SCHEME FOR UTILIZING INVESTMENT-RELATED TREATIES

— THE PERSPECTIVE OF INVESTMENT VIA A THIRD COUNTRY —

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SUMMARY

- Companies investing in a foreign country may use investment-related treaties as a means of avoiding risk arising from unjust measures taken by the recipient country.
- However, the number of investment-related treaties around the world has begun to decline due to measures to strengthen economic security in the wake of recent tensions between the US and China.
- Therefore, the approach of leveraging existing investment-related treaties is becoming increasingly important. Even if there is no investment-related treaty between the country in which the company is based and the recipient country, such risks can be avoided through a scheme that utilizes investment-related treaties between the recipient country and third countries.

1. INTRODUCTION

Currently, there are 2,591[1] investment-related treaties[2] in existence in the world, which are of great benefit to companies. When investing and operating in foreign countries, companies are exposed to risks from arbitrary application of laws and regulations as well as sudden policy changes, such as forcible expropriation or nationalization of production facilities by the recipient country. Investment-related treaties contain a great variety of provisions (see Figure 1 for main provisions) that protect foreign investors and are effective in mitigating risks arising from unjust measures taken by the recipient country.[3] However, as the result of a change of government or the like, a recipient country may occasionally take measures that violate the provisions, resulting in losses by foreign investors (see Figure 1). An effective countermeasure to this is the use of investor–state dispute settlement provisions (ISDS[4] clauses), which are included in many investment-related treaties. Under ISDS clauses, companies can take the recipient country to international arbitration in accordance with the arbitration rules of the International Centre for Settlement of Investment Disputes (ICSID), which is affiliated with the World Bank, and the United Nations Commission On International Trade Law (UNCITRAL). As a result, if the company's claim is accepted, an arbitral award is rendered, including reparations such as monetary compensation or restoration of the original conditions.[5] According to the United Nations Conference on Trade and Development (UNCTAD), the total number of cases in which companies have used ISDS clauses to bring

[1] United Nations Conference on Trade and Development (UNCTAD) website
https://investmentpolicy.unctad.org/international-investment-agreements (accessed November 27, 2023)

[2] This report collectively refers to investment treaties, which are primarily bilateral, and free trade agreements that contain similar clauses to those treaties, as investment-related treaties.

[3] Normally, when a company invests in a foreign country, it makes a comprehensive decision on whether or not to do so based on consideration of various factors, such as the risk of the recipient country, tax system, and profit expected after the sale, and it is thought to be important that this consideration includes the existence or absence of an investment-related treaty.

[4] Investor–State Dispute Settlement

[5] However, a state may default on an arbitral award. For more information on the effectiveness and limitations of investment-related treaties, see Mitsui & Co. Global Strategic Studies Institute Monthly Report, January 2023, "Protecting Investments via Investment-Related Treaties"
https://www.mitsui.com/mgssi/en/report/detail/__icsFiles/afieldfile/2023/02/27/2301_matano_e.pdf

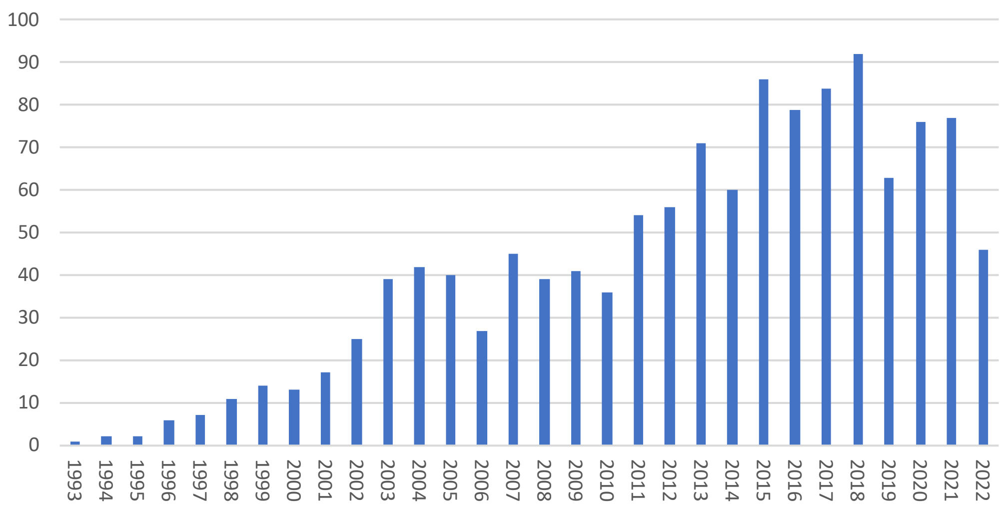
investment recipient countries to international arbitration in order to resolve investment disputes has reached 1,257 worldwide as of 2022 (Figure 2).

Figure 1 Main contents of investment-related treaties

Provision name	Purpose of the provision	Examples of possible violations
National treatment	The recipient country shall not treat an investment by a company from a country with which it has concluded an investment-related treaty less favorably than a similar investment by a company of the recipient country.	Cases in which the recipient country imposes a high fixed-asset tax rate on foreign capital companies only, resulting in the property necessary for business operations being seized due to inability to pay the tax and making it impossible to continue business operations.
Most-favored-nation treatment	The recipient country shall not treat an investment by a company from a country with which it has concluded an investment-related treaty less favorably than a similar investment by a company of a third country.	Cases in which a recipient country allows investment in a certain industry by a company from a third country, but does not allow investment by a company from a country that has concluded an investment treaty with the recipient country.
Fair and equitable treatment	The recipient country shall treat the businesses of a country with which it has concluded an investment-related treaty and its investments fairly and equitably. This includes the following obligations: (1) prohibition of denial of justice, (2) prohibition of arbitrary measures, (3) no frustration of the reasonable expectations of the company, and (4) due process of investments by the company.	Cases in which renewal of a business license is refused before expiration without reasonable grounds, even though the business was allowed to continue for a certain period of time. Cases in which, without reasonable cause, a toll rate increase necessary to enable prospect of profit is not permitted for a toll road construction and operation project funded by a company from a country that has concluded an investment-related treaty with the recipient country.
Expropriation and compensation	The recipient country shall not expropriate, nationalize or take equivalent measures with respect to investments by a company of a country with which it has concluded an investment-related treaty, except in cases of the public interest, in a non-discriminatory manner, with payment of compensation, and in accordance with legal procedures. The term "equivalent measures" refers to actions that render the investment economically worthless through regulation, legislation, taxation, or business obstruction, even if the ownership of the investment remains unchanged, and is also referred to as indirect expropriation.	Cases in which, without paying compensation, the recipient country nationalizes plants and infrastructure facilities funded by a company from a country that has concluded an investment-related treaty with the recipient country. Cases in which a water and sewerage company funded by a company from a country that has concluded an investment-related treaty with the recipient country is forced to lower its water rates without reasonable grounds, or obstructed from billing residents for water without justifiable reason, causing the company to abandon the project.
Transfer of funds	The recipient country shall ensure the free transfer without delay of funds and salaries into the recipient country, as well as that of profits earned in the recipient country to other countries.	Cases in which conversion of the local currency into dollars is not permitted when remitting profits earned in the recipient country to another country.

Source: Compiled by MGSSI based on Ministry of Economy, Trade and Industry website, Investment-related treaties FAQ [in Japanese], https://www.meti.go.jp/policy/trade_policy/epa/investment/qa/qa.html (last accessed November 22, 2023), and Nippon Export and Investment Insurance, Guide to Trade Insurance Supporting Trade Transactions VII [in Japanese] (issued in April 2023)

Figure 2 Number of international arbitrations utilizing ISDS clauses

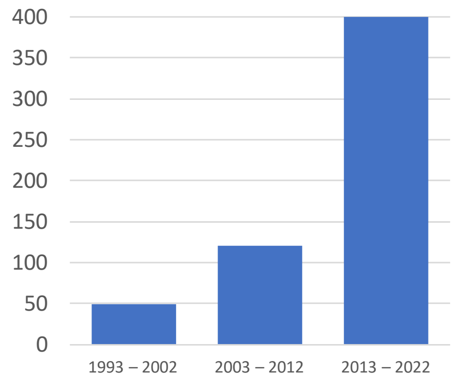


Note: Vertical axis shows number of cases; horizontal axis shows the year
Source: Compiled by MGSSI based on UNCTAD https://investmentpolicy.unctad.org/investment-dispute-settlement（accessed December 18, 2023)

2. DECREASE IN INVESTMENT-RELATED TREATIES

Despite the advantages that investment-related treaties inherently have, the number of terminations has been increasing in recent years. According to UNCTAD, 569 such treaties have been terminated since 1993. Approximately 70% of these were terminated since 2013 (Figure 3). Investment treaties between EU member states account for many of those terminated. EU member states long debated whether the ISDS clauses in these investment treaties are contrary to EU law. Member states concluded the treaties before the creation of the EU, and so did new member states with existing member states before their accession to the EU.[6] While the issue remained unsettled from a legal standpoint, the EU member states signed an agreement to terminate the investment treaties in 2020 due to a political decision.[7] This terminated 277 treaties.

Figure 3 Number of investment-related treaties terminated



Note: Vertical axis indicates number of cases
Source: Compiled by MGSSI based on UNCTAD "World Investment Report 2023"

India and China are also terminating many treaties. India has so far entered into 86 investment-related treaties, 76 of which it has terminated. Similarly, China has terminated 22 of 145 investment-related treaties.[8] In contrast to the case of the EU, these countries have not given an explicit reason for the termination, but it may be because they have become more aware of the disadvantages of investment-related treaties, which narrow the discretionary scope for protectionist policies. The background to this is protracted US–China tensions, also known as the New Cold War, and the increased need to strengthen economic security in recent years. One example is that a country imposes restrictions on the types of industries for foreign investors to enter or their investment ratio in order to protect the industries and enterprises of that country. This could violate national treatment and fair and equitable treatment provisions, which are the main contents of investment-related treaties (Figure 1). Violations of these provisions increase the risk of being sued by the foreign companies concerned on the basis of ISDS clauses. If its investment-related treaties remain in place, the country may face multiple lawsuits in various cases.

The increase in the number of countries perceiving investment-related treaties in this way is leading not only to terminating them but also to impeding the conclusion of new treaties. For example, an increasing number of countries are introducing investment screening from the perspective of economic security. Investment screening is a mechanism for countries to establish restrictions on foreign investment ratios and a permit system for foreign investors in advanced and key industries, and this appears to be inconsistent with the national treatment and fair and equitable treatment provisions of investment-related treaties. Therefore, countries that are positive toward adopting this system are likely to be negative toward concluding investment-related treaties. In fact, New

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[6] Masao Sakata, "The Compatibility Problem of Intra EU Investment Treaty Arbitration and EU Law" [in Japanese], The Annals of human and social sciences, Faculty of Economics Shiga University, Vol. 27 (2020)
[7] "Agreement for the termination of Bilateral Investment Treaties between the Member States of the European Union"29.5.2020 Official Journal of the European Union
[8] Same as note 1. India's partners in investment treaties it has terminated include the United Kingdom, Mexico, and China. China's partners in investment treaties it has terminated include Russia, Chile, and Mauritius.

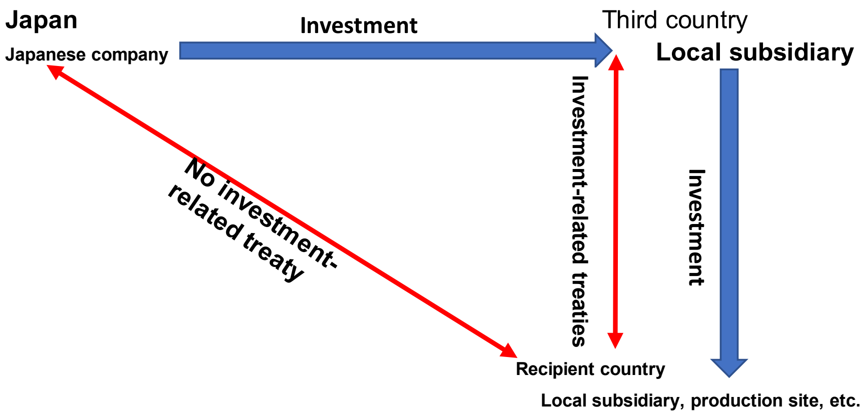
Zealand,[9] which introduced this system in 2021, has signed only two investment-related treaties so far.

Japan has signed 57 investment-related treaties to date. Of these, the majority (22) were concluded in the 2010s, including six each in 2014 and 2017, and four in 2015. Meanwhile, the Foreign Exchange and Foreign Trade Act, which constitutes an investment screening system, was amended in 2020 to lower the threshold for requiring prior notification when acquiring shares from 10% to 1%. This is interpreted as a tightening of investment regulations. In line with this trend, the number of new Japanese investment-related treaties has been declining in recent years, with three in 2021 and one each in 2022 and 2023. Reflecting the above, the number of global investment-related treaties terminated has exceeded the number in effect since 2020, and the total number of treaties in effect has fallen for the third consecutive year, with 58 treaties terminated in 2022 compared to 17 in effect.[10]

3. SCHEMES THAT UTILIZE INVESTMENT-RELATED TREATIES BETWEEN THE RECIPIENT COUNTRY AND A THIRD COUNTRY

In light of these facts, it will become increasingly important for companies investing in foreign countries in the future to seek out and utilize investment-related treaties that enable them to receive the benefits mentioned above. Taking a Japanese company as an example, if an investment-related treaty including ISDS clauses is concluded between Japan and the recipient country, that company receives the same benefits and therefore does not need to search elsewhere. However, if no such treaty has been concluded, it will be difficult to avoid the risks discussed above. In this case, a company can still enjoy the same benefits by researching which countries have investment-related treaties with the recipient country, establishing a local corporation in a country that has such a treaty, and investing through that corporation (Figure 4). If the company already has invested in a country that has no investment-related treaty with Japan, it can hedge against future risk by seeking out third countries that have such treaties with the recipient country and rerouting its investment through that country.

Figure 4 Scheme that utilizes investment-related treaties between the recipient country and a third country



Source: Created by MGSSI

9 See Mitsui & Co. Global Strategic Studies Institute Monthly Report January 2022, Foreign Investment Screening Systems Affecting Companies
https://www.mitsui.com/mgssi/en/report/detail/__icsFiles/afieldfile/2022/02/13/2201c_matano_e.pdf

10 It is usually stipulated that when an investment-related treaty is terminated, the treaty remains in effect for a certain period after termination with respect to investments made prior to the termination. For example, the Japan–Vietnam Investment Agreement states, "In respect of investments acquired prior to the date of termination of this Agreement, the provisions of this Agreement shall continue to be effective for a period of ten years from the date of termination of this Agreement" (Article 23.3). On the other hand, with regard to the above-mentioned termination of investment treaties among EU member states, there is no such provision in the treaties listed in Note 7. However, it is stipulated that arbitration proceedings initiated prior to March 6, 2018 shall remain in effect (Article 6), and that pending arbitration proceedings may be entered into settlement procedure (Article 9).

If a multinational corporation already has a local subsidiary in a third country that has an investment-related treaty with the recipient country, the time and cost of establishing a new local subsidiary for the said investment will naturally be saved. If the multinational has local subsidiaries in several third countries that have investment-related treaties with the recipient country, it may choose the country with the most advantageous treaty and invest via its local subsidiary there.

4. CASES WHERE LOSS WAS AVOIDED BY THIS SCHEME

4-1. The Saluka case

In the Saluka case, a Japanese company utilized an investment-related treaty between the recipient country and a third country, and it successfully avoided loss caused by unjust measures taken by a recipient country.[11] Four former Czech state-owned banks, which occupied an important position in the financial market, all had large volumes of non-performing loans. In 1998, Nomura International PLC, a UK subsidiary of Nomura Securities, established a special purpose company called Saluka as a local subsidiary in the Netherlands, and used it to acquire a 46% stake in one of these banks, Investicni a Postovni Banka (IPB). The Czech government injected public funds into all three banks excluding IPB, and its operations deteriorated further. In 2000 all IPB operations were transferred to another bank, Ceskoslovenska Obchodni Banka. Claiming that the actions of the Czech government violated an investment treaty between the Netherlands and the Czech Republic, Saluka took advantage of an ISDS clause and filed a complaint with the UNCITRAL.[12] As a result, the Czech government was found to have violated the fair and equitable treatment provisions of the treaty, and in 2006 Saluka was awarded compensation of approximately 18.7 billion yen with interest.

It is not clear whether Nomura invested in the Czech bank through its subsidiaries in the UK and the Netherlands with the intention of hedging risk. However, there is no investment treaty between Japan and the Czech Republic, and by investing under such a scheme, consequently at least, the Czech–Dutch bilateral investment protection treaty protected the company's investment.

4.2 The ExxonMobil case

The ExxonMobil case is an example where a foreign company utilized an investment-related treaty between the recipient country and a third country, successfully avoiding loss caused by unjust measures taken by a recipient country.[13] US oil giant ExxonMobil held a 41.7% interest in a multi-billion dollar oil and gas development project in the Orinoco Basin of Venezuela. When the Chavez administration took office in 1999, it began adopting resource-nationalistic policies. With a sense of alarm at this development, ExxonMobil rerouted its investment in the project through a subsidiary it had established in the Netherlands, in order to utilize the ICSID's international arbitration rules if necessary. In fact, the Chavez administration decided to nationalize the project in 2007. Claiming that the nationalization violated the investment treaty signed between the Netherlands and Venezuela in 1991, ExxonMobil then utilized the ISDS clauses of the treaty and filed a lawsuit under ICSID's international arbitration rules. As a result, the Venezuelan government was found to have violated the treaty's fair and equitable treatment and prohibition against forced expropriation provisions, and ExxonMobil was awarded $1.6 billion in compensation in 2014.

The lesson here is, as the arbitral tribunal that handled the case pointed out, that ExxonMobil determined the

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[11] *Overview of Investor–State Dispute Settlement (ISDS) Procedures* [in Japanese], Ministry of Foreign Affairs (2017), and "Dispute Settlement through Payment of Settlement by the Czech Government" [in Japanese], Nomura Holdings News Release June 10, 2008.

[12] According to UNCTAD, the Netherlands currently has 75 investment treaties in force. Other countries with many investment treaties include Germany (114), Switzerland (110), France (84), Turkey (82), and Egypt (72). These are notable candidates for the "third country" mentioned above. A list of the countries with which these countries have concluded treaties can be found at the site below. https://investmentpolicy.unctad.org/international-investment-agreements/countries/148/netherlands (accessed December 8, 2023)

[13] UNCTAD website "Investment Policy Hub" https://investmentpolicy.unctad.org/investment-dispute-settlement/cases/253/mobil-and-others-v-venezuela, and "The Netherlands: A Gateway to 'Treaty Shopping' for Investment Protection" January 12, 2012 International Institute for Sustainable Development (IISD).

increased risk posed by the Venezuelan government, given the absence of an investment treaty between the United States and Venezuela, and routed its investment in the project through the Netherlands, which allowed it to take advantage of the investment treaty.[14]

5. CONCLUSION

As above, the number of investment-related treaties around the world has begun to decline, mainly because measures to increase economic security have become more common in recent years. In light of this, companies expanding business abroad will be more likely to take advantage of investment-related treaties already in place, such as the aforementioned schemes that utilize investment-related treaties between the recipient country and a third country, in order to protect their investments from unjust measures taken by the recipient country.

[14] The two cases in this report are examples of successfully obtaining compensation. Even if a company prevails in international arbitration, it may not receive compensation. For more information, see Mitsui & Co. Global Strategic Studies Institute Monthly Report January 2023, Protecting Investments via Investment-Related Treaties https://www.mitsui.com/mgssi/en/report/detail/__icsFiles/afieldfile/2023/02/27/2301_matano_e.pdf