 2 to the PPA was illegal and void and that it was not bound by it. Shortly thereafter, the Attorney General also informed the court of GOP's decision not to hold any further negotiations with the Company. The Company was left with no option but to seek a resolution of the dispute through the dispute resolution process provided in the PPA.

Request for ICC Arbitration

Accordingly, on 9 July 1998, the Company filed a request for ICC arbitration in London seeking a declaration that Amendment No. 2 to the PPA is valid and that WAPDA is bound by its terms.

Coercive Environment

The court proceedings during May-June 1998 took place against the background of a generally oppressive and coercive atmosphere in relation to the Company. On 19 May 1998 the power station at Hub was surrounded by the provincial police who prevented the foreign nationals working at the plant from leaving the plant. However, after diplomatic intervention, the police was withdrawn two days later. The Accountability Bureau required the delivery, within 24 hours, of virtually the whole of the Company's records (amounting to some 100,000 individual pieces of paper). While the Company made every effort to cooperate with the Accountability Bureau, when its demands exceeded all limits and action was threatened against the Company's finance director, the Company obtained court orders staying the unlawful and coercive acts of the investigating officer.

At the beginning of June 1998 the provincial Government of Balochistan also took a number of actions against Hubco, including the issue of notices alleging legal violations in relation to the property registration and acquisition of the plant site and environmental violations. During this time the Tax Authorities also raised various tax demands against the Company and sought to freeze the Company's bank accounts.

Criminal Complaints

On 3 September 1998, WAPDA filed two criminal complaints with the police against former and serving directors and officers of Hubco and a number of former government officers and WAPDA employees. The first alleged fraud and criminal conspiracy among them to cause wrongful loss to WAPDA and GOP and corresponding wrongful gain to the Company while the second (made only against the chief executive and finance director of Hubco) alleged meter tampering and theft of electricity. Meanwhile Hubco remained blissfully unaware of the existence of these complaints and its directors, acting

in the belief that GOP and WAPDA also wanted a reasonable commercial settlement, continued to discuss the tariff and related matters with WAPDA during the period between June and September 1998. A written offer to reduce the tariff was made on September 9, 1998.

Civil Litigation

In the light of these developments the Company's apprehension that WAPDA would seek to frustrate the arbitration proceedings by having the dispute adjudicated in the municipal courts appeared to be close to realisation. In November 1998, the Company, therefore, filed a suit in the SHC requesting the court to direct WAPDA to proceed to ICC arbitration and to restrain WAPDA from seeking to have the dispute resolved through any proceedings except ICC arbitration. The next four months saw much interlocutory and procedural wrangling, including an appeal by WAPDA to an appellate bench of the high court, which ordered a hearing of all the pending applications.

On 16 January 1999, WAPDA also filed a suit against the Company and others in the court of the Senior Civil Judge at Lahore claiming, *inter alia*, rescission of the agreements amending the PPA, the recovery of seventeen billion rupees, alleged to have been overpaid to the Company, unquantified damages and other consequential relief. As had already been anticipated, the court was also requested to restrain the Company from proceeding with the ICC arbitration in London and from seeking the recovery of any moneys under the standby letter of credit given by WAPDA to secure its payment obligations under the PPA. The same day an order was passed *ex parte,* restraining Hubco from proceeding with the arbitration and from recovering from the letter of credit.

A full hearing was held over several weeks before a single judge of the SHC, and an order was passed on 22 March 1999 whereby, *inter alia*, the Company was permitted to continue with the arbitration.[9]

Both WAPDA and the Company appealed this order, albeit on different grounds. The Appellate Bench immediately suspended the single judge's order, including the direction to proceed to arbitration, at WAPDA's behest. In addition to suspending the

[9] Hubco v. WAPDA 1999 CLC Karachi 1320.

order, the Appellate Bench went further and also restrained the Company from proceeding with the arbitration. The Company applied to vacate this order. After extensive hearings, concluding in June 1999, judgment was reserved. Almost two months later the court passed a short order declining to lift the injunction against proceeding with arbitration and stated that it would determine the application along with the WAPDA's appeal.

Preliminary Termination Notices (PTNs)

Following the repudiation of the amending agreements, the Company had issued notices to WAPDA under the PPA contending that this was a fundamental breach by WAPDA of the PPA which entitled it to exercise its contractual remedy of termination. Corresponding notices were also issued in respect of the Implementation Agreement (IA) to GOP and to Pakistan State Oils, the state-owned fuel supplier, under the Fuel Supply Agreement, as required by the contracts. These notices could have lead to the termination of the PPA and, as a consequence, the IA, which would have entitled the Company (and, through the Company, the shareholders of the Company) to compensation as set out in the IA. WAPDA therefore moved the SHC to suspend the PTNs but its request was refused.

Sovereign Guarantee

When WAPDA persisted in not paying the amounts due under the PPA up to the limit set by the Supreme Court of Pakistan's order that was Rs. 845 million, the Company called the GOP's sovereign guarantee on 23 September 1999 in respect of the unpaid sums. The call was met by silence.

Appeals in the Supreme Court

The Company petitioned the Supreme Court in early September 1999 for leave to appeal against the SHC's order of August 1999 refusing to lift the restraint on the Company proceeding with the arbitration.

At about the same time, WAPDA, having failed to obtain relief in the SHC in respect of the PTNs, also filed its own petition to the Supreme Court and applied to have

the PTNs, as well as the Company's call on the sovereign guarantee suspended. By an order passed *ex parte* in chambers by a single judge, further action on the PTNs as well as the call on the guarantee was stayed.

A five-member bench of the Supreme Court heard the Company's appeal on various dates over a period of three months between 15 February and 15 May 2000 and on 14 June 2000, by a majority of 3 to 2, dismissed the Company's appeal. The Company was restrained from invoking the arbitration clause in the PPA for the purpose of resolving its tariff disputes with WAPDA through the agreed forum of ICC arbitration. WAPDA's appeal was allowed (even though no hearing had taken place on it). The minority allowed the appeal and ordered the arbitration to proceed. [10] The majority found that prima facie the facts alleged by WAPDA raised issues of criminality which public policy required be tried by the domestic courts and not by international arbitrators. Hubco's case was that no matter what the facts, even if there was prima facie evidence of criminal conduct, the requirements of public policy were fully satisfied by the prosecution of the wrongdoers in the pending criminal proceedings and that under English law, that was the governing law of the contract, and, for that matter, under Pakistan law, the arbitrators were the sole judge of their own competence; that fraud and corruption in the procurement of the amending agreements did not prevent arbitration on the issue as to the effect of those matters on the validity of those amendments. Fortunately for Hubco, as the PPA itself was signed during Nawaz Sharif's first term, WAPDA had been compelled not to disown it or the arbitration clause embedded in it but this pivotal fact, unfortunately, made no difference to the outcome.

The majority judgment is a mere six pages long and concentrates on reciting the so-called "facts" alleged by WAPDA which they found to be the basis for invoking public policy to defeat Hubco's right to arbitration. It contains not a single reference to any case, whether cited for Hubco or WAPDA. By contrast, the minority judgment extends to 62 pages, is fully reasoned and cites a raft of case law.

At last, in December 2000 an agreement was finally signed between WAPDA and the company. In essence, the shareholders gave up a major chunk of their return (an IRR

[10] Hubco v. WAPDA PLD 2000 SC 841.

of just under 18% to financial close investors was reduced to just over 12%) resulting in a saving to WAPDA of over 60 million dollars a year. The numerous pending cases were withdrawn.

The consensus is that the IPP dispute (and the Hubco dispute in particular) even more so than the nuclear tests of May 1998, was responsible for the ensuing economic crisis, the drying up of direct foreign investment and the withdrawal of foreign portfolio investment in the stock market leading to its virtual crash and from which it has yet to recover. Many argue that if the issue was "affordability" as it was ultimately characterised, then accusing foreign investors of criminal conduct, as a negotiating tactic, was unlikely to elicit a particularly helpful response from them. In fact it soon became only too apparent that if the dispute were settled on terms commercially acceptable to the government, the criminal cases would be withdrawn.

Unfortunately, the lasting damage caused by this dispute will also remain with us. A number of retrogressive precedents have been set. The full faith and credit of the GOP as a sovereign guarantor has been fundamentally prejudiced by the grant of an injunction against it at the behest of the state debtor itself. The judiciary (personified in the majority judgment of the Supreme Court) has apparently set its face against international commercial arbitration by invoking public policy and the development of the law has been diverted into barren lands where it can only wither away. The deleterious effect of these developments will be reaped in due course by the country itself in the enhanced perceptions of political risk in investing in it and the added costs of returns to compensate for those risks.

3.3.2 SGS Société Générale de Surveillance S.A. v. Islamic Republic of Pakistan[11]

Following a series of discussions, written communications, and negotiations, on 29 September 1994, the Government of Pakistan entered into a contract with SGS whereby SGS agreed to provide "pre-shipment inspection" services with respect to goods to be exported from certain countries to Pakistan. SGS undertook to inspect such goods (i) abroad through its offices and affiliates; and (ii) at Pakistani ports of entry jointly with

[11] *SGS Societe Generale de Surveillance S.A. v. Islamic Republic of Pakistan*, ICSID Case No. ARB 01/13, 18 ICSID REV. 307.

Pakistani Customs. The objective of such inspection was to ensure that goods were classified properly for duty purposes and to enable Pakistan to increase the efficiency of its customs revenues collection and thereby contribute to the national treasury. SGS was to (i) physically identify goods; (ii) verify their dutiable value prior to shipment; and (iii) recommend appropriate customs classifications to the Pakistani authorities for goods to be imported into Pakistan.[12]

Once goods were pre-inspected, SGS was required to prepare a Clean Report of Findings (CRF) containing the information gathered by the local SGS office or affiliate in the different countries of supply, together with a recommendation for a tariff rate for each particular item, and verification of the relevant goods within Pakistani territory. Pakistan was to rely upon the CRFs issued by SGS for the purpose of collecting the correct duties and taxes leviable on inspected imports.

Article 4 of the PSI Agreement required SGS to prepare and submit to Pakistan monthly reports. These reports were to set forth:

(a) The value of orders received and goods inspected by country of supply;

(b) The estimated amount of customs revenue generated by country of supply;

(c) The incremental amount of duties and taxes realized by Pakistan as a result of the PSI Agreement; and

(d) A description of SGS's findings in the pre-inspection process.

Pursuant to Article 5.7 and 5.8 of the PSI Agreement, SGS was given permission to open one or more liaison offices in Pakistan and the Government undertook to ensure that SGS obtained the necessary immigration and working permits and authorizations. These offices were to convey information to Pakistan's customs authorities. The offices were to be "restricted to carrying out liaison activities and [could] not indulge in any commercial or trading activities whatsoever."[13] SGS established two such offices in Karachi and Lahore as duly authorized by Pakistan's Board of Investment.

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[12] SGS's Request for Arbitration (the "Request"), dated 12 October 2001, at paragraphs 5-10.

[13] Letter from Pakistan's Investment Promotion Board to SGS, dated 22 December 1994, at paragraph i. Exhibit S4 to the Request for Arbitration.

The PSI Agreement had a term of five years that was renewable automatically provided neither party objected to such renewal in writing. In addition, pursuant to Article 10.6, Pakistan had the right to terminate the PSI Agreement after the first appraisal of SGS's work, by giving three months notice. "After the expiry of the first full financial year and the appraisal as aforesaid, any of the two parties [had] the right to terminate the agreement at any subsequent time after giving a three months notice of such termination to the other party."

The PSI Agreement contained a dispute settlement provision in its Article 11, entitled "Arbitration and Governing Law," the relevant part of which stated:

> *Arbitratio: Any dispute, controversy or claim arising out of, or relating to this Agreement, or breach, termination or invalidity thereof, shall as far as it is possible, be settled amicably. Failing such amicable settlement, any such dispute shall be settled by arbitration in accordance with the Arbitration Act of the Territory as presently in force. The place of arbitration shall be Islamabad, Pakistan and the language to be used in the arbitration proceedings shall be the English language.*

The PSI Agreement entered into force on 1 January 1995. It was subsequently performed by both parties in the sense that services were rendered by SGS and invoices issued by it were paid by Pakistan. Both parties dispute the adequacy of the other's performance, but for the purposes of resolving these Objections it is unnecessary to inquire into these matters of contractual performance. On 12 December 1996, the Government of Pakistan notified SGS that the PSI Agreement was terminated with effect from 11 March 1997.

In various *fora,* SGS has described Pakistan's act as follows: the Agreement was not "validly terminated" by the Respondent; there was a "wrongful repudiation of contract"; there was an "unlawful and ineffective" termination of the PSI Agreement; and there were "breaches of the PSI Agreement as well as violations of the BIT" that "therefore give rise to Pakistan's liability to SGS for breach of contract, as well as its liability to SGS for infringement of the BIT."

Pakistan defended its actions as lawful and justified and on 11 September 2000 filed a claim against SGS in the PSI Agreement arbitration alleging various breaches of that agreement on SGS's part.

Chronology of post-PSI Agreement termination events

After notice of termination was given by Pakistan, communications were exchanged between the two parties as well as between the Government of the Swiss Confederation and the Government of Pakistan. These communications did not lead to a resolution of the dispute and on 12 January 1998, SGS initiated a commercial claim in the courts of Switzerland seeking relief against what it alleged was Pakistan's unlawful termination of the PSI Agreement.

The Swiss legal proceedings

SGS's Petition in the Court of First Instance of Geneva, Switzerland, alleged wrongful termination of the PSI Agreement. That Agreement, according to SGS, was perfectly performed by SGS from 1 January 1995 to 11 March 1997. Pakistan had never, before 29 December 1997, pretended that the contract was null *ab initio;* to the contrary, Pakistan on 12 December 1996 purported to terminate the contract *ex nunc.* Moreover, during the period from 1 January 1995 to 11 March 1997, the Government of Pakistan had, without reservations, partially paid the invoices issued by SGS Geneva. The Government of Pakistan hence, still owed the following amount for services rendered by SGS before 12 March 1997, which amounts were due in accordance with Article 6.5 of the PSI Agreement:

In capital: U.S.$8,368,430.49
In interests: U.S.$1,065,371.7518
21. SGS'S prayer for relief asked the Geneva Court of First Instance:

(a) to declare its jurisdiction to decide the Petition;
(b) to determine that the PSI Agreement had not been validly terminated *ab initio* by Pakistan;
(c) to require Pakistan to pay to SGS the amounts of
In capital: U.S.$8,386,430.49
In interests until December 31, 1997: U.S.$1,065,371.75
(d) To order Pakistan to pay SGS interest at the rate of 7.5% in accordance with Article 6.6 of the PSI Agreement (LIBOR for three (3) months plus 2%) on the mentioned capital amount from January 1, 1998 without

prejudice to any other claims of SGS in particular for damages "for abusive termination of contract;" and;

(e) Finally, to dismiss the contrary submissions of Pakistan and to require Pakistan to pay all legal costs.

Pakistan opposed this claim on various grounds but principally on the ground that the parties had agreed to the arbitration of any disputes arising out of the PSI Agreement rather than to submit to the courts of any country and on the ground that as a sovereign State it was immune to the legal process of the Swiss courts.

On 24 June 1999, the Court of First Instance rejected SGS's claim, principally on the first ground asserted by the Respondent. SGS then appealed to the Court of Appeal of Geneva. On 23 June 2000, the Court of Appeal dismissed the appeal but on grounds (basically, that of sovereign immunity) different from those specified by the Court of First Instance. SGS then appealed to the Swiss Federal Tribunal.

The Swiss legal proceedings concluded with the denial of the Claimant's final appeal on 23 November 2000. Both appellate courts, the Court of Appeal of Geneva and the Swiss Federal Tribunal upheld the judgment of the Geneva Court of First Instance, but on the ground of sovereign immunity. These legal proceedings (the "Swiss legal proceedings") unfolded over a period of some twenty-two months. No further appeal was available in the Swiss court hierarchy once the Federal Tribunal dismissed SGS's appeal.

Pakistan's initiation of the PSI Agreement arbitration

On 11 September 2000, after the judgments of the first two Swiss courts were rendered, but before the judgment of the Swiss Federal Tribunal was issued, Pakistan formally invoked Article 11.1 of the PSI Agreement to commence arbitration proceedings in Pakistan. (The Tribunal will refer to this proceeding as the "PSI Agreement arbitration.") Pakistan applied to the Court of the Senior Civil Judge, Islamabad, pursuant to s. 20 of the Pakistan Arbitration Act, 1940, for an order that the dispute between the parties be referred for decision by an arbitrator to be appointed by the Court. (Pakistan did not file a Statement of Claim at this time.)

SGS then appeared before the Senior Civil Judge by filing, on 7 April 2001, a set of preliminary objections to the PSI Agreement arbitration and, without prejudice to such objections, a counter-claim against Pakistan for alleged breaches of the PSI Agreement.

With respect to the merits, SGS alleged that there had been a wrongful repudiation of the PSI Agreement and that:

> *...the wrongful repudiation of contract by the Government of Pakistan and its subsequent, false, malicious and politically motivated accusations have caused colossal loss and damages to the Respondent...*[14]

SGS thus claimed the following relief:

(a) Payment of outstanding invoices for services rendered, U.S.$8,368,430.48;

(b) Interest on unpaid invoices in the amount of U.S.$2,299,953.38;

(c) Damages for premature termination of the PSI Agreement, U.S.$31,500,000;

(d) Demobilisation costs, U.S.$2,400,000;

(e) Reputation damage due to Pakistan's allegedly defamatory statements, U.S.$213,000,000;

(f) Damages for loss of opportunity, U.S.$70,000,000;

(g) Legal fees and expenses, U.S.$1,500,000; and

(h) Interest at the rate specified in the PSI Agreement from the date of termination to the date of payment on all amounts claimed.

Approximately eleven months after Pakistan initiated the PSI Agreement arbitration and some six months after the filing of its objections to jurisdiction and its counter-claim in the PSI Agreement arbitration, by letter dated 10 October 2001, SGS wrote to the Minister of Foreign Affairs of Pakistan (copied to the President and the Minister of Finance of Pakistan and the Ambassador of Pakistan to the Swiss Confederation), referring to the Treaty and observing that disputes had arisen between the two parties "in connection with investments by SGS, and notably with the Pre-Shipment Program established by SGS."[15]

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[14] Reply on behalf of the Respondent in the matter of *Islamic Republic of Pakistan* v. *Société Générale de Surveillance S.A.*, at counter-claim, paragraph 2.

[15] Letter from SGS to Pakistan dated 10 October 2001. Exhibit S18 to the Request for Arbitration.

The ensuing court proceedings in Pakistan

Having initiated the present ICSID arbitration, SGS then took steps to oppose the PSI Agreement arbitration. On 4 January 2002, SGS filed an application with the Senior Civil Judge, Islamabad, for an injunction against the PSI Agreement arbitration on the ground principally that SGS was entitled to have the dispute settled through ICSID arbitration and that the PSI Agreement arbitration should be stayed until the ICSID Tribunal determined Pakistan's objection to its jurisdiction.

On 7 January 2002, the application was rejected by the Senior Civil Judge who also directed both parties to submit the names of arbitrators, one of whom could be appointed to arbitrate the PSI Agreement dispute. SGS then appealed to the Lahore High Court. The Lahore High Court dismissed that appeal on 14 February 2002. SGS appealed further to the Supreme Court of Pakistan on 5 March 2002. Pakistan, for its part, filed its own appeal against one paragraph of the Lahore High Court's judgment and filed as well an application for an injunction to restrain SGS from pursuing the ICSID arbitration.

Following the parties' respective petitions filed in the Supreme Court of Pakistan, the Court, on 15 March 2002, allowed both petitions and granted leave to appeal. At the same time, the Supreme Court restrained both parties from pursuing their respective arbitration proceedings pending a decision on their appeals. While the two appeals were before the Supreme Court, on 17 April 2002, an application was made by the Government of Pakistan to the Court to hold SGS in contempt of court because it had taken steps in furtherance of this ICSID arbitration. The contempt application has been addressed in the Tribunal's Procedural Order No. 2, and it is unnecessary to discuss that further in the context of these Objections.

On 3 July 2002, the Supreme Court of Pakistan rendered its final decision on both the appeals, dismissing the Claimant's appeal and granting the Respondent's request to proceed with the PSI Agreement arbitration and restraining the Claimant from pursuing or participating in the ICSID arbitration.

The Supreme Court's Reasons for Judgment were followed on 7 July 2002, with the appointment of Mr. Justice (Retd.) Nasir Aslam Zahid as sole arbitrator to hear the

PSI Agreement arbitration.[16] The newly appointed PSI Agreement arbitrator accepted his appointment and scheduled a meeting with the parties for 18 October 2002. After SGS's application for interim measures of protection was heard by the Tribunal at The Hague, The Netherlands, and the Tribunal recommended a stay of that arbitration until the Tribunal determined whether it had jurisdiction to consider the claims brought before it, the PSI Agreement arbitrator agreed to stay that arbitration for the time being.[17]

On 18 October 2002, Pakistan filed its Statement of Claim with the PSI Agreement arbitrator. Pakistan alleged that SGS failed to perform its obligations in accordance with the PSI Agreement and that Pakistan did not receive the benefit therefrom that it had bargained for. Accordingly, Pakistan's request for relief sought the following:

a) Restitution of the sum of US$43,211,553.00 paid to the Defendant in respect of the aforementioned 85,945 CRFs;

b) Interest/compensation for moneys wrongfully received and held at the rate of 18% per annum from the date of receipt till the date of the decree on the award; and

c) Any other relief that the Arbitral tribunal may deem fit and appropriate in the circumstances.

Pakistan asserted that the Tribunal does not have jurisdiction over any of the claims set forth in SGS's Request for ICSID Arbitration. It observed that SGS has acknowledged that the present dispute "*arises out of* Pakistan's actions and omissions with respect to the Pre-Shipment Inspection Program and the PSI Agreement". Pakistan relied upon a recent ICSID *ad hoc* Annulment Committee decision, in the *Vivendi* case,[18] where the Committee stated:

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[16] Judgment of the Supreme Court of Pakistan (Appellate Jurisdiction) on Civil Appeal No. 459 (*Société Générale de Surveillance S.A.* v. *Pakistan, through Secretary Ministry of Finance, Revenue Division, Islamabad)* & Civil Appeal No. 460 *(Pakistan through Secretary Ministry of Finance, Revenue Division, Islamabad v. Société Générale de Surveillance S.A.*), June 2002, at paragraph 78. Exhibit P 21 to Respondent's Objections to Jurisdiction.

[17] Letter from counsel for Pakistan to the Tribunal dated 22 November, 2002, attaching the Stay Order issued by the sole Arbitrator, Justice Nasir Aslam Zahid, on 12 November 2002.

[18] *Compañia de Aquas del Aconquija, S.A. and Compagnie Générale des Eaux* v. *Argentine Republic ("Vivendi"* or *"Vivendi Annulment"*), Case No. ARB/97/3, Decision on Annulment of 3 July 2002.

> *In a case where the essential basis of a claim brought before an international tribunal is a breach of contract, the tribunal will give effect to any valid choice of forum clause in the contract.*[19]

Pakistan maintained that the essential basis of the present claims is breach of contract and that even if the labels in the Request for Arbitration were accepted at face value and SGS's claims were analyzed in terms of the three categories of "Contract, Defamation and BIT" claims, the broad PSI Agreement arbitration clause requires the parties to bring any dispute to the PSI Agreement arbitrator, regardless of whether such claims sound in contract, tort, or treaty. Pakistan also proffered a number of other objections to this proceeding based on the doctrines of *lis pendens,* waiver, and estoppel.

During the hearing, counsels for Pakistan set out four propositions, each of which was averred to be sufficient to command the dismissal of the claim:

(a) No ICSID arbitration because of the existence of another prior agreement;

(b) Alternatively, no ICSID arbitration because of waiver;

(c) Alternatively, no ICSID arbitration because of contractual claims; and

(d) In the final alternative, ICSID arbitration would at any rate be premature.

In its principal argument, Pakistan submits that under the ICSID Convention and under the principle of *pacta sunt servanda,* this Tribunal does not have jurisdiction where the parties have agreed to submit disputes elsewhere. The jurisdiction of ICSID tribunals is limited to the adjudication of disputes that the parties have actually agreed to submit to the Centre and not to an alternative forum. Conversely, if the parties agree to submit their disputes to a forum other than ICSID, Article 26 of the ICSID Convention requires the ICSID tribunal to respect their agreement.[20]

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[19] *Ibid.*, at paragraph 98.

[20] Article 26 states: *"Consent of the parties to arbitration under this Convention shall, unless otherwise stated, be deemed consent to such arbitration to the exclusion of any other remedy. A Contracting State may require the exhaustion of local administrative or judicial remedies as a condition of its consent to arbitration under this convention."* Pakistan refers in this respect to works such as Professor Christoph Schreuer's *The ICSID Convention: A Commentary,* awards of other ICSID tribunals, and decisions of national courts. Objections, at paragraphs 65-69.

SGS responds to Pakistan's objections by firstly pointing out that it does not accept the characterization of SGS's claims as "Contract," "Defamation" and "BIT Claims." All of SGS's claims are "BIT Claims" in the sense that they are brought before this Tribunal on the basis of the BIT. It is for the Claimant, not the Respondent, to formulate its claims; they must be taken as they are, not as Pakistan would like them to be.

In SGS's view, for the Tribunal to have jurisdiction over the dispute, the conditions set forth in Article 25(1) of the ICSID Convention must be met.[21] Article 25 sets out the conditions for jurisdiction as follows:

(a) the dispute must be a "legal" one;

(b) it must "aris[e] directly out of an investment";

(d) it must be between a Contracting State...and a national of another Contracting State; and

(d) the parties to the dispute must "consent in writing to submit it to the Centre."

In SGS's view, Pakistan disputed only the fourth condition. The burden was on Pakistan to prove that this is not met. SGS argued that there was a written consent. The parties' written consent consists of (i) the written offer of ICSID arbitration made by Pakistan, in Article 9 of the BIT, and (ii) the written acceptance by SGS in its letter to Pakistan of 10 October 2001. SGS goes on to submit that a long line of ICSID decisions shows that a forum selection clause in a contract will not apply to the exclusion of ICSID jurisdiction. SGS pointed out that in every case on which Pakistan relied *(Klöckner, Tradex Hellas, Lanco, Salini* and *Vivendi Annulment*), the ICSID tribunal retained jurisdiction.

SGS concluded that in conformity with the text of the ICSID Convention and the weight of ICSID precedent, the Tribunal must hold that the forum selection clause in the PSI Agreement does not and cannot exclude the jurisdiction of this Tribunal with respect

[21] Article 25 states:
The jurisdiction of the Centre shall extend to any legal dispute arising directly out of an investment, between a Contracting State (or any constituent subdivision or agency of a Contracting State designated to the Centre by that State) and a national of another Contracting State, which the parties to the dispute consent in writing to submit to the Centre. When the parties have given their consent, no party may withdraw its consent unilaterally.

to SGS's claims. At the very most, the Islamabad arbitrator may have, *prima facie,* concurrent jurisdiction over some aspects of the current dispute relating to the interpretation and performance of the PSI Agreement. However, even then, the Tribunal's jurisdiction was meant to prevail.

Considering the principal objections to the jurisdiction of this Tribunal and the arguments adduced by the Respondent to support those objections, and having regard to the principal claims and arguments submitted by the Claimant to resist the Respondent's objections and to sustain the jurisdiction of this Tribunal, we believe that the principal issues that we must address in this Decision may be usefully formulated in the following manner:

(a) Has the Claimant made an "investment" "in the territory" of the Respondent?

(b) What effect may be given to the Claimant's characterization of its own claims, for purposes of these proceedings on jurisdiction?

(c) Does the Tribunal have jurisdiction to determine the Claimant's BIT claims, that is, claims of violation of certain provisions of the Swiss-Pakistan BIT?

(d) Does the Tribunal have jurisdiction to determine the Claimant's contractual claims that is, claims of violation of the PSI Agreement?

(e) Does Article 11 of the Swiss-Pakistan BIT transform purely contract claims into BIT claims?

(f) Does the Claimant's conduct in the Swiss legal proceedings and in the PSI Agreement arbitration give rise to estoppel?

(g) Does the Claimant's conduct in the Swiss legal proceedings and in the PSI Agreement arbitration amount to waiver of its rights under the Swiss-Pakistan BIT?

(h) Does the doctrine of *lis pendens* preclude the Claimant from pursuing its claims before the Tribunal?

(i) What effect may be given to the requirement of consultations between the parties in Article 9 of the Swiss-Pakistan BIT?

(j) Should this Tribunal dismiss or stay these proceedings as urged by the Respondent until the contract claims are addressed?

The CSID Tribunal held that the expenditures made by SGS pursuant to the PSI Agreement constituted an investment within the meaning of the BIT and that the PSI Agreement amounted to "a concession under public laws" falling well within the BIT's

definition of investment. It also held that the ICSID Convention's requirement that there be a legal dispute arising directly out of an "investment" is satisfied.

As a matter of general principle, the same set of facts can give rise to different claims grounded on differing legal orders: the municipal and the international legal orders. In the event, this proposition has recently been discussed and documented *in extenso* in the *Vivendi Annulment* decision where the Annulment Committee said:

> As to the relation between breach of contract and breach of treaty in the present case, it must be stressed that *Articles 3 and 5 of the BIT do not relate directly to breach of a municipal contract. Rather they set an independent standard. A state may breach a treaty without breaching a contract, and vice versa,* and this is certainly true of these provisions of the BIT. The point is made clear in Article 3 of the ILC Articles, which is entitled "Characterization of an act of a State as internationally wrongful": *The characterization of an act of a State as internationally wrongful is governed by international law. Such characterization is not affected by the characterization of the same act as lawful by internal law...*

Where the *fundamental basis* of the claim is *a treaty laying down an independent standard* by which the conduct of the parties is to be judged, *the existence of an exclusive jurisdiction clause in a contract between the claimant and the respondent state—cannot operate as a bar to the application of the treaty standard.* At most, it might be relevant—as municipal law will often be relevant—in assessing whether there has been a breach of the treaty.

The Tribunal concluded that it had jurisdiction to pass upon and determine the claims of violation of provisions of the Swiss-Pakistan BIT raised by the Claimant and that such jurisdiction would to any degree be shared by the PSI Agreement arbitrator. The Tribunal, however, also concluded that it had no jurisdiction with respect to claims submitted by SGS and based on alleged breaches of the PSI Agreement which do not also constitute or amount to breaches of the substantive standards of the BIT. The Tribunal also found that as the causes of action are not identical, the doctrine of *lis pendens* cannot operate to preclude us from exercising jurisdiction over the BIT claims.

The tribunal did not think that the word "commitments" used in Article 11 should extend as far as an investment contract between an investor and a state. Whilst the tribunal's reasoning was clearly driven by policy considerations, it sought to ground its decision in a creative textual analysis of the meaning of Article 11. The tribunal was

concerned that the word "commitments" was open to indefinite expansion and so could include "statutory" and "administrative" commitments of the state and could even extend to commitments of the State itself as a legal person, or of any office, entity or subdivision (local government units) or legal representative thereof whose acts are under the law state responsibility, attributable to the State itself. The tribunal was against such a construction. It felt instead that the article did not "purport to state" that investor-state contracts "are automatically elevated to the level of breaches of international treaty law."

Clearly, the tribunal was concerned with the far-reaching effects that the claimant's interpretation would have on international law, potentially opening the floodgates for claims that such an interpretation would entail. The concern was that accepting an umbrella clause would "amount to incorporating by reference an unlimited number of state contracts" into international law obligations. This could, it was suggested, effectively neutralize the traditional substantive treaty provisions by allowing an investor to fall back on a simple breach of contract claim. In the face of the widely accepted principle of general international law that a violation of a contract entered into by a state with an investor of another state is not, by itself, a violation of international law, SGS would have to show convincing evidence that the parties to the treaty intended Article 11 to have the effect that it contended for. The tribunal found that SGS was unable to do this.

In addition to concern about "instant transubstantiation of contract claims into BIT claims, the tribunal feared that a broad interpretation of Article 11 would enable investors to override dispute settlement clauses negotiated in particular contracts. This would mean that the state could only ever benefit from the contractual clause originally bargained for at the behest of the investor. There would be a serious risk of "cherry picking" by, the investor, begging the question: why should the investor be permitted to enforce certain provisions of its contract, such as performance or payment, while ignoring others? As a matter of policy the tribunal thought that such an imbalance in power was unacceptable.

3.3.3 SABAH SHIPYARD LIMITED v. ISLAMIC REPUBLIC OF PAKISTAN/ PRIVATE POWER & INFRASTRUCTURE BOARD

Sabah Shipyard Company Limited, an intending independent power producer (IPP) under the Islamic Republic of Pakistan's (IRP) 1994 Power Policy, was issued a Letter of Support (LOS) on 1st January 1995 for the setting up of two barge-mounted combined cycle power generation units of 288 MW capacity at Korangi, Karachi. Power from the plant was to be supplied to the Karachi Electric Supply Corporation (KESC). The Company finalized the Security Documents and achieved Financial Close in March 1996. Sabah had been allotted 10.64 acres of land by Port Qasim Authority (PQA) for its Complex but the Government of Sindh wrongly allotted 4 acres of this to another intending IPP, Jaya Holdings, who filed a civil suit on 15.08.1996 and obtained a stay order against PQA and IRP for wrongful allotment of 4 acres of land to Sabah. Sabah belatedly entered the suit proceedings and had the stay vacated on 14.05.1997. However, Sabah failed to start the Project within the stipulated time-frame and the KESC, after the RCOD date of 26.11.1997 had elapsed, sent invoices for liquidated damages beginning on 26.11.1997 till 30.11.1998 and subsequently Government of Pakistan through a termination notice dated 19.11.1998 terminated the IA and the PPA Upon the Bank of America (guarantor bank) refusing to pay the LC amount of US $ 6.84, the KESC took the Bank before the Sindh High Court on 04.01.1999, in a writ petition. A settlement was eventually reached between the parties on 02.07.1999 to the effect that the Bank of America would pay the principal amount of the LC of US$ 6.84 to the KESC. This sum was duly paid to the KESC through the Court. Consequent thereto a spate of litigation has occurred between Sabah Shipyard and the KESC & Sabah Shipyard and the Government of Pakistan/ Private Power & Infrastructure Board (PPIB).

The Company proceeded to arbitration under the International Chamber of Commerce's (ICC) arbitration rules in Singapore against the KESC for wrongfully drawing upon the LC claiming US $ 6.84 Million with costs and interest on 07.12.1998. The KESC's failure to take account of the stay order of the Sindh High Court over part of Sabah's land site which constituted an event of force majeure were substantial factors in the arbitrator deciding in favour of Sabah Shipyard on 04.06.2001, through an award of US $ 6.84 million with interest and costs which amounted to US $ 8.956 million at that

time and is currently about $15 million. The KESC did not challenge the ICC award and committed a serious miscalculation. The KESC's intention after losing the award appears to have been to abscond without paying the award amount. KESC did not however consider that IRP as guarantor with its extensive assets and sovereign status cannot similarly abscond. Government of Pakistan for its part should have intervened either in the KESC's ICC proceedings or at a minimum persuaded KESC to file an appeal before the Singapore High Court against the award. Consequently the award has attained finality against the KESC (and subject to interpretation by English case law possibly against Government of Pakistan as guarantor). The Company demanded this arbitral amount from the KESC but it refused and instead initiated litigation in the Sindh High Court at Karachi on 21.06.2001 praying that the ICC award be declared void and illegal.

Simultaneously with filing the Request for Arbitration, Sabah also filed another Request for Arbitration under the ICC arbitration rules in Singapore against the Government of Pakistan /PPIB on 07.12.1998 for damages in the sum of $ 227 Million for wrongful termination of the Implementation Agreement. After getting the award against the KESC, Sabah enhanced its claim against IRP to $510 million. Both the Claimant and the Respondent were asked to pay the costs of Arbitration but while the Government of Pakistan /PPIB paid its initial share of $ 50,000/- it refused thereafter and under ICC Rules Sabah alone was ordered to pay and asked to deposit after the initial $50,000/- a further $330,000/- with the ICC at various stages. Sabah paid $300,000/- of this, but failed to pay the balance of $80,000/- and consequent thereto its claim was treated as withdrawn without prejudice to reintroduce the claim at a later stage. The ICC after deducting its own costs offered the balance un-availed amounting to US$ 200,000 to Sabah through a letter, with a copy to Government of Pakistan, whereupon Government of Pakistan promptly filed a suit before the Senior Civil Judge at Islamabad for restraining Sabah from withdrawing this amount from the Bank where it was placed by ICC. An injunction was granted in favor of Government of Pakistan from which Sabah is in appeal before the District Court at Islamabad. Further upon Sabah increasing its claim to $510 million, the Government of Pakistan asked for security for costs and in consequence a performance guarantee worth $162,500/- was given to Government of Pakistan /PPIB by Sabah. Due to the stiff resistance of Government of Pakistan /PPIB

after nearly 3 years of proceedings Sabah ultimately withdrew from the Arbitration proceedings on 02.04.2002. Its claim for $510 million is apparently time barred and cannot be resuscitated as a period of 6 years under Singapore law has now elapsed from the cause of action accruing to Sabah. Government of Pakistan made a claim for all of its costs due to the withdrawal of Sabah and was awarded $592,000/- by a further ICC arbitral hearing on 16.12.2004. Even prior to this award on the 27th of May, 2003, Government of Pakistan had filed a suit against Sabah before the Sindh High Court at Karachi for encashment of the performance guarantee worth US$ 162,500 obtained due to the application for security for costs above which is still pending final adjudication by the Court. The balance is being sought through a Winding-up petition under the Companies Ordinance 1984. Sabah Shipyard after the grant of the award for US $ 592,000 in favor of Government of Pakistan filed an appeal before the Singapore High Court which is pending adjudication. On the KESC's refusal to pay, Sabah Shipyard approached the Government of Pakistan /PPIB under the terms of the Pakistan's Sovereign Guarantee initially on 08.06.2001, and subsequently through a notice dated 03.09.2001, made a call on the Sovereign Guarantee of the Islamic Republic of Pakistan. The Government of Pakistan /PPIB challenged the call made on the Sovereign Guarantee by Sabah Shipyard before the court of the Senior Civil Judge at Islamabad and sought to have it declared void and illegal. An appeal against an order given upon a miscellaneous application under Order VII, Rule 10 filed by Sabah whereby the jurisdiction of the civil court was challenged, has been filed by Sabah which is being defended in the Court of District Judge, Islamabad

To counter the moves to have the Arbitration Award made a local award and the call on the Sovereign Guarantee declared illegal, Sabah sought to have the litigation in Pakistan anti-suited (stayed) by the High Court at London on 11.12.2001. The High Court at London ruled in favour of Sabah on 06.02.2002. The Government of Pakistan /KESC thereafter filed before the Court of Appeal from the London High Court decision but the Court of Appeal on 14.11.2002 upheld Sabah's plea and restrained Government of Pakistan and the KESC from proceeding against Sabah in Pakistan.

On 15.02.2002, Sabah filed a suit before the High Court at London seeking a Summary Judgment of the arbitral award with interests and costs against the Government

of Pakistan /PPIB as guarantor/surety for the KESC. To counter the suit for Summary Judgment the Government of Pakistan /PPIB in the same proceedings sought to have the suit dismissed by filing a striking out application raising the objection in the striking out application that the suit was not duly authorized as under Pakistani law a resolution of the Board of Directors of Sabah (Pakistan) was required for proper authorization to commence a suit. The basis for this striking out application is that according to the 2nd Witness Statement of Peter Shelford, a partner in DLA (lawyers at that time for Sabah in London) instructions were ultimately being received from the Administrators in Malaysia. Under Article 70 of the Articles of Association of Sabah (Pakistan), the Board of Directors have authority to institute suits. In reply Sabah through its Chief Executive stated in his Wintness Statement that he instructing Sabah lawyers in London at the time of institution of these proceedings. The Chief Executive is not authorized to file a suit which under Article 70 of the Articles of Association of Sabah (Pakistan) lies in the purview of the Board of Directors. Sabah is, however, relying on Article 80 that specifically states that the Chief Executive is authorized to file legal proceedings subject to a resolution of the Board of Directors. In order to determine this issue, Sabah and Government of Pakistan entered into a mutual consent order on 25.06.2004, through the Court that the original articles of association and memorandum of association would be provided by Sabah to the Court. These documents are however in the possession of the Sindh High Court consequent to the accountants of Sabah having filed suit against Sabah for non-payment of their professional fees. Sabah has not been able to obtain these documents from the Court on account of losing this case and are currently in appeal before a division bench. Consequently, at each date of hearing totaling eight dates till the present before the High Court in London, an adjournment has had to be granted by the Court for non-production of the documents by Sabah but the London High Court, after over two years, is clearly losing its patience with Sabah and asking for detailed explanations as to why the documents cannot be obtained. Under Pakistani law, a company cannot file a civil suit without a resolution of its Board of Directors unless its officers are authorized through the articles of association.

Sabah Shipyard had challenged the jurisdiction of the Arbitrator to enter upon the proceedings before the Singapore High Court, as Sabah was of the view that arbitration

proceedings having been concluded and no costs having been awarded under it, the matter had therefore become settled. The Singapore High Court, however, held that the Arbitrator did have jurisdiction. Sabah having failed to make headway against the IRP in its suit for Summary Judgment due to the above Consent Order filed a petition before the High Court at London against the KESC for enforcement of the ICC Award. One possible purpose of filing before the High Court at London is that as the UK is a reciprocating State under Section 44 of the Civil Procedure Code, 1908, i.e., a decree passed by a London High Court is executable in the Courts at Pakistan. A corollary to this is that if the New York Convention has been ratified by Pakistan and incorporated into Pakistan Law, dependent upon its enactment terms the ICC award could again be construed as a Pakistani decree, and therefore, execution can be sought in Pakistan. Alternatively, it might be possible to seek judgment in London and attempt to execute it in London through attachment of any KESC assets/accounts in England. The KESC appeared in these proceedings at London, lost the case and then requested through an application for a review of the judgment before the same Court. The KESC was asked to pay US $ 10 million as a pre-condition for review. The KESC, on the passing of this order, withdrew from the suit and absconded. Final judgment was passed on 03.11.2004.

As a consequence of the above litigation PPIB has to date spent a sum of over US $ 1 million in litigation. An attempt was made by the parties through out of court settlement negotiations in October, 2003, in Singapore, that failed with the Pakistan led team insisting upon flexibility on all issues and Sabah's insistence that only costs and interests and not the principal were negotiable. Dr Tariq Hassan was appointed by the Prime Minister to lead the second round of settlement negotiations. The negotiations however failed to materialize due to Dr Tariq Hassan's insistence that an opinion be obtained from the Attorney-General of Pakistan that the views of PPIB's English Lawyers namely, that settlement negotiations be delayed in view of the recent cost award dated 16.12.2004, made in favour of Government of Pakistan by the ICC and that a winding up petition should be filed against Sabah (Pakistan) and negotiations postponed for a matter of several months to await developments, did not prejudice settlement negotiations before he would proceed to them. The Law Secretary and the A.G in response to a request for an opinion by PPIB on this issue replied that first the views of

the terms of the settlement be conveyed to them before they advised on whether it was appropriate to proceed to settlement negotiations. PPIB replied that the terms of settlement had been fixed by the Prime Minister that *the negotiation team may be given the mandate to negotiate the best possible settlement less than the original encashed amount of US$ 6.84 million,* despite which no legal opinion on this matter was forthcoming. A winding up petition was subsequently filed in Sindh High Court at Karachi for failure to pay the cost award. A letter from Sabah's lawyer in London was given to Government of Pakistan that the winding-up petition is in breach of the anti-suit injunction granted by the Court of Appeal and that contempt proceedings will be initiated if IRP does not desist from pursuing the same further. Upon the advice of PPIB's lawyers that the winding up petition did not violate the terms of the anti-suit injunction PPIB proceeded with the winding up petition. After the 60th Board Meeting of PPIB on the 31st of January, 2006, Dr Tariq Hassan requested that he be relieved from his duty to lead the settlement negotiations and a new team leader is yet to be appointed.

Two further developments have since occurred. Firstly, the KESC has been privatized and IRP has undertaken to pay any costs awarded against the KESC upon fulfillment of certain conditions the principal one being the exhaustion of all legal remedies. Secondly due to the presence of the Consent Order dated 25.06.2004, a new suit against the IRP before the High Court in London for enforcement of the award of the ICC made against the KESC as well as the judgment given against the KESC by the London High Court has been filed. On the preliminary information obtained, it appears to be a repetition of the earlier suit and could be construed as an abuse of the Court. It could also be possible to construe this as a separate action based upon the recent judgment against the KESC in the High Court at London.

The defences which a guarantor (Islamic Republic Pakistan) can raise are more or less limited to the defences which the principal party (KESC) can raise. Pakistan's case is, therefore, only as strong as that of the KESC. The KESC has argued a full case on the merits over 2 1/2 years before a neutral arbitrator (ICC) and has lost. Similarly when Sabah filed a case before the High Court in London against the KESC, the English High Court Judge ruled against the KESC and directed it to deposit nearly $10 million when the KESC through an application sought review of the Court's final order against it. This

is a clear indication of what a British High Court Judge thought of the merits of the KESC's case.

Government of Pakistan has, through the fault of Sabah, managed to obtained a consent order which requires Sabah to produce the original memorandum and articles of association of Sabah which are in the custody of the Sindh High Court through litigation and therefore adjournments are being granted before the English High Court. The chances of success of the strikeout applications are in my reckoning bleak. The counter argument of having met the requirements of a British Court for filing of a suit and the contract being governed by British Law is also available. After the strikeout application the application for summary judgment will be heard. Government of Pakistan's main defence that Sabah misrepresented the facts required for Financial Close which is based on documents filed by creditors of Sabah (Malaysia) in the Malaysian High Court that wound up Sabah (Malaysia) may perhaps get Government of Pakistan leave to defend but is unlikely to win the case for Pakistan. Sabah (Malaysia) has been wound up and put in charge of liquidators to sell all of its assets. The Administrators are not in charge anymore and presumably the workout proposal to revive Sabah was not positive (proposal is being obtained). Completion of the case would involve a further expenditure of $ 1.0-1.5 million which would not be recovered from Sabah as it is bankrupt. Sabah despite being bankrupt will not withdraw from the suit as it has spent too much money and has a strong case and therefore will expect to get some money.

If so much money has to be spent on a weak case and then to lose it, it is far wiser to settle or attempt to settle at a low figure. If settlement cannot be reached, Government of Pakistan will have to bear whatever the court decides. The consequences of losing is either an appeal to the Court of Appeal in England or payment of nearly $ 15 million. Pakistan cannot like the KESC abscond, as it has assets and accounts in England that may be seized besides being embarrassed by seizure of its assets in the process.

3.3.4 BAYINDIR INSAAT TURIZM TICARET VE SANAYI A.Ş. v. ISLAMIC REPUBLIC OF PAKISTAN

The National Highway Authority ("NHA") is a public corporation established by the Pakistani Act No XI (National Highway Authority Act) of 1991 to assume responsibility

for the planning, development, operation and maintenance of Pakistan's national highways and strategic roads. Although controlled by the Government of Pakistan, NHA is a body corporate in Pakistan with the right to sue and to be sued in its own name.[22]

In 1993, NHA and Bayindir entered into an agreement for the construction of the M1 Project (the "1993 Contract"). The 1993 Contract was a two page agreement incorporating, *inter alia*, the Conditions of Contract Part I and II, General Specifications, Special Provisions and Addenda to General Specifications, Drawings, and Priced Bill of Quantities (BOQ). In particular, it bears noting that:

(i) Part I incorporated the FIDIC General Conditions of Contract for Works of Civil Engineering Construction (1987 edition).

(ii) Part II, entitled "Conditions of Particular Applications", incorporated the amendments and supplements to Part I as negotiated by the Parties.

Disputes arose in connection with the 1993 Contract, which NHA and Bayindir resolved in 1997. As part of their settlement, on March 29, 1997, the parties executed a Memorandum of Agreement "with the objective of reviving The Contract Agreement dated 18 March 1993". Under Clause 8 of this Memorandum of Agreement, the Parties agreed "to apply to the arbitration tribunal in the appropriate manner to seek the decision of the tribunal on only the issue of the quantum of expenses incurred by Bayindir as specified in Bayindir's claim for expenses only".

On July 3, 1997, the Parties entered into a new contract, the "Agreement for the Revival of Contract Agreement for the Construction of Islamabad-Peshawar Motorway" (the "1997 Contract"). The 1997 Contract incorporated the 1993 Contract "in its entirety" with some "overriding conditions" agreed by the parties in the Memorandum of Agreement signed on 29 March 1997. It was a term of the Contract that NHA would pay to Bayindir 30% of the Contract price as an advance payment (the "Mobilization Advance"). Thereafter, NHA paid to Bayindir an amount of US$ 159,080,845 as Mobilization Advance (namely two separate amounts of US$ 96,645,563.50 and PKR 2,523,009,751.702). It was a further term of the Contract that Bayindir would provide a bank guarantee equivalent to the amount of the Mobilization Advance. On January 9,

[22] Section 3(2) of the National Highway Authority Act, 1991.

1998, a consortium of Turkish banks issued two guarantees on behalf of Bayindir to secure the Mobilization Advance (the "Mobilization Advance Guarantees") in accordance with the Contract. Consistent with the Contract, the Mobilization Advance Guarantees were payable to NHA on its first demand without whatsoever right of objection on the Bank's part and without his first claiming to the Contractor. The amounts of the Mobilization Advance Guarantees were to decrease, as interim payments were made for work in progress. The performance of the Contract was to be supervised by an Engineer.

The Contracts set forth a multi-tier mechanism for "Settlement of Disputes", which may be sketched as follows:

- Any "matter in dispute shall, in the first place, be referred in writing to the Engineer" (67.1(1) of the Contract).
- Either of the parties dissatisfied with any decision of the Engineer "may give notice to the other party of his intention to commence arbitration" (67.1(3) of the Contract).
- The parties "shall attempt to settle such dispute amicably" and, unless the parties otherwise agree, arbitration cannot be commenced on or after the fifty-sixth day after the day on which notice of intention to commence arbitration was given.
- The dispute shall then be "finally settled under the rules and provisions of the Arbitration Act 1940 as amended or any statutory modification or re-enactment thereof for the time being in force".

On June 3, 1998, the Engineer issued the order to proceed to the construction with original completion dates foreseen on July 31, 2000. Between September 1999 and April 20, 2001, Bayindir submitted several claims regarding payment and four claims for extension of time (EOT) invoking different omissions on the part of Pakistan, in particular delays in the construction work resulting from late hand over of the land by Pakistan and/or NHA. The first two EOT claims were settled by agreement among the parties during a meeting held on February 18, 2000. This agreement led to the execution of Addendum No. 9 of 17 April 2000 to the Contract, which set out, among other things, that "the revised Contract Completion Date shall be 31st December 2002" and that "NHA will hand over the remaining land as expeditiously as possible but not later than 4 months from the signing" of Addendum No. 9. The detailed schedule attached to Addendum No.

9 provided that two priority sections had to be completed before March 23, 2003 (the Priority Sections). Asserting primarily that NHA failed "to give the Possession of Site as per Addendum No. 9", on January 15, 2001, Bayindir submitted its third EOT claim (EOT/03) for completion of the two "Priority Sections" by October 2001. On April 3, 2001, the Engineer's representative granted Bayindir a limited extension of time of twenty-seven and ten days respectively.

By letter of April 6, 2001, Bayindir disputed this extension of time and referred the matter to the Engineer for his decision under Clause 67.1 of the Contract reiterating its entitlement to an extension under EOT/03.8 The NHA informed Bayindir that liquidated damages would be imposed on Bayindir for late completion of the two Priority Sections with effect from 20 April 2001; that is, the end of the limited extension granted on 3 April 2001. The same day, Bayindir wrote to NHA to refer the decision to impose liquidated damages to the Engineer pursuant to Clause 67.1, in particular on the ground that EOT/03 was "still pending with the Engineer for decision". On April 20, 2001, Bayindir wrote to NHA to inform that it had been unable to complete the Priority Sections "due to reasons beyond its control" and requested that "the procedure [that is the submission of EOT/03 to the Engineer for decision under Clause 67.1] be allowed to follow to determine [its] entitlement for Time extension". On April 23, 2001 – before the engineer issued its determination – NHA served a "Notice of Termination of Contract" upon Bayindir requiring the latter to hand over possession of the site within 14 days. Thereafter, the Pakistani army surrounded the site and Bayindir's personnel were evacuated. On December 23, 2002, NHA concluded a contract for the "Completion of Balance Works of Islamabad – Peshawar Motorway (M-1) Project with "M/s Pakistan Motorway Contractors Joint Venture (PMC JV)" providing for a completion term of 1460 days.

On April 30, 2001, Bayindir filed a constitutional writ petition against the notice of termination served by NHA before the Lahore High Court . On 7 May 2001, the Lahore High Court dismissed Bayindir's constitutional petition on the ground that the Contract contained an arbitration clause. An appeal against this decision was dismissed as withdrawn by the Supreme Court of Pakistan on 16 November 2003. Between 2001 and early 2003, NHA raised a series of claims against Bayindir and served a notice of

arbitration. On March 31, 2003, NHA sought Bayindir's concurrence in the appointment of a sole arbitrator. On 10 April 2003, Bayindir informed NHA that it had already submitted the matter to ICSID jurisdiction and requested to await the decision on Bayindir's request for ICSID Arbitration. On January 5, 2004, NHA applied for the appointment of an arbitrator in Pakistan under section 20 of the Arbitration Act 1940. On May 28, 2004, the Court of Civil Judge in Islamabad appointed Mr. Justice (Retd.) Afzal Lone as arbitrator. The court subsequently upheld an objection of NHA claiming that Mr. Lone was too closely linked with the previous government of Pakistan; that is the government that decided the revival of the contract in 1997 and appointed Mr. Justice (Retd.) Zahid. Following a request by Pakistan, NHA moved for an extension of time limits in such a manner that the arbitration would not proceed prior to this Tribunal's decision on jurisdiction. In the meantime, on April 24, 2001, NHA called for payment under the Mobilization Advance Guarantees of approximately US$ 100,000,000. Bayindir then obtained an order from the Turkish courts enjoining the Banks from paying. This injunction was lifted on September 12, 2003. Execution proceedings against the Banks, to which Bayindir is not a party, are currently stayed following this Tribunal's Procedural Order No. 1 (PO#1) that Pakistan take steps to ensure that NHA does not enforce any final judgment it may obtain from the Turkish courts with regard to the Mobilization Advance Guarantees.

On April 15, 2002, Bayindir submitted a Request for Arbitration (the "Request" or "RA") to the International Centre for the Settlement of Investment Disputes ("ICSID" or the "Centre"), accompanied by 15 exhibits. In its Request Bayindir invoked the provisions of the BIT and sought the following relief:

(i) payment of outstanding Interim Payment Certificates US$62,514,554.00;

(ii) payment of additional financial claims related to the Works completed by Bayindir provisionally quantified as US$27,000.000.00;

(iii) reimbursement of all costs incurred in anticipation of completing the Project by Bayindir amounting to US$19,071,449.00;

(iv) payment against all fixed and movable assets expropriated by Pakistan US$43,050,619.00;

(v) compensation for mobilisation and demobilisation costs US$7,444,854.00;

(vi) compensation for profits lost through Pakistan's unlawful acts and omissions provisionally quantified as US$107,154,634.00;

(vii) compensation for damage to Bayindir's reputation resulting from Pakistan's unlawful acts and omissions provisionally quantified as US$150,000,000.00;

(viii) compensation and costs on account of the following items:

(i) the reimbursement of all costs incurred by Bayindir in pursuing the resolution of the claims brought in this arbitration, including but not limited to the fees and/or expenses of the arbitrators, ICSID, legal counsel, experts and Bayindir's own experts and staff;

(ii) compounded interest on all amounts awarded at an appropriate, rate or rates and over an appropriate period or periods;

(iii) compensation for opportunities lost as a direct result of Pakistan's unlawful acts and omissions;

(iv) compensation for losses and damages suffered by Bayindir in Turkey as a direct consequence of Pakistan's unlawful acts and omissions;

(v) any other relief that the Arbitral Tribunal may deem fit and appropriate in the circumstances of this case.

After a long and extensive exchange of correspondence between Bayindir, Government of Pakistan, NHA and the Centre, on December 1, 2003, the Secretary-General of the Centre registered Bayindir's RA, pursuant to Article 36(3) of the Convention on the Settlement of Investment Disputes between States and Nationals of other States (the "ICSID Convention" or "the Convention"). On the same date, the Secretary-General, in accordance with Institution Rule 7, notified the parties of the registration of the request and invited them to proceed, as soon as possible, to constitute an Arbitral Tribunal.

In its written and oral submissions, Bayindir advanced the following four main contentions:

(i) Bayindir made an "investment" under both the BIT and the ICSID Convention;

(ii) Bayindir has *prima facie* claims against Pakistan for breaches of the BIT, namely for breaches of the treaty provisions on national and most

favoured nation treatment, fair and equitable treatment and expropriation without compensation (hereinafter generally referred to as "Treaty Claims");

(iii) The Treaty Claims are distinct and autonomous claims which Bayindir can assert against NHA (and or Pakistan) independently from those claims which arise out of the Contract (hereinafter generally referred to as Bayindir's "Contract Claims").

(iv) Finally, as an independent argument, Bayindir claims that the Tribunal also has jurisdiction over the Contract Claims.

On the basis of these contentions, Bayindir requested the Tribunal to decide that the Tribunal had jurisdiction to hear the contractual claims for breach of the BIT. In its written and oral submissions, Pakistan advanced the following six main arguments:

(i) Bayindir had not made an investment within article I(2) of the BIT or Article 25 of the ICSID Convention.

(ii) The basis of Bayindir's claims was alleged breach of the Contract. The Contract was governed by the law of Pakistan and, pursuant to the law of Pakistan, the Employer (NHA) was a separate legal person, distinct from Pakistan. The Tribunal had no jurisdiction in respect of alleged breaches of the Contract as such breaches are not attributable to Pakistan.

(iii) The Contract Claims were inadmissible in the light of the agreement of the Employer and the Contractor to refer their disputes to arbitration, and the proceedings were liable to be stayed pending resolution of the contractual dispute by arbitration.

(iv) To the extent that Bayindir's claims were based on an alleged breach of the BIT, i.e., to the extent that they were Treaty Claims, they were entirely artificial and advanced solely for purposes of expediency.

(v) Since Bayindir's Treaty Claims were dependent upon the claims for breach of the Contract that have to be settled in another forum, the Tribunal cannot exercise jurisdiction over the Treaty Claims, at least until that other forum had reached a conclusion with regard to the alleged breach of the Contract.

(vi) Insofar as Bayindir's Treaty Claims were distinct from the alleged breach of the Contract, these allegations "have no colourable basis" and are insufficient for this Tribunal to assert jurisdiction.

In support of their position, both parties relied extensively on previous ICSID decisions or awards, either to conclude that the same solution should be adopted in the present case or in an effort to explain why this Tribunal should depart from that solution. The parties disagreed on the meaning of the phrase "in conformity with the hosting Party's laws and regulations" following the "investment" in Article I(2). On the one hand, Bayindir argued that the requirement of conformity was meant "to exclude investments that have been made in violation of local law from the treaty's protection" and had no bearing on the definition of the term investment itself. By contrast, Pakistan contended that this phrase limited the definition of investment under the BIT to "investment within the laws and regulations of Pakistan". Pakistan further asserted that Bayindir had obtained the authorisation by the Pakistan Board of Investment to engage in the construction work upon an express representation that it was not making an investment, so that "there has been no investment for the purposes of the laws and regulations of Pakistan as required by Article I(2)" of the BIT.

For the purpose of deciding on its jurisdiction, the Tribunal held that it did not need to determine the exact legal significance of Bayindir's statements before the Pakistan Board of Investment. In and of itself the representation that Bayindir was not making an investment given for the purposes of obtaining an authorisation by the Board of Investment did not mean that the activity of Bayindir did not qualify as an investment under Pakistani laws. Moreover, Pakistan did not set forth any domestic laws or regulations providing for a specific definition of investment. The Tribunal did not see any reason to depart from the decision of the tribunal in *Salini v. Morocco* holding that "this provision [i.e., the requirement of conformity with local laws] refers to the validity of the investment and not to its definition".[23]

Considering Bayindir's contribution both in terms of know how, equipment and personnel and in terms of injection of funds, the Tribunal held that Bayindir did contribute "assets" within the meaning of the general definition of investment set forth in Article I(2) of the BIT.

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[23] *Salini v. Morocco* [*supra* No. 98], Neither the fact that the regularity-validity of the investment under the host state law is specifically dealt with in another provision of the Treaty (namely Article II(1) and (2)) nor the fact that in *Salini* the provision qualified the words 'assets invested' and not 'the term investment', provides sufficient grounds to depart from the *Salini* reasoning.

> *As a preliminary matter, the Tribunal notes that Pakistan accepts that "treaty claims are juridically distinct from claims for breach of contract, even where they arise out of the same facts". The Tribunal considers that this principle is now well established. The ad hoc committee in Vivendi v. Argentina described this "conceptual separation"[24] as follows: A particular investment dispute may at the same time involve issues of the interpretation and application of the BIT's standards and questions of contract.*[25]
> *Whether there has been a breach of the BIT and whether there has been a breach of contract are different questions. Each of these claims will be determined by reference to its own proper or applicable law in the case of the BIT, by international law, in the case of the Concession Contract, by the proper law of the contract. As a matter of principle, this arbitration clause is irrelevant for the purpose of the jurisdiction of this Tribunal over the Treaty Claims.*[26]

Bayindir alleged that Pakistan had breached the MFN clause because it awarded PMC JV, the local contractor that replaced Bayindir, a four-year extra 'time and space', while it was itself expelled having requested an EOT for a much shorter period. It also argued that, although the project is still not terminated, the local contractor remains in place and continues to benefit from Pakistan's leniency as to delays. The mere fact that Bayindir had always been subject to exactly the same legal and regulatory framework as everybody else in Pakistan does not necessarily mean that it was actually treated in the same way as local (or third countries) investors. Bayindir asserted that "Pakistan failed to promote and protect Bayindir's investment in violation of Article II of the BIT [and] failed to ensure the fair and equitable treatment of Bayindir's investment, in violation of Article II (2) of the BIT. In summary, Bayindir's fair and equitable treatment claim is based on Pakistan's alleged "failure to provide a stable framework for Bayindir's investment" and on the alleged fact that "Pakistan's expulsion of Bayindir was unfair and

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[24] B. Cremades and D.J.A Cairns, Contract and Treaty Claims and Choice of Forum in Foreign Investment Disputes, in: T. Weiler (Ed) International investment law and arbitration: leading cases from the ICSID, NAFTA, bilateral treaties and customary international law, London, 2005, p. 331.

[25] *Compañia de Aguas del Aconquija SA and Vivendi Universal (formerly Compagnie Générale des Eaux) v. Argentine Republic*, Decision of Annulment, 3 July 2002; ICSID Review (2004), vol. 19, No. 1, 41 ILM 1135 (2002), also available at http://www.worldbank.org/icsid/cases/vivendi_annul.pdf

[26] *Camuzzi International S.A. v. Argentine Republic*, ICSID Case No. ARB/03/2, Decision on Jurisdiction of 11 May 2005, available at http://www.worldbank.org/icsid/cases/camuzzi-en.pdf,

inequitable". Pakistan's case was that there was no obligation of equitable treatment in the BIT and, even if there were, there would be no violation of fair and equal treatment.

The preamble to the BIT described the objectives which Turkey and Pakistan pursued in entering into the BIT as follows:

> *The Islamic Republic of Pakistan [...] and the Republic of Turkey [...] agre[e] that fair and equitable treatment of investment is desirable in order to maintain a stable framework for investment and maximum effective utilization of economic resources.*

According to the Tribunal, the sole text of the preamble constituted a sufficient basis for a self-standing fair and equitable treatment obligation under the BIT. The Tribunal considered, *prima facie*, that Pakistan was bound to treat investments of Turkish nationals "fairly and equitably."[27] The Tribunal held that, in the light of the terms of the BIT's preamble and for purposes of establishing jurisdiction, it could not *prima facie* be ruled out that Pakistan's fair and equitable treatment obligation comprised an obligation to maintain a stable framework for investment.

It is true that Pakistan asserted that the obligation to afford fair and equitable treatment as expressed in *Tecmed v. Mexico*[28] relates to "changes to the regulatory framework in which an investment has been made" and that "Bayindir can point to no equivalent regulatory changes in this case and of course there are none". However, the general definition of fair and equitable treatment in *Tecmed* refers not only to "all rules and regulations that will govern [the] investments" but also to "the goals of the relevant policies and administrative practices or directives". Hence, the fact that in *Tecmed* the change concerned a failure to renew a necessary operating permit does not rule out that a State can breach the 'stability limb' of its obligation through acts which do not concern the regulatory framework but more generally the State's policy towards investments. The Tribunal considered that, if proven, Pakistan's alleged change in its general policy toward

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[27] As to the general possibility to "import" a fair and equitable treatment provision contained in another BIT, see, for instance *Pope & Talbot Inc. v. Government of Canada,* Decision of 10 April 2001.

[28] *Técnicas Medioambientales, Tecmed S.A., v. The United Mexican States*, Case No. ARB (AF)/00/2, Award of 29 May 2003; ICSID Review (2004), vol. 19, no. 1, also available at http://www.worldbank.org/icsid/cases/laudo-051903%20-English.pdf.

Bayindir's investment is capable of constituting a breach of Pakistan's obligations to accord fair and equitable treatment.

Article III (1) of the BIT states the following in connection with expropriation: Investments shall not be expropriated, nationalized or subject, directly or indirectly to measures of similar effects except for a public purpose, in a non-discriminatory manner, upon payment of prompt, adequate and effective compensation, and in accordance with due process of law and the general principles of treatment provided for in Article II of this Agreement.

Bayindir contended that the following actions of Pakistan constitute an expropriation within the meaning of Article III (1) of the BIT:

(i) Pakistan's expulsion of Bayindir from the site, enforced by armed units of the Frontier Works Organization, was a large-scale taking of Bayindir's Motorway investment [including a right to payment for several months of Interim Payment Certificates and works in progress], for the purpose of transferring property and interests into government hands before being passed along to PMC JV.

(ii) On the ground that Bayindir did not re-export equipment within the time limit set by the applicable Pakistani regulation, Pakistan's Customs services encashed bank guarantees issued by Standard Chartered Bank ("SCB") securing unpaid import customs duties on behalf of Bayindir.

The Tribunal also held that expropriation is not limited to *in rem* rights and may extend to contractual rights. The Tribunal considered that, in the absence of a specific definition in the BIT, expropriation could take place also where the measure is not technically a regulatory act. As it has been consistently held in investment cases, expropriation might arise out of a simple interference by the host State in the investor's rights with the effect of depriving the investor – totally or to a significant extent – of its investment.

Without prejudging its eventual determination of the relevant facts, the Tribunal ruled that there might have been a sufficient involvement by the State in the alleged taking of Bayindir's investment so as to amount to an expropriation under the BIT.

3.4 Disincentives to Foreign Investment

Corruption and transparency issues are still of concern, as demonstrated by the Transparency International ranking of Pakistan, despite a number of measures being implemented under the guidance of the World Bank to improve the situation. It is recognized by most people met during the course of this study that the situation has improved marginally with the present administration. Enforcement of laws, rules and regulations could still be improved, with lower levels of the administration not presently fully efficient. One major drawback is the contentious legal framework which does not automatically recognize and implement international arbitration decisions. The judicial system also still lacks effectiveness. Intellectual property rights, while legally protected, are not always enforced – pirated and copied goods are prevalent in most sectors of the economy.

Pakistan has been on the U.S. 301 Watch List since 1985. In May 2004, the United States Government downgraded Pakistan from Watch List to Priority Watch List in its Special 301 review. Also, in June 2004, the United States Government agreed to consider a GSP petition filed against Pakistan by entertainment industry representatives due to extensive production and export of illegal optical disks in Pakistan. Areas of specific concern include optical media piracy (Ten optical disc factories in Pakistan currently produce an estimated 230 million unlicensed discs annually, the majority of which are exported); unauthorized reproduction of U.S. printed works; and textile design piracy. A general complaint is that, even where Pakistan's intellectual property laws appear to provide adequate protection, enforcement is slow, sporadic, and ineffective. Weak enforcement is partially attributed to the division of responsibilities for copyrights, patents, and trademarks among a variety of government ministries. In January 2004, the Pakistani Cabinet approved legislation to create the Pakistan Intellectual Property Rights Organization (PIPRO), a regulatory body that would consolidate IPR oversight.

The multifarious shortcomings affecting Pakistan's legal system, such as frequent legislative changes, excessive accumulation of laws and regulations, contradictions between different pieces of legislation, ill-defined laws, ex *post facto* changes in the rules and difficulties to find copies of newly enacted legislation, have oftentimes been deplored by foreign investors. In any country, greater or lesser conformity to the principle of the

rule of law is conditioned by various historical and political factors and that, as a matter of fact, the rule of law often enters in conflict with other values.[29] To say the least, Pakistan's current legal reform epitomizes such conflict.

3.5 Political Risk to Foreign Investment in Pakistan

Political risk can be understood as the occurrence of events in the political sphere (governmental actions, politically motivated insecurity in the country and international conflict) which impede the normal operations of a business venture with a detrimental financial impact on the commercial viability of the venture. Political risk also includes the risk that the laws of a country will unexpectedly change to the investor's detriment after the investor has invested capital in the country, thereby reducing the value of the individual's investment. Put simply, political risk is the risk of government intervention.[30] Examples of political risk are the risks that a government will raise import or export duties, increase taxes, impose further regulations, or nationalize or expropriate the assets of the investor.

Political risks manifest themselves in diverse ways. One possible motive for the activities of the government could be derived theoretically in the concept of rent-seeking groups. According to this perspective whenever a government restricts the otherwise market-oriented economic activity, there is a potential rent. The existence of rent or potential rent initiates action by a rent-seeking group which could act as groups or as loosely organized individuals. Rent-seeking is an additional cost for the society and economy in general because the activity of rent-seeking groups contributes to a higher level of political uncertainty in a given economy and therefore hinders the FDI.

Foreign investors are well aware that political factors can be the impetus behind policies directly affecting their interests in the host country. As evidence of its receptiveness to foreign investment, a country's favorable political climate thus plays a determinant part in enticing foreign capital. Long-term political stability, a crucial

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[29] J. Raz, "The Rule of Law and its Virtue" (1977) 93 L.Q.Rev. 195, at p. 198.

[30] As pointed out by the Italian legal theorist Bruno Leoni in his *Freedom and the Law*, even if a given statute is written clearly, "we are *never certain* that tomorrow we shall still have the rules we have to day." Bruno Leoni, *Freedom and the Law*, p. 75 (3d ed. 1991).

element of a reliable political environment, has to be a top priority area for a country eyeing foreign investment. Paradoxically, flowing from the political stability required to provide a favorable investment climate is the maintenance of the existing rule in the country.

Concessions, directly negotiated between the investor and the host state, containing stabilization and international arbitration clauses, are one method of reducing political risks; purchasing government-sponsored or even private insurance is still another. The protections won by BITs also serve to reduce the political risks inherent in foreign investment. BITs create a regime anchored in international law which is favorable, not hostile, to in vestment—a regime which attempts to prevent expropriation, direct or indirect, and to provide for full compensation when expropriation does occur.

Another issue is the security situation, which has three dimensions: the still unstable situation in Afghanistan, which spills over to the neighboring regions in Pakistan; the conflict with India over Kashmir, which is the subject of renewed peace talks between the two countries, initiated at the end of 2003; and sectarian violence between Shiites and Sunnis. In this context, foreigners need to be cautious and are advised to keep themselves informed e.g. by consulting travel advice issued by the European foreign ministries. It is worth noting however, that Pakistan-India relations have improved recently, and negotiations are being undertaken to try and resolve a number of issues including Kashmir.

3.6 Foreign Investment and the Rule of Law in Pakistan

The conventional wisdom within the international development community is that foreign direct investment (FDI) is an important component of economic growth and prosperity in the developing countries and that a crucial, if not decisive, factor in enticing such investment is a stable, consistent, fair, and transparent legal and judicial system. Implicit in this general realization is the premise that the foreign investor is a passive spectator of the reform process, hesitant to enter the fray until a modification or overhaul of the legal system has occurred.

This conclusion is based on the theory that a transparent, modern "Western" legal system is a prerequisite for foreign investors to venture into host states. The logic of this

argument derives from neo-institutional theory of the behavior of economic actors, which maintains that efficient and transparent legal systems reduce transaction costs for economic actors, including foreign investors. Since transaction costs increase the costs of direct investment, foreign investors should be averse to investing in countries with such higher costs and, thus, will gravitate toward states with more "effective" or "efficient" legal regimes.

It has been often observed that in order to not only attract, but also keep foreign investment, Pakistan must abide by the rule of law. Tracing its roots as far back as the Aristotelian philosophy of Ancient Greece, the principle of the rule of law has been restated many times over the years.[31] At the end of the nineteenth century, English jurist Albert Venn Dicey introduced the well-known classical version of this principle.[32] While parliamentary sovereignty was meant to put an end to the absolute power of the monarch, the rule of law served to prevent any abuse of powers on the part of the government. Essentially, Dicey viewed the rule of law as a shield against arbitrary power: all authority derived from the law and no one (including the administration) was above the law. The major flaw in Dicey's theory is that it failed to discriminate between arbitrariness and discretion, holding them both to be proscribed.[33] For its part, far from excluding the use of discretionary powers by governmental authorities, the modern conception of the rule of law makes it clear, however, that the administration remains subject to the law.[34] The principle also dictates that the law should be such as to allow the citizen to organize his

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[31] I.N. Shklar, "Political Theory and the Rule of Law in A.C. Hutchinson & P. Monahan, *eds., The Rule of Law - Ideal or Ideology* (Toronto: Carswell, 1987) p. 1. Shklar submits that there are two archetypes of the rule of law: Aristotle's rule of reason and Montesquieu's bid to protect ruled against the ruler, adding that the two have become blurred over the years. Stating that Dicey's version of the rule of law was the most influential restatement of the principle since the eighteenth century, she nonetheless refers to it as an "unfortunate outburst of Anglo-Saxon parochialism. In her article, Shklar also reviews the works of contemporary legal theorists Friedrich Hayek, Roberto Unger, Lon Fuller and Ronald Dworkin,

[32] A.V. Dicey, *Introduction to the Study of the Law of the Constitution,* lîhh *ed.* (London: Macmillan, 1960).

[33] *Ibid.* at p. 202. Indeed, according to Dicey, the rule of law actually precluded 'wide discretionary authority on the part of the government.'

[34] A.C. Hutchinson & P. Monahan, "Democracy and the Rule of Law in Hutchinson & Monahan, *eds.*, supra, p. 97 at p. 101.

affairs and predict the consequences of his actions.[35] Accordingly, the law itself must meet certain criteria.[36]

The Constitution of Islamic Republic of Pakistan 1973 itself makes express references to the supremacy of law: its Article 12 stipulates that the state manages society through law and its Article 4 provides that all organizations must operate within the framework of the Constitution and the law. Whether these constitutional provisions together with official declarations on rule of law are sufficient to conclude that Pakistan's legal system and its operation in real life is genuinely based on the rule of law or that it will eventually be so is, however, remains open to debate.

Undeniably, Pakistan's legal framework for foreign investment remains to be perfected in order to meet the requirements of a market economy. Much has been said about the "regulatory miasma" awaiting foreign investors in Pakistan. For instance, not only do they find themselves having to cope with rapid changes in the law making it hard for them to predict the consequences of their actions, but they are also sometimes faced with conflicting regulations or varying interpretations of the laws and regulations not only by the administrative authorities but also by courts. The role for the rule of law and government to promote FDI should be to set a framework establishing the limits for acceptable effective market conduct and deter, at the same time, anticompetitive behaviour.[37]

Clearly, Pakistan, like most other developing states, is torn between promotion and control of foreign investment. Its desire to protect its national sovereignty and avoid having its economy foreign-controlled is most legitimate. However, to successfully attract outside capital, it must be able to offer a favorable investment climate. For Pakistan, the major legal, regulatory and institutional challenges over the next few years

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[35] This is the basic intuition from which the doctrine of the rule of law derives: the law must be capable of guiding the behavior of its subject. J. Raz, "The Rule of Law and its Virtue", (1977) 93 L.Q. Rev. 195 at p. 198.

[36] *Ibid.* at pp. 198- 199. Raz lists some other important aspects of the principle of the rule of law at pp. 198-202 and divides them into two groups. Aspects in the first group are meant to ensure that the law can adequately guide behavior; those in the second group relate to the enforcement of the law *per se* (independence of the judiciary, accessible courts with review powers, etc.).

[37] C. R. Frischtak, "From Monopoly to Rivalry: Policies to Realize the Competitive Potential of Transnational Corporations" (1992) 1:2 Transnat'l Corporations 57.

are to systematically unwind extensive state involvement in the economy, discourage entrenched habits of rent-seeking, build new capacities in the public administration, reduce legislative uncertainty, enhance transparency and legal clarity,[38] and create the market-based regulatory regimes and institutions that will support investment, innovation, and vigorous competition.

[38] Policies and standards must be unmistakably clear and fairly implemented. Simplicity is more important than a regulatory regime that addresses every situation. In countries with weak legal traditions like Pakistan, simple rules place fewer demands on courts, are cheaper and more likely to be accurate, and reduce the risk of corruption.

Chapter 4

CONCLUSION

> *The life of the Law has not been logic, it has been experience (...). The Law embodies the story of a nation's development through many centuries, and it cannot be dealt with as if it contained only the axioms and corollaries of a book of mathematics. In order to know what it is, we must know what it has been, and what it tends to become.*
>
> O.W. HOLMES[1]

In the past two decades, the general climate surrounding FDI has undergone significant changes. These changes are both causes and effects of the ongoing process of globalization and the changing role of FDI in it. All developing countries now welcome FDI, and have unilaterally liberalized their national regulatory regimes. It is widely recognized by the host governments that foreign investment can play a key role in the economic growth and development process, and FDI is a vital instrument through which "economies are being integrated at the level of production into the globalizing world economy by bringing a package of assets, including capital, technology, managerial capacities and skills, and access to foreign markets".[2]

The FDI inward legal regimes of most countries around the world, both developed and developing, have taken on a liberal framework in the recent years. The liberalization of core FDI policies consists of reducing barriers for inward FDI, strengthening standards of treatment for foreign investors and ensuring the proper functioning of markets and a level playing field for all investors. Ironically, with policy regimes becoming increasingly open and similar, many countries have found that they need to make further efforts to attract FDI in such a competitive climate; FDI is now recognized as one of the most important sources of much needed capital and managerial, technical and marketing know-how not only in the manufacturing industry, but also in services and the resource-based

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[1] Oliver Wendell Holmes, *The Common Law*, Dover Publications, 1991 (1881).

[2] UNCTAD, "A Partnership for Growth and Development", United Nations Doc. No. TD/378, (New York and Geneva: United Nations Publications, 1996) at para. 36.

industry. Moreover, world-wide liberalization convergence increases the locational choice for FDI. Countries have implemented active FDI promotion policies that have evolved over the years, as the objective has shifted from simply attracting a desired quantity of FDI to attracting quality FDI with a highly beneficial impact on the domestic economy. In the first generation of investment promotion policies, many countries adopt market-friendly policies. They liberalize their FDI regimes by reducing barriers to inward FDI, strengthening standards of treatment of foreign investors and assigning a greater role to market forces in resource allocation. Some countries can go a long way in attracting foreign investment with these steps, if the basic economic determinants for obtaining FDI are right.

Although these relatively liberal attitudes towards FDI are pervasive, they are by no means uniform or invariably true for all host developing countries. First, the heterogeneous economic conditions amongst the host nations give rise to a diversity of national perceptions and concerns over international economic policy. Secondly, host developing countries subscribe to the view that certain investment measures and restrictions are not only necessary, but can, *inter alia,* play a crucial part in their national policies to foster economic development. Policy considerations, in this sense, go beyond the mere liberalization of domestic regulatory frameworks and the legal protection of foreign investors. These considerations are indeed rationalized underlying the necessary employment of entry restrictions and conditions and performance requirements by developing countries, with a view to building up domestic capability and stimulating greater innovation. Therefore, developing countries continue to face some of the old conflicts at the multilateral level. The current desire of the developed countries for a comprehensive uniform international investment regime contrasts with their attitude towards the efforts undertaken in the past through the United Nations to regulate the activities of TNCs. Obviously, they are now aiming at the elimination of all restrictions within the national regulatory regime of host developing countries and the establishment of high standards of liberalization for global investment movements.

Developing countries like Pakistan, on the other hand, have yet to be prepared for such multilateral governance. They are concerned that multilateral negotiation towards

such agreement might be inevitably dominated by the agenda of the strongest economies, thus ignoring the substantial development demands of developing countries.

Legal approaches have shifted their focus in response to these significant changes in the world economy, as well as the political reality of national governments. The debate surrounding international rule-making has largely turned to pragmatic, policy-oriented considerations, as Professor Fatouros summarized, "not so much what is the law, not even which are the 'correct' legal principles or rules, but what policies and measures are effective in promoting international flows of capital and technology, under present conditions".[3]

This shift in the focus of concerns has resulted in an emphasis on international arrangements, bilateral, regional and multilateral, as the principal source of pertinent legal regulation. In legal terms, customary international law continues to provide the indispensable background against which other normative principles can be understood and developed. Nevertheless, its lack of specific contents and its alternation between the twin foundations considerably undermine its practical effectiveness. At the same time, an international legal framework for FDI has begun to emerge in recent years, albeit with extensive gaps and sometime even ambivalence. It consists of regulatory understandings operating at different levels. These include national statutory regimes, as well as international rules and principles established at bilateral, regional and multilateral level, which together can become in the course of time of customary, conventional or institutional nature.

At the bilateral level, a complex network of BITs has grown as a preferable solution to address some highly contentious issues in connection with FDI in view of the current uncertainty of customary international law. They have replaced earlier forms of FCNs for the protection of foreign investment. Such BITs usually begin with declarations stressing mutual desire to enhance economic cooperation and to promote private investment. Typically, they set out normative rules and principles in four substantive areas: admission and establishment, treatment of foreign investment, expropriation and compensation, and settlement of dispute. However, a deeper examination of the BITs

[3] See A.A. Fatouros, "Towards an International Agreement on Foreign Direct Investment?" (1995) Vol. 1 0 No. 2 ICSID Review - Foreign Investment Law Journal 181, at p. 184.

exposes a clear asymmetry attached to these treaties. While they oblige host countries to accord certain standards of treatment to the investors, no specific duty is imposed on home countries to promote private investment flows to their treaty parties. Nor do they spell out any obligations for private investors, whose abusive business practices may actually have serious adverse effects on the host states' national economic development, or even political independence. On the other hand, developed host countries are not satisfied with the approach of BITS either. For their part, although certain standards of treatment are in place, there exists no efficient mechanism to achieve liberalization, and in particular, the issue of entry and admission has been left to exclusive discretion of the host states.

At the multilateral level, no effort towards a comprehensive framework governing FDI has yet come to fruition. The multilateral trading system - the GATT- WTO framework - already deals with some investment issues in the TRIMs Agreement, the GATS and the TRIPS, but the scope is rather limited and, in the view of industrialized nations, the Pace of liberalization is not responsive to the dynamics of the ongoing integration of the world economy. Consequently, these nations launched the negotiations on the MAI, seeking to establish a constitutional "GATT" in the FDI sphere. However, such an over-ambitious approach has proved to be even more problematic. The fundamental premise upon which the MAI has been built is evidently unbalanced and one-sided. It confers to foreign investors unfettered rights and powers, and imposes restrictive obligations on the host countries, limiting considerably the sovereign regulatory powers of the host governments. The developing country governments have strongly opposed the approach of the MAI, and have increasingly seen the agreement as "an exercise in neo-colonialism, designed to give rich world investors the upper hand".[4]

In principle, two dimensions can be identified sense from a development perspective for the purpose of a multilateral investment framework. One part would be how the proposed agreement could be formulated in such a flexible manner as to allow a sufficient margin of autonomy for developing countries to pursue their own policies with

[4] See "Finance and Economics: the Sinking of the MAI" in The Economist (March 14, 1998), at p. 81.

respect to FDI. The UNCTAD has stressed in one of its reports the need for retaining room for government to regulate by recognizing that:

> *[the quality and quantity of investment can be improved by means of closer linkages with the world economy through trade and capital flows including FDI. But these external linkages must be complementary to and not a substitute for the domestic forces of growth through capital accumulation and technological capacity building. This can be achieved only through a carefully managed and phased integration into the world economy, tailoring the process to the level of economic development in a country and the capacity of existing institutions and industries. Such a strategy contrasts sharply with the "big bang" liberalization adopted by some countries in recent years.*[5]

The development dimension needs to be built into the framework through various substantive norms, as well as special arrangements reflected in the overall structure. First of all, developing countries and developed countries should be distinguished as separate categories, and developing country members should be granted broader exceptions, longer transitional periods and other preferential treatment. Substantive and specific obligations should also be imposed on developed country members to positively promote private FDI flows to developing countries, through insurance programmes, fiscal incentives, or special investment financing. The issue of admission and establishment and national treatment standard should be addressed in such a flexible way that host governments can give expression to their priorities in certain sectors and protect some infant and vital industries, thereby promoting development of their national economies. Performance requirements should be allowed for developing nations to foster the learning and externality effects of FDI, so long as the application of these measures will not have a serious adverse effect on trade flows and will proceed on a non-discriminatory basis.

The problem of indirect expropriation also deserves particular attention in that an over-broad definition will definitely fetter host governments' sovereign power to legitimately control and regulate the economic activities of private actors.

The other particularly important aspect that should be accommodated in the multilateral context is the regulation of obligations of foreign investors. To strike a fair

[5] UNCTAD, Trade and Development Report 1997 (New York and Geneva: United Nations, 1997) at p. vii.

balance between treatment of principles governing the government practices and the corporate practices, any approach towards an MIF should spell out foreign investors' obligations, legally binding wherever possible. In today's increasingly integrated and liberalized world economy, a broader international framework that calls for more active cross-border co-operation has acquired particular significance, especially in the area of restrictive business practices, transfer of technology, environment and labor protection, illicit payments and other possible political interference.

The role of an enabling environment for FDI including political stability as a key factor in attracting and maintaining investors cannot be overemphasized. Another universally acknowledged principle is the need to offer stable, transparent and non-discriminatory regimes for foreign investors. Such an environment would consist, among other things, of a legal framework maximizing a country's potential for attracting FDI, adequate infrastructure, good governance, an effective judicial system and respect for the rule of law.

In 1992, as part of an integrated investment promotion strategy, the government of Pakistan initiated a comprehensive program of economic reforms including liberalization, privatization and deregulation designed to steer the economy toward a fully market-oriented system. Power generation, telecommunication, highway construction, port development and operations, oil and gas, services and infrastructure, and the social and agriculture sectors were opened to foreign investment. By 1997, this liberalization had been significantly expanded, with restrictions on FDI eased and foreign investors allowed unrestricted profit repatriation in the agriculture, services, infrastructure and social sectors. Full foreign ownership, already permitted in the manufacturing sector, was expanded to the social and infrastructure sectors. In June 2004, the Government of Pakistan abolished the requirement that foreign investors in the services sector accumulate a minimum of 40% Pakistani equity within five years of life of the initial investment. Now foreign investors in the services sector may retain 100% equity "for the life of the investment." In addition, the minimum allowable equity investment in the services sector has been reduced from $300,000 to $150,000. Also 100 percent repatriation of profits is now allowed in the services sector. In the social and infrastructure sectors 100 percent foreign ownership is allowed with the minimum

investment requirement of $300,000. In the agricultural sector, 60% foreign ownership is allowed. Corporate farming is permitted remittance of full capital, profits and dividends, with dividends tax-exempt. There are no limits on the size of corporate farming land holdings and the sector is allowed to lease land for 50 years with renewal options.

Virtually all legal systems, including those of the countries that are considered as having some of the most liberal and FDI hospitable countries in the world, do exclude foreign ownership in particular sectors or on specific grounds. However, in countries characterized by a high level of hospitability towards FDI, such prohibitions are often limited to a significant extent to sectors or circumstances in which national security concerns, or at least superior national interests, are involved. The latter can include sub-sectors in the energy industry with the objective of ensuring the provision of energy to the local populations at all times. The FDI regime in Pakistan offers an example of a system that almost exclusively contains prohibitions that are considered imperative to protect the national security. The sectors involved are the defense industry, national security provision, disposal of hazardous wastes and real estate. The relation of the latter with national security concerns, at first glance, seems quite distant. However, viewed in the context of the particular problems the country faces and the rationale of the exclusion, *i.e.*, to hinder money laundering, there is a clearer connection between the prohibition and national security.

It is not infrequent that beyond concerns of national security and superior national interests, FDI hospitable countries exclude a few other sectors of their economy, generally because they are considered sensitive. Those sectors are often some of the following: banking and financial services, mail and telecommunications, broadcasting, aviation, maritime shipping, real estate, specific national resources and/or governmental contracting. Whether excluded for national security reasons, superior national interests or because considered as sensitive sectors, and apart from those already listed above, the sectors most frequently excluded for foreign investment are nuclear energy generation, uranium and toxic industry, military equipment, hydrocarbons, mining, air and sea transport, electric power, agriculture, forestry, health services, insurance, security services, brokerage, customs agencies, publishing, fishing and the uranium industry.

The legal FDI framework of many states contains a variety of incentives to entice foreign investment. The most commonly used attraction devices are financial incentives, especially tax advantages. What has already been stated for FDI incentives in general, is also true for tax advantages: they can be offered to foreign investors in general, but usually a state limits the applicability of such provisions to specific categories of investors complying with a set of conditions in order to maximize the benefits from productive FDI.[6] Pakistan has granted significant tax and duty incentives to three categories of industries. "Priority industries" include tourism, housing, engineering, chemicals and construction. "Value added export industries" include manufacturing categories such as garments, bed linens, surgical instruments, and sporting goods. High-Tech and Information Technology industries include chip manufacturing, software development and precision equipment manufacturing. For all above-mentioned industries Pakistan has reduced the maximum custom duty from 10% to 5% on imported plant, machinery and equipment in contrast to 0.25% custom duty for all other industries. However, export industries are also entitled to zero-rated import of raw materials and sales tax exemption. The government removed minimum equity investment and national ownership requirements for investments in these categories and granted a 50% depreciation allowance to all fixed assets.

The stability and contents of a host country's tax regime, especially of the provisions directly affecting foreign investors, is an important element when appreciating the attractiveness of its investment climate. Foreign investors in Pakistan have complained of being subject to a confusing array of federal and provincial taxes and controls. Their application - with considerable administrative discretion - has been a source of inefficiency and corruption.[7] The taxation and tariff policies in Pakistan, nonetheless, are still considerably less favorable to the corporate sector as a whole. The top marginal corporate tax rate for 1996 was the highest of the countries like Malaysia, India and Thailand. The magnitude of tariff- and non-tariff barriers on manufactured

[6] Sornarajah, M., *The International Law of Foreign Investment*, Cambridge University Press, Cambridge, 1999, p. 99.

[7] An ambitious program of income tax self-assessment was recently introduced with World Bank support to reduce the administrative cost of taxation. In early 2005, the World Bank will also launch a $100 million multi-year tax reform program in Pakistan.

goods also indicates a high degree of protectionism, when compared to Malaysia, Sri Lanka and Thailand. There are significant anomalies in the tariff structure leading to uncertainty for investors in Pakistan. For example, in the economic revival programme announced in early 1997, the existing regulatory import duty of 10% was withdrawn, but at the same time a minimum tariff rate of 10% was imposed.

A significant hurdle to investment in Pakistan has been the bewildering series of approvals, permits, and licenses required from various levels of government prior to launching a project. A series of government agencies, most recently the Board of Investment, have been created in an attempt to ease this burden by providing a one-stop interface between investors and relevant Pakistani authorities. Mandatory foreign investor registration with the Board of Investment has been eliminated, although investors still must register with the Securities and Exchange Commission of Pakistan (SECP) and the State Bank of Pakistan (SBP). Earlier requirements that foreign investors seek provincial government clearance for project location have also been eliminated. Regulations on petroleum and petroleum product marketing were lifted in 2001. Some pharmaceuticals remain on a regulated list and registration with the Ministry of Health is required for local production.

The 1976 Foreign Private Investment Promotion and Protection Act specifically provides that foreign investment will not be subject to higher income tax levels than those assessed on similar investments made by Pakistani citizens. This Act, and the Economic Reforms Act, 1992, are the primary statutory safeguards for the rights of foreign direct investors. While Pakistan's legal framework and economic strategy do not discriminate against foreign investment, contract enforcement is problematic given the domestic court system's dysfunction and lack of transparency. Information is the critical bottleneck in the entire regulatory regime. The single institutional reform that would be most welcomed by potential market entrants is improved transparency throughout the policy process. Transparency is key to regulatory quality. In addition to democratic values of openness, transparency in regulatory decisions and applications helps to cure many of the reasons for regulatory failures - capture and bias toward concentrated benefits, inadequate information in the public sector, rigidity, market uncertainty and inability to understand policy risk, and lack of accountability. Transparency at any stage has powerful upstream

and downstream effects in the policy process – it encourages the development of better policy options, and helps reduce the incidence and impact of arbitrary decisions in regulatory implementation. Moreover, transparency helps create a virtuous circle - consumers trust competition more because special interests have less power to manipulate government and markets. Transparency is also rightfully considered to be the sharpest sword in the war against corruption.

Pakistan has bilateral investment treaties with Australia, Azerbaijan, Bangladesh, Belarus, Belgium, the Peoples Republic of China, France, Germany, Indonesia, Iran, Italy, Japan, the Republic of Korea, Kuwait, Kyrgyzstan, Malaysia, Mauritius, the Netherlands, Oman, Portugal, Qatar, Romania, Singapore, Spain, Sri Lanka, Sweden, Switzerland, Syria, Tajikistan, Thailand, Tunisia, Turkey, Turkmenistan, the United Arab Emirates, the United Kingdom and Uzbekistan. A draft proposal for a Business Development Forum to facilitate business development between the United States and Pakistan was initiated in 1996, but has not yet been finalized so far. In another very positive move, Pakistan became a member of the Multilateral Investment Guarantee Agency (MIGA)[8] in April 1992. MIGA offers insurance cover in Pakistan against the risks of expropriation, war and civil disorder and currency transfer (though not currency convertibility).

By Charter of 8 December 1985, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka1 established the SAARC in order to increase economic cooperation between the member countries. The Charter mainly focuses on the liberalization of inter-SAARC trade and from that perspective established the *South Asian Free Trade Area* (SAFTA).[9] However, article 8.h. of the Charter focuses on foreign investment. It is stated: *"Contracting States agree to consider ... the adoption of trade facilitation and other measures to support and complement SAFTA for mutual*

[8] The Multilateral Investment Guarantee Agency (MIGA) was established under the Convention to provide to foreign investors guarantees against non-commercial risks in its Member countries. Once MIGA has paid an insured claimant who has suffered loss from the specified non-commercial risks, it then obtains rights of subrogation against the host country, who shall also be a party of the Convention. For an analysis of ICSID and MIGA, see generally Ibrahim F.I. Shihata, "Towards a Greater Depoliticization of Investment Disputes: the Role of ICSID and MIGA" (1986) Vol. 1 No. 1 ICSID Review – Foreign Investment Law Journal1.

[9] Article 2 of the Charter.

benefit. These may include, among others: ... h) removal of barriers to intra-SAARC investments." Nevertheless, the provision primarily aims at facilitating intra-SAARC trade by removing trade-restraining investment measures. In the context of this provision 8.h, the SAARC prepared a draft Regional Agreement on Promotion and Protection of Investment within the SAARC Region. The draft contains provisions on the promotion and protection of investments from investors from other Member States, on arbitration of disputes, and on the avoidance of double taxation.

The culture of export processing and free zones is significantly underdeveloped in Pakistan as compared to some of its competitors in Asia. These zones are reported to be 124 in China and 26 in Indonesia.[10] Such zones are attractive in terms of providing trade and fiscal incentives, as well as appropriate infrastructure, to encourage production for international markets. This undoubtedly reduces the economy's attractiveness for this form of FDI. Apart from certain discouraging factors in the sphere of policies and politics, there is a further important factor limiting the FDI inflows, namely the low level of investment in physical infrastructure. There is a shortage of facilities normally expected by investors, such as telecommunications, electricity supply, road and rail linkages, sewerage and drainage. Existing infrastructures are also plagued by cost inefficiencies and waste, undermining attempts to achieve competitive levels of productivity.

Ostensibly, despite the various liberalizing measures taken by the government of Pakistan, which should have directly or indirectly stimulated inward FDI, actual inflows have remained modest. The increase in inflows in recent few years might be attributed to the more liberal FDI regime, but equally it may be the result of the ongoing process of privatization. It would be difficult to foresee if the higher inflows mark the beginning of a new phase in economic development of Pakistan, or whether they will fall back again as privatization — necessarily a limited, once-and-for-all process — is completed.

A market cannot be wished into existence. Yet many governments, including that of Pakistan, try precisely this. Through a process of political negotiation that is intended to reduce opposition to reform, governments have often adopted unworkable and risky policies of partial liberalization. For example, they privatize telecommunications, but do

[10] WIR 98.

not separate competitive activities from natural monopolies, leading to higher prices. They liberalize business entry but do not remedy competitive abuses, leading to cartels. They privatize but do not control dominant firms, reducing entry. They establish independent regulators without giving them the powers and political support to challenge the huge incumbent utilities, in effect using inadequate institutions to remedy weak reforms. They maintain exclusive concessions even while encouraging entry. They reduce existing permits without controlling the introduction of new permits. They permit foreign entry behind high tariffs, which can create foreign-dominated oligopolies that reduce national income. They deregulate retail prices, but not wholesale prices (a cause of the electricity crisis in California, USA in 2001). They maintain golden shares of former public companies even while hoping for new investors. Pakistan's regulatory and policy re-engineering betrays the error of partial liberalization with a synergistic and holistic reform still awaited.

Selective liberalization, however, is dangerous. It produces unforeseen incentives and increases the risk of costly market failures. Many market problems that have arisen after liberalization in Pakistan are due, not to too much or too fast reform, but to uncoordinated, and fragmented reforms. Often, the neglected aspect of reform has been the construction of new institutions to provide the right market incentives. For example, Pakistan has introduced market forces in network sectors, but lack of an adequate institutional basis for regulatory oversight has blunted competition and delayed structural reform, distorted incentives for market actors, reduced the social value of investments, and provided opportunities for corruption.

Pakistan must take measures to improve its investment climate or else run the risk of seeing foreign investors turn to more receptive markets in the region. Importantly, less control over foreign enterprises would also alleviate two very grave problems plaguing the Pakistani investment environment, bureaucracy and corruption. To exert a high level of control, authorities have to rely on a huge bureaucratic apparatus. The number of approvals, licenses, permits, and stamps required to conduct business operations in Pakistan is still flabbergasting, amounting to sheer bureaucratic obstructionism. And evidently, the more red tape, the more opportunities for corruption. As a matter of fact, bribery and graft have often been perceived to be the only way to make business

predictable in Pakistan. Despite all the official denunciations, anti-corruption campaigns and arrests, the incidence of graft in the country remains far from satisfactory. This was to be expected. The problem of corruption in Pakistan is indeed just the more formidable as it originates in part from and is exacerbated by the very nature of the government bureaucratic structure and the neo-patriarchal culture and by the authorities' interventionist propensity. Reformers should also use international disciplines such as WTO requirements to drive administrative and regulatory reforms. Reform programs should recognize the linkages between institutions and competition and trade policies. Pakistan's foreign investment framework is currently too skewed toward control: state interference in business decisions must be kept to a strict minimum. As long as Pakistan fails to limit discretionary powers of government agencies over foreign enterprises and to provide for genuine review of administrative action, it will continue to be viewed as a risky place of investment. This might not exactly be the image Pakistan wants to project as it vigorously competes with its neighbors to spur foreign capital within its borders.

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ANNEX-I

FDI INFLOWS INTO PAKISTAN

Fiscal Year (July - June)	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
Growth of Gross Total Investment	9.0%	-3.6%	10.2%	8.6%	3.2%	10.7%	17.4%	15.0%
Growth of Gross Fixed Investment	1.5%	1.6%	10.5%	8.5%	3.2%	8.2%	17.4%	15.6%
Growth of Gross Private Fixed Investment	13.3%	-11.4%	14.3%	7.2%	17.3%	9.8%	9.6%	19.3%
Total Foreign Investment (mn US$)	822.6	403.3	543.4	182	474.6	820.1	921.7	1,676.6
Of which: Portfolio Investment	221.3	27.3	73.5	-140.4	-10.1	22.1	-27.7	152.6
Foreign Direct Investment	601.3	376	469.9	322.4	484.7	798	949.4	1,524
FDI Shares by sector:								
Power	39.80%	27.80%	14.30%	12.50%	7.50%	4.10%	-1.49%	4.8%
Chemical, Pharm. & Fertilizer	12.00%	11.50%	25.50%	8.20%	3.70%	11.60%	3.00%	6.1%
Construction	3.60%	2.90%	4.50%	3.90%	2.60%	2.20%	3.37%	2.8%
Mining & Quarrying and Oil exp.	16.50%	23.90%	17.00%	26.30%	56.70%	23.60%	21.43%	12.8%
Food, Beverages & Tobacco	3.20%	1.60%	10.60%	14.00%	-1.10%	0.90%	0.47%	1.5%
Textile	4.50%	0.40%	0.90%	1.40%	3.80%	3.30%	3.73%	2.6%
Transport, Storage & Comm.	1.70%	7.10%	6.60%	25.30%	7.30%	14.30%	24.29%	34.9%
Machinery other than electrical	0.00%	0.20%	0.70%	0.10%	0.00%	0.10%	0.07%	0.2%
Electronics	0.40%	0.30%	0.50%	0.90%	3.30%	0.80%	0.79%	0.7%
Electrical Machinery	1.40%	0.40%	0.30%	0.70%	2.20%	1.30%	0.92%	0.2%
Financial Business	3.40%	5.20%	6.30%	-10.80%	0.70%	26.00%	25.50%	17.7%
Trade	2.10%	1.20%	1.60%	4.10%	7.10%	4.90%	3.75%	3.4%
Petrochemicals & Refining	0.30%	8.20%	2.60%	2.70%	1.00%	0.40%	7.62%	1.6%
Tourism/Paper & Pulp	0.90%	0.00%	0.10%	0.40%	0.20%	0.20%	0.19%	0.0%
Cement / Sugar	0.50%	0.40%	1.30%	4.70%	0.10%	0.20%	0.24%	1.1%
Other	9.60%	9.10%	7.20%	5.80%	4.90%	6.20%	6.09%	9.7%
FDI Shares by Country:								
USA	42.70%	45.40%	35.50%	28.80%	67.30%	26.50%	25.11%	21.4%
United Kingdom	22.50%	18.90%	36.00%	28.10%	6.30%	27.50%	6.84%	11.9%
UAE	3.20%	1.50%	1.20%	1.60%	4.40%	15.00%	14.18%	24.1%
Germany	4.00%	4.20%	2.20%	4.80%	2.30%	0.50%	0.74%	0.9%
France	0.80%	2.10%	0.30%	0.20%	-1.40%	0.30%	-0.59%	-0.2%
Hong Kong	0.30%	0.60%	0.20%	1%	0.60%	0.70%	0.66%	2.1%
Italy	0.10%	0.00%	0.10%	0.40%	0.00%	0.00%	0.20%	0.0%
Japan	3.00%	12.50%	3.80%	3%	1.30%	1.80%	1.59%	3.0%
Saudi Arabia	0.20%	4.80%	6.10%	17.60%	0.30%	5.50%	0.76%	1.2%
Canada	0.10%	0.10%	0.00%	0.00%	0.70%	0.10%	0.05%	0.1%
Netherlands	4.50%	1.20%	2.30%	1.50%	-1.10%	0.40%	1.48%	2.4%
Korea	1.00%	1.00%	2.00%	1.10%	0.10%	0.00%	0.10%	0.1%
Others	17.60%	7.60%	10.30%	12.00%	19.10%	21.80%	48.88%	33.0%
Selected Industrial Out Put:								
Fertilizer ('000 tonnes)	3,894	4,242	5,059	5,129	5,187	5,269	5,673	5,989
Sugar (000 tonnes)	3,555	3,541	2,429	3,015	3,249	3,676	4,021	3,092

Cement ('000 tonnes)	9,364	9,634	9,314	9,674	9,935	11,020	12,862	15,038
Pig Iron ('000 tonnes)	1,016	989	1,107	1,071	1,043	1,140	1,176	1,137
Tractors (Units)	40,144	26,644	34,559	31,635	23,801	26,240	35,770	43,200
Cars (Units)	33,684	38,619	32,461	39,819	41,233	63,095	98,461	126,403
Paper & Paper Board ('000 tonnes)	345	356	435.4	531.1	547.8	374.4	406.5	419.8
Stock Market Indicators:								
KSE-100 index (Nov.1991=100)	879.62	1,054.67	1,520.73	1,366.43	1,770.11	3,402.47	5,279.18	7,450.12
SBP General index (2000-01=100)	98.72	106.38	128.8	118.72	106.7	204.9	323.3	362.76
Market Capitalization (bn. Rupees)	259.3	289.2	391.86	339.3	407.6	746	1,429.13	2,074.50
Turnover of Shares (bn. Rupees)	15	25.5	48.1	29.2	29.1	52.7	96.96	N.A.

ANNEX-II

LIST OF COUNTRIES / ORGANIZATIONS WITH WHICH PAKISTAN HAS BILATERAL INVESTMENT AGREEMENTS

S. No.	*Name of Country*	*Signing Date*	*S. No.*	*Name of Country*	*Signing Date*
1.	Germany	25.11.1959	25.	Indonesia	08.03.1996
2.	Sweden	12.03.1981	26.	Tunisia	18.04.1996
3.	Kuwait	17.03.1983	27.	Syria	25.04.1996
4.	France	01.06.1983	28.	Belarus	22.01.1997
5.	South Korea	25.05.1988	29.	Mauritius	03.04.1997
6.	Netherlands	04.10.1988	30.	Italy	19.07.1997
7.	Uzbekistan	13.08.1992	31.	Oman	09.11.1997
8.	China	12.02.1989	32.	Sri Lanka	20.12.1997
9.	Singapore	08.03.1995	33.	Australia	07.02.1998
10.	Tajikistan	13.05.2004	34.	Japan	10.03.1998
11.	Spain	15.09.1994	35.	Belgium	23.04.1998
12.	Turkmenistan	26.10.1994	36.	Qatar	06.04.1999
13.	United Kingdom	30.11.1994	37.	Philippines	11.05.1999
14.	Turkey	15.03.1995	38.	Yemen	11.05.1999
15.	Portugal	17.04.1995	39.	Egypt	16.04.2000
16.	Romania	10.07.1995	40.	OPEC Fund	24.10.2000
17.	Malaysia	07.07.1995	41.	Lebanon	09.01.2001
18.	Switzerland	11.07.1995	42.	Denmark	18.7.1996
19.	Kyrgyz Republic	23.08.1995	43.	Morocco	16.04.2001
20.	Azerbaijan	09.10.1995	44.	Bosnia	04.09.2001
21.	Bangladesh	24.10.1995	45.	Kazakhstan	08.12.2003
22.	U.A.E.	05.11.1995	46.	Loas	23.04.2004
23.	Iran	08.11.1995	47.	Cambodia	27.04..2004
24.	Czech Republic	07.05.1999	48.	Belgo-Luxemburg Economic Union	23.04.1998

ANNEX-III

COUNTRIES HAVING AGREEMENT WITH PAKISTAN FOR AVOIDANCE OF DOUBLE TAXATION

S.No.	*Name of Country*	*S.No.*	*Name of Country*
1.	Austria	27.	Malta
2.	Bangladesh	28.	Mauritius
3.	Belarus	29.	Netherlands
4.	Belgium	30.	Nigeria
5.	Canada	31.	Norway
6.	China	32.	Oman
7.	Denmark	33.	Philippines
8.	Finland	34.	Poland
9.	France	35.	Qatar
10.	Germany	36.	Romania
11.	Greece	37.	Saudi Arabia
12.	Hungary	38.	Singapore
13.	India	39.	South Africa
14.	Indonesia	40.	Sri Lanka
15.	Iran	41.	Sweden
16.	Ireland	42.	Switzerland
17.	Italy	43.	Syria
18.	Japan	44.	Thailand
19.	Jordan	45.	Tunisia
20.	Kazakhistan	46.	Turkey
21.	Kenya	47.	Turkmenistan
22.	Republic of Korea	48.	U.A.E.
23.	Kuwait	49.	U.K.
24.	Lebanon	50.	U.S.A.
25.	Libyan Arab Republic	51.	Uzbekistan
26.	Malaysia		