PROTECTING INVESTMENTS VIA INVESTMENT-RELATED TREATIES

— CORPORATE RESPONSES AND THEIR LIMITATIONS —

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SUMMARY

- Companies may be disadvantaged by the arbitrary application of laws and regulations by the governments of countries in which they invest. These risks can be avoided if an investment-related treaty is in place between an investor's home country and the host country.
- In particular, through the use of Investor-State Dispute Settlement (ISDS) clauses in such treaties, companies can obtain compensation from the host country if international arbitration rules in the company's favor.
- In some cases, however, the host country may refuse to pay compensation and the company must take further action, such as filing an enforcement lawsuit, seeking diplomatic protection, or supplementing with trade insurance. It is important for companies considering foreign investment to be aware of this possibility.

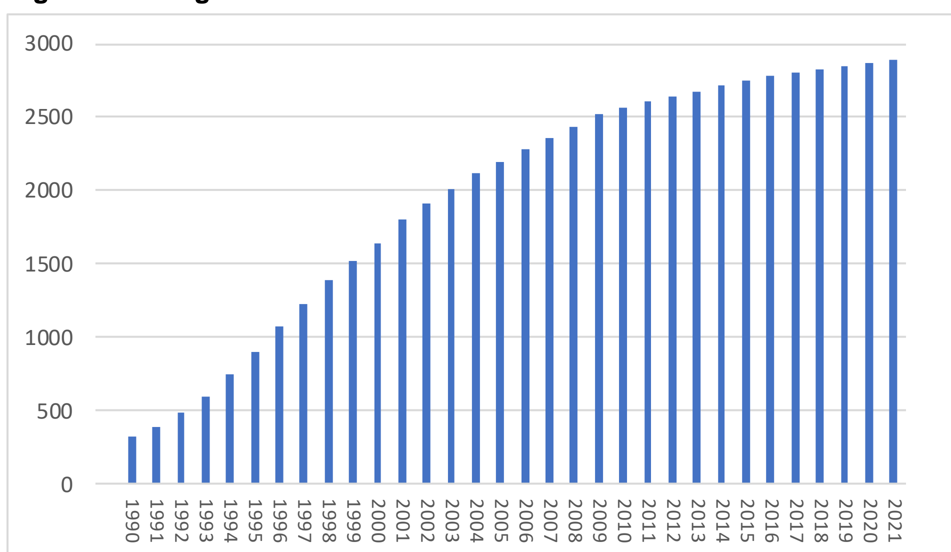
1. THE INCREASING NEED OF COMPANIES FOR INVESTMENT-RELATED TREATIES

Companies that invest and conduct business in foreign countries may be disadvantaged by arbitrary application of laws and regulations, sudden policy changes, or by nationalization or compulsory expropriation of local production facilities by the host country. investment-related treaties[1] are international commitments entered into in order to protect companies from such risks resulting from measures taken by the host country. The need for companies to have investment-related treaties in place continues to rise.[2] Against this backdrop are global increases in foreign direct investments since the end of the Cold War, as well as the growing need to strengthen economic security due to Russia's invasion of Ukraine and the escalation of the rivalry between the US and China in recent years.

In reflection of this, the number of investment-related treaties is increasing around the world (Figure 1). Looking at Japan's investment-related treaties, we see that the number continues to rise, starting with a bilateral investment treaty with Egypt in 1978, a treaty with Russia in 2000, and an increasing number of free trade agreements throughout the 2000s that include investment clauses equivalent to those in investment treaties, with a total of 52 treaties in force as of November 2022.

[1] Accompanying the primarily bilateral investment agreements, in recent years, there has also been an increasing number of free trade treaties that include clauses equivalent to those in investment agreements. This report refers to these collectively as investment-related treaties.
[2] For example, in 2019, Keidanren (the Japan Business Federation) released its Policy Proposal on Investment Treaties, suggesting what should be included in investment-related treaties, as well as partner countries and regions with which investment-related treaties should be concluded.

Figure 1. Changes in the number of investment-related treaties in the world



Note: Vertical axis indicates the number of investment-related treaties; horizontal axis indicates the year.
Source: Compiled by MGSSI based on the UNCTAD website (https://investmentpolicy.unctad.org/international-investment-agreements, accessed November 24, 2022) and Ministry of Foreign Affairs of Japan website (https://www.mofa.go.jp/mofaj/ecm/ep/page24_001088.html, accessed November 24, 2022)

2. MAIN CONTENTS OF INVESTMENT-RELATED TREATIES

investment-related treaties establish various provisions that impose obligations on the host country in order to protect investments by foreign companies from risks resulting from the aforementioned measures taken by the country. The main issues addressed are shown in Figure 2. The existence of such provisions can restrain, to a certain extent, the host country from taking measures that would be in violation. It is unlikely that the host country would enter into an investment-related treaty if it knows in advance that it will be unable to comply with the provisions included. The country would instead either conclude a treaty that did not include such provisions[3] or take the measures required to be able to comply prior to entering into the treaty.

[3] For example, although many investment-related treaties include provisions on Most-Favored Nation Treatment (MFN), no such provisions were established in the investment chapter of the economic partnership agreement (EPA) concluded between Japan and Singapore in 2002—a free trade agreement. This suggests that Singapore might take measures that treat investments by Japanese companies less favorably than those by third-country companies, such as permitting third-country companies to invest in certain industries while barring Japanese companies.

Figure 2. Main contents of investment-related treaties

Name of provision	Purpose of provision	Examples of possible violations
National Treatment	The host country must not treat investments by companies from a country with which it has concluded an investment-related treaty less favorably than investments by domestic companies; provided, however, that the company is of similar condition.	Cases in which the host country imposes a high property tax rate exclusively on foreign-affiliated companies, and due to an inability to pay, a company becomes unable to continue business due to the seizure of property necessary in carrying out its business.
Most-Favored Nation Treatment	The host country must not treat investments by companies from a country with which it has concluded an investment-related treaty less favorably than investments by third-country companies, provided, however, that the company is of similar condition.	Cases in which the host country permits third-country companies to invest in certain industries while barring investments by companies from a country with which it has concluded an investment-related treaty.
Fair and Equitable Treatment	The host country must treat companies from a country with which it has concluded an investment-related treaty, as well as investments made by such companies, both fairly and equitably. This includes the following obligations: (1) Prohibit the denial of justice; (2) Prohibit arbitrary measures; (3) Do not betray the reasonable expectations of the company; and (4) Ensure that investments by the company are appropriately processed.	Cases in which, even though a company had been permitted to continue business for a certain period of time, the host country refuses to renew the business permit prior to the expiration of term without reasonable grounds. Cases in which the host country does not permit a toll road construction and operation project funded by a company from a country with which it has concluded an investment-related treaty to raise toll rates high enough to make the project profitable without reasonable grounds.
Expropriation and compensation	The host country must not expropriate, nationalize, or enact any equivalent measures in regard to investments by companies from a country with which it has concluded an investment-related treaty, except when such action is for the public interest in a non-discriminatory manner in the course of legal procedures and accompanied by the payment of compensation. The term “equivalent measures” refers to actions that render the investment concerned economically worthless through regulation, legislative measures, taxation, or interference with business, even if ownership of the investment does not change. This is also known as “indirect expropriation.”	Cases of nationalization of plants and infrastructure facilities in which a company from a country with which the host country has concluded an investment-related treaty without payment of compensation. Cases in which the country of investment forces a water supply and sewerage company funded by a company from a country with which it has concluded an investment-related treaty to lower its water rates without reasonable grounds, or forces the abandonment of business by interfering with a water supply and sewerage company’s ability to bill residents for water without justifiable reasons.
Remittance of Funds	The host country shall allow remittances to proceed freely and without delay when companies transfer funds and salaries to the host country or revenue earned within the host country to another country.	Cases in which local currency is not permitted to be converted into dollars when companies transfer revenue earned within the host country to another country.

Source: Compiled by MGSSI based on Ministry of Economy, Trade and Industry website, "Investment Related Treaties FAQ" https://www.meti.go.jp/policy/trade_policy/epa/investment/qa/qa.html, accessed November 24, 2022, and NEXI website "Foreign investment insurance booklet" (https://www.nexi.go.jp/product/booklet/pdf/pr07_08_02.pdf, accessed November 24, 2022)

3. RESPONSES TO INVESTMENT-RELATED TREATY VIOLATIONS

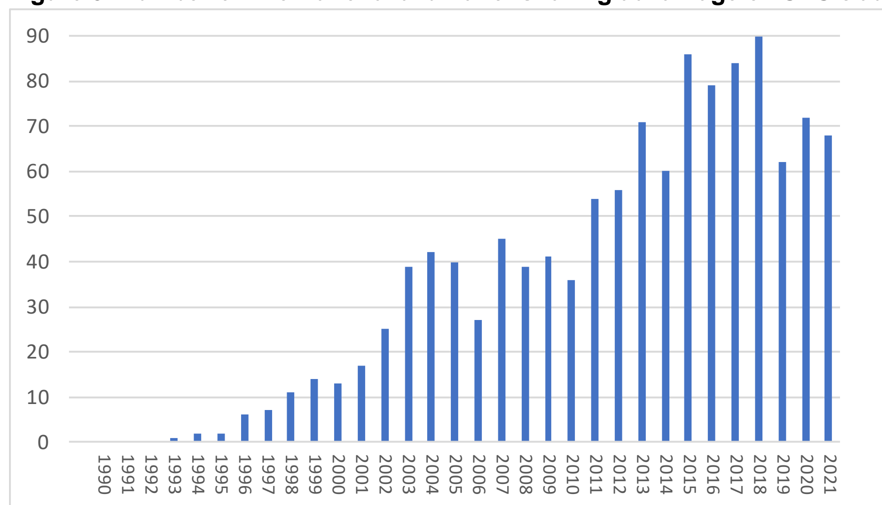
Even if an investment-related treaty is concluded under the premise of compliance, a host country could still violate its provisions through policy changes and other factors resulting from a change of administration. For example, suppose that a company believes it has suffered damage due to such a violation after investing in a country in the course of business. In that case, the company can use provisions in the relevant investment-related treaty on procedures for settling investor-state disputes (ISDS[4] clauses) to appeal for international arbitration in accordance with the arbitration rules of organizations such as the United Nations Commission on International Trade Law (UNCITRAL) and the International Centre for Settlement of Investment Disputes (ICSID) under the World Bank. Although it is possible to appeal to a court in the host country, there are concerns that this could result in a ruling that is unfairly in favor of the host country. ISDS clauses are thus prepared to provide a neutral forum to settle disputes. If, through the process of international arbitration, the company’s claim is deemed valid, then the arbitration award will include monetary compensation and restoration of the property to its original state. According to the United Nations Conference on Trade and Development (UNCTAD),

[4] Abbreviation of “Investor-State Dispute Settlement.”

the number of examples[5] of companies taking advantage of ISDS clauses to settle investment disputes is on the rise, with the international cumulative total reaching 1,189 cases by 2021 (Figure 3).

That being said, ISDS clauses are not incorporated into all investment-related treaties.[6] It is thought that host countries are more likely to violate treaties without ISDS clauses than those with such clauses due to the difficulty that companies would face in appealing to international arbitration.

Figure 3. Number of international arbitrations taking advantage of ISDS clauses



Source: Compiled by MGSSI based on the UNCTAD website (https://investmentpolicy.unctad.org/investment-dispute-settlement, accessed November 24, 2022)

4. LIMITATIONS ON RESPONSES TO VIOLATIONS

4-1. Non-fulfillment of Arbitral Awards

Arbitral awards are final and binding for both the host country and the companies involved in an investment dispute. However, in practice, host countries occasionally fail to provide compensation even when ordered to do so under an arbitral award, and such cases have become frequent in recent years. According to a survey[7] conducted by Harvard Law School and others, payment is not made in roughly 40% of all cases in which a host country loses an investment dispute and is obligated to provide a company with compensation. The survey targeted 32 countries that had 10 or more lawsuits filed under ISDS clauses by 2019. A total of 776 cases were filed against these 32 countries, which accounts for 74% of the total 1,049 cases filed worldwide. Arbitral awards were made in 528 of these cases, and in 170 of these, the host country was obligated to provide compensation. Payment of compensation has been confirmed for 85 of these 170 cases. For the remaining 85 cases, either payment has not been made, or the status of payment is unknown. Nonetheless, the aforementioned "roughly

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[5] An example of a Japanese company making use of an ISDS clause is the Saluka case. According to the Outline of Procedures for Investor-State Dispute Settlement (ISDS) between Nations and Investors (2017), released by the Ministry of Foreign Affairs, four formerly state-owned Czech banks held a large amount of non-performing loans, and Saluka (a special purpose overseas subsidiary established in the Netherlands by Nomura International PLC, a UK-based subsidiary of Nomura Securities Co., Ltd.) held 46% of the shares in IPB, one of the four banks. The Czech government extended financial assistance to the three state-owned banks, including the injection of public funds, but did not provide the same assistance to IPB. IPB's operations further deteriorated, and ownership was transferred to a separate state-owned bank. Saluka filed a lawsuit in accordance with the rules of the UNCITRAL, claiming that the measures taken by the Czech government violated the Netherlands-Czech Investment Treaty. As a result, it was ruled that the Czech government had violated the provisions on Fair and Equitable Treatment set forth in the Treaty, and in 2006, Saluka was awarded approx. 18.7 billion yen (plus interest) in compensation.

[6] For example, among treaties concluded by Japan, no such clauses exist in the Regional Comprehensive Economic Partnership (RCEP) or Japan-Philippines Economic Partnership Agreement (EPA).

[7] ICSID Review-Foreign Investment Law Journal, "State Compliance with Investment Awards" 15 February 2021,Oxford University Press.

40%" (i.e., the quotient of 67 cases divided by 170 cases) was derived from the fact that payment enforcement proceedings have been initiated in 67 of these remaining 85 cases.

4-2. High Barriers to Enforcement

If a host country fails to fulfill an arbitral award, the company can file for enforcement in a court in its own country or in a third country. Enforcement in this case refers to the country concerned seizing property from the host country located within its borders commensurate with the compensation and transferring ownership to the company. However, even if a ruling that orders enforcement is issued, actual enforcement is rare due to customary international law, under which "the property of a foreign country is exempt from compulsory execution in other countries."[8]

4-3. Unpredictable Diplomatic Protections

If, even after an enforcement lawsuit, a company is unable to receive the compensation that it is entitled to under an arbitral award, the company can appeal to its home country for the execution of diplomatic protection. Diplomatic protection refers to a home country requesting another country to provide appropriate relief to its citizens (including companies) through diplomatic procedures when its citizens have been wrongfully or illegally infringed upon in the other country. This is not limited to responding to non-fulfillment of an arbitral award. That being said, since this is enacted at the nation's own discretion, diplomatic protection is not necessarily provided simply because a company makes a request. In addition, it is not clear what "diplomatic protection as a response to non-fulfillment of an arbitral award" refers to specifically.[9]

4-4. Supplementation via Trade Insurance

The above discussion makes it clear that there are cases in which companies are unable to fully protect their investments in foreign countries based on investment-related treaties alone. One way to address this issue is to make use of trade insurance. For example, in Japan, one of the various trade insurance products offered by Nippon Export and Investment Insurance (NEXI) is overseas investment insurance. This insurance is able to cover a certain amount of damage in the event that a company becomes unable to do business as a direct result of an action taken by the host country. The condition for coverage is whether or not the action constitutes what NEXI considers an "infringement of rights." In order to satisfy this condition, the action by the host country must be recognized as equivalent to a violation of either domestic or international law. Whether an act is equivalent to a violation of international law is decided by referencing investment-related treaties and the like as a first step. In the absence of such a treaty between Japan and the host country, the hurdle to recognition is likely to be even higher.[10] In other words, just because companies make use of trade insurance does not mean that investment-related treaties are unnecessary, and it is important to consider taking advantage of both to protect business activities in foreign countries.

5. EXAMPLES OF COUNTRIES THAT DO NOT FULFILL ARBITRAL AWARDS

5-1. Spain

Spain is one country noted for not fulfilling arbitral awards. To date, the country has 52 published cases against it, 47 of which are related to investments in the renewable energy industry.[11] When the Spanish government introduced a feed-in tariff (FIT) for solar power generation in the 2000s, a stream of foreign companies entered

[8] RIETI Discussion Paper Series 13-J-078, "Problems Concerning the Enforcement of Investment Arbitral Awards," December 2013, Research Institute of Economy, Trade and Industry (independent administrative corporation).

[9] Same as footnote 10. According to interviews with Japanese government officials conducted by the author regarding diplomatic protection as a response to non-fulfillment of an arbitral award, the government would seek enforcement by the host country through various forums.

[10] Based on the author's interviews with NEXI.

[11] Same as footnote 7.

the market in anticipation of high profits. This resulted in achieving power generation capacity far in excess of the government's target. Power distribution companies were forced by the FIT to purchase all of the power generated, including the excess portion, while regulations prohibited them from raising electricity rates, resulting in massive debts. Therefore, the government took decisive action to repeatedly reduce the purchase price.

Many of the entrants, believing that they had suffered losses due to these measures, used ISDS clauses to file lawsuits against Spain (the host country) for violating the provisions on expropriation and compensation as well as the provisions on fair and equitable treatment set forth in the Energy Charter Treaty and other investment-related treaties.[12] By the end of 2019, arbitral awards were rendered in 15 of the aforementioned 47 cases, with Spain winning three cases and the companies winning 12 cases. In these 12 cases, the companies won compensation totaling the equivalent of 880 million dollars, of which payment has been confirmed in only a single case for 300 million dollars. In eight of the cases, Spain has refused to pay.

5-2. Russia

Russia is another such country. To date, the country has 27 published cases against it.[13] Of these, 11 cases were won by companies and four by Russia, while ten cases are still ongoing. Also, one case has been suspended, and another was settled out of court. In all but one of the cases won by companies, Russia continues to outright refuse to pay compensation. For example, after annexing Crimea in 2014, ten cases were filed against Russia for compulsory expropriation of companies operating in the region, of which Russia has so far lost three cases and been ordered to provide compensation. However, the country has not made any of the payments.[14]

Following its invasion of Ukraine in February 2022, Russia designated some countries as "unfriendly countries," including Japan and many Western countries that opposed the invasion. In addition, Russia is preparing legislation that could effectively nationalize companies from "unfriendly countries" doing business in Russia through compulsory expropriation of their property.[15] According to a survey conducted by Yale University, as of May 2022, more than 300 companies have decided to withdraw from Russia. For example, Siemens AG (Germany) calculated a loss of 600 million euros due to withdrawal-related expenses.[16] While it is highly likely that even more companies operating in Russia will appeal for international arbitration against the country in the future, in light of the prior cases mentioned above, it is expected to be difficult for companies to receive payment of compensation even if they win their cases.[17]

6. CONCLUSION

In light of the above discussion, prior to investing in a foreign country, companies need to keep the following points (1) through (5) in mind when considering investment-related treaties. (1) Check whether the home country and the potential host country have concluded an investment-related treaty. (2) If they have, check whether it contains an ISDS clause. (3) If they have not and there is no ISDS clause, then be aware that there is a higher

[12] RIETI Discussion Paper Series 17-J-060, "Legal Issues Arising from the Feed-in Tariff of Renewable Energy: Controversial issues in investor-state dispute settlement," October 2017, Research Institute of Economy, Trade and Industry (independent administrative corporation) "Solar Power Generation: Learning from the Lessons of Spain—The Pros and Cons of Feed-in Tariff Systems," April 2011, Research Center for Advanced Science and Technology, the University of Tokyo.

[13] UNCTAD website: "Investment Dispute Settlement Navigator."

[14] Same as footnote 7. In one case, the arbitral award ordered the payment of approximately 2.3 million dollars, but Russia refused to pay. In response, the investors who filed the lawsuit conducted enforcement procedures in Germany and Sweden, and successfully collected a portion of the award.

[15] The bill was submitted to the State Duma on April 12, 2022 (Russian: "ФЕДЕРАЛЬНЫЙ ЗАКОН О внесении изменения в статью 235 части первой Гражданского кодекса Российской Федерации и регулировании отдельных правоотношений по принудительному изъятию имущества" / English: Regulations on Specified Legal Relationships relating to the Civil Code of the Russian Federation and the Forcible Seizure of Property in regard to Amending Article 235 of Part 1 of the Civil Code)

[16] *Nihon Keizai Shimbun*, dated May 17, 2022.

[17] According to Professor Kazuyori Ito, Graduate School of the University of Tokyo, "Even so, investment arbitration is currently the most effective way for companies to attempt to recover damages from Russia on their own." *Keidanren Times*, "The Ukraine Crisis and Japan-Russia Investment Agreement," July 28, 2022.

risk of being placed at a disadvantage due to the arbitrary application of laws and regulations or sudden policy changes and that it will be difficult to receive compensation when disadvantaged. (4) Be aware that even if you win an investment dispute by making use of an ISDS clause, there are cases in which the host country will not fulfill its obligations and it will not be possible to receive compensation. (5) In such cases, compensation may be obtained through an enforcement lawsuit or diplomatic protection, but be aware that the risk cannot be completely avoided and that there are countries where the risk is particularly high based on their past behavior. It is therefore important to incorporate these points into the decision-making process when considering foreign investments.

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