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### **Columbia FDI Perspectives**\*

Perspectives on topical foreign direct investment issues

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#### **Investment contracts are not a substitute for investment treaties**

by

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Common in sectors such as petroleum, investment contracts embody the well-established principle of *pacta sunt servanda* (“agreements must be kept”) for which there is a long history of international jurisprudence. Where they provide directly for international arbitration, such contracts can obviate the need for a specialized treaty regime. In contrast to heavily standardized international investment agreements (IIAs), contracts allow parties to tailor their commitments, often by reference to industry practice and clearly defined goals. With negotiated contractual protections in place, countries receive the benefit of FDI in the form and manner of their choosing, just as investors enjoy the assurance of host countries’ binding commitment to honor their obligations.

Given this flexibility and legal certainty, some observers have advocated investment contracts as a substitute for IIAs, partly because of suspicion over the IIA regime’s legitimacy.<sup>2</sup> Yet most foreign investment is not covered by individual contracts with host countries, and contract-based arbitration currently represents only a small portion of total investor-state claims.<sup>3</sup> The International Centre for Settlement of Investment Disputes (ICSID) reported in 2016 that investment contracts were the source of tribunals’ jurisdiction in only 17% of cases.<sup>4</sup> More tellingly, the portion of contract-based claims at ICSID has steadily declined since 2010, when it comprised 22% of all claims.<sup>5</sup> This trend may indicate that there are good reasons to be suspicious of investment contracts as a replacement of IIAs:

- Although IIAs contain indeterminate concepts such as fair and equitable treatment and indirect expropriation, some contracts do the same: albeit well-developed, the common law of commercial contracts is hardly free from ambiguity, as evidenced by recent high-level judgments.<sup>6</sup> Moreover, it is far from clear that there is indeed a body of international commercial rules (known as *lex mercatoria*, or “merchant law”) to assist in interpreting investment contracts and to fill in gaps where necessary.<sup>7</sup>
- Without IIAs, investors would have to negotiate contracts with countries on an individual basis. This may well be within the resources of large multinational enterprises (MNEs) in the infrastructure or extractive sectors where such contracts are more common. But the transaction costs would be onerous for small and medium-sized enterprises (SMEs) operating in other sectors where SMEs are the direct beneficiaries of IIAs signed by their home countries. This is problematic as more SMEs undertake outward FDI, relative to large MNEs.<sup>8</sup> Indeed, governments negotiating trade agreements with investment chapters

regularly point out the strategic advantages of these instruments for SMEs.<sup>9</sup> Furthermore, given that more than 100,000 MNEs exist (with more than 1 million foreign affiliates), most of them SMEs, this implies the need for many contracts.<sup>10</sup>

- While parties can negotiate situation-specific terms in investment contracts in a manner impossible with respect to IIAs, it is equally plausible that the one-sided bargaining power thought to characterize treaty drafting may also accompany investment-contract negotiations. Highly mobile investors (likely those safest from governmental interference) may be able to extract benefits from host countries by threatening to relocate<sup>11</sup> or simply through more assertive negotiations assisted by expensive counsel unavailable to many governments. This may be especially the case in extractive sector concession arrangements with developing countries. Of course, unequal bargaining power can act against foreign investors, too, most notably in the case of investment contracts structured as joint ventures. Investors have demonstrated reluctance to pursue these types of contracts with host countries because of the difficulties involved in divided management, as well as the forced disclosure of technology and business secrets, both typical features of such arrangements.<sup>12</sup>

Finally, the use of investment contracts instead of IIAs does nothing to resolve problems associated with investor-state dispute settlement, as such contracts also tend to provide for international arbitration (at ICSID, for example). Without reform of the underlying regime, therefore, a shift from treaty-based to contract-based FDI protection would have minimal impact.

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<sup>2</sup> See, e.g., M. Sornarajah, *The International Law on Foreign Investment* (Cambridge: CUP, 2010), p. 301; Jeswald W. Salacuse, *The Law of Investment Treaties* (Oxford: OUP, 2015), pp. 19-21.

<sup>3</sup> Only a handful of reported claims are based on investment contracts. See, e.g., *Vacuum Salt Products Ltd. v. Ghana*, ICSID Case No. ARB/92/1 (Award) (Feb. 16, 1994).

<sup>4</sup> ICSID, *The ICSID Caseload: Statistics* (2016, 2nd issue), p. 10, available at <https://icsid.worldbank.org/apps/icsidweb/resources/pages/icsid-caseload-statistics.aspx>.

<sup>5</sup> ICSID, *The ICSID Caseload: Statistics* (2010, 1st issue), p. 10, available at <https://icsid.worldbank.org/apps/icsidweb/resources/pages/icsid-caseload-statistics.aspx>.

<sup>6</sup> See, e.g., *Attorney General of Belize v. Belize Telecom* [2009] UKPC 10 (Privy Council) (discussing implied terms).

<sup>7</sup> Sornarajah, *op. cit.*, p. 303.

<sup>8</sup> E.g., OECD, “Enhancing the competitiveness of SMEs through innovation” (2000), p. 18, available at <http://www.oecd.org/cfe/smes/2010176.pdf>.

<sup>9</sup> E.g., European Commission, “Transatlantic Trade and Investment Partnership: the opportunities for small and medium-sized enterprises,” available at [http://trade.ec.europa.eu/doclib/docs/2014/march/tradoc\\_152266.pdf](http://trade.ec.europa.eu/doclib/docs/2014/march/tradoc_152266.pdf).

<sup>10</sup> UNCTAD, *World Investment Report 2016: Investor Nationality - Policy Challenges* (Geneva: UNCTAD, 2016), p. 134, available at [http://unctad.org/en/PublicationsLibrary/wir2016\\_en.pdf](http://unctad.org/en/PublicationsLibrary/wir2016_en.pdf).

<sup>11</sup> Avi Nov, “The ‘bidding war’ to attract foreign direct investment: the need for a global solution,” *Virginia Tax Review*, vol. 25 (2005), pp. 835-875.

<sup>12</sup> Jeswald W. Salacuse, *The Three Laws of International Investment: National, Contractual and International Frameworks for Foreign Capital* (Oxford: OUP, 2013), p. 208.

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