

*Bilateral Investment Treaties ("BITs") are very useful tools for foreign investors, both at the stage of making their investments and when disputes arise. Every outbound investor should consider the availability and level of protection a BIT can provide in relation to any particular investment as an essential part of their strategic planning, since this can be an effective method to manage and mitigate political risk*

*Chinese investors are fortunate that China provides the second-largest number of BITs in the world, second only to Germany. This article explores how investors can best make use of this advantage*

# Strategic Suggestion on Using China's Bilateral Investment Treaties to Protect Outbound Investment

By Robert Hunter

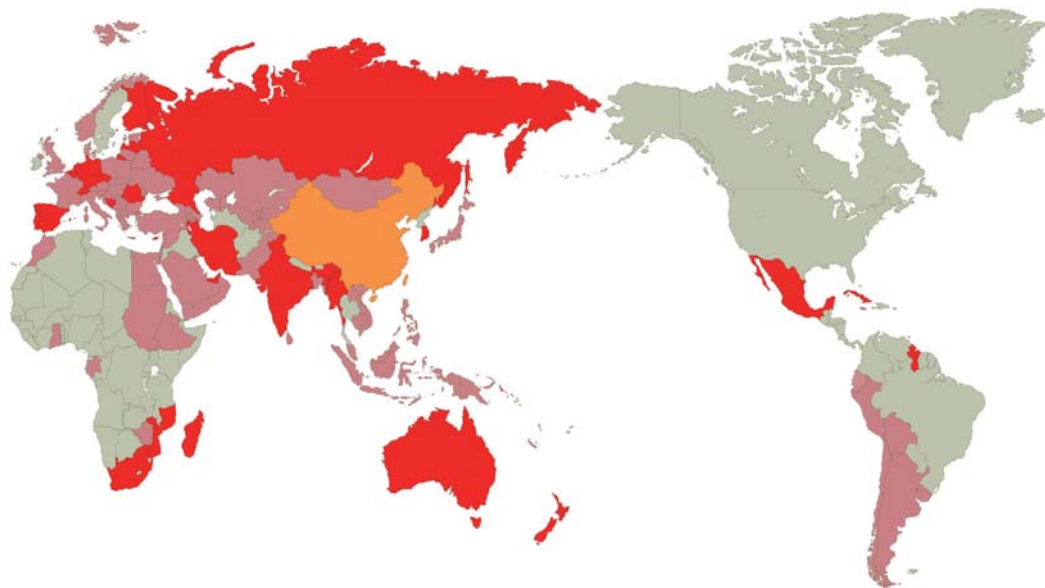
An increasing number of Chinese companies are beginning to encounter a variety of risks as a result of their growing presence on the international markets. Examples of such risks, which can have a direct influence on the strategic and commercial interests of the investor, include changes in the political situation and policy adjustments in the market of the investments.

One of the key strategic considerations that should be made by any investor with outbound investments, especially where the investment is intended to be long-term, is how best to avoid these kinds of risks materialising and how to deal with them when they

do. Bilateral Investment Treaties ("BITs") provide an effective tool in this respect. In particular, once a dispute arises between a contracting state and the investor of the other contracting state, the investor can typically bring it to arbitration before an international tribunal without having to rely on diplomatic protection or local judicial proceedings. In fact, a BIT is not only a powerful risk management tool but also a useful investment tool, particularly with regard to financing and investment guarantees. The protective function provided by BITs should therefore play a key role in every investor's strategic planning.

Figure1  
China's BITs: Arbitration

■ 有关赔偿金额的争议  
"...concerning an amount of compensation for expropriation"  
■ 有关投资的争议 "... concerning investments..."



### Some Important Concepts about BITs

Before delving into the details of how to use BITs to avoid and deal with the risk from host state's politics and policy, it is necessary first to clarify four important related concepts: "BITs", "Investment", "Investor" and "Treatment".

#### ★ BITs

A Bilateral Investment Treaty is a treaty established between two countries to encourage and promote investments by one state's investors in the other, above all by providing the promise of appropriate investment treatment and guarantees to investors. China has the second most BITs of any state. (Only Germany has more.) The Chinese Ministry of Commerce's ("MOFCOM") website lists all of China's BITs that have been signed and ratified. The world map on page 44 of this article shows the states with which China has such treaties in force.

#### ★ What Is An Investment?

Each investment treaty defines what constitutes an "investment" for the purpose of that treaty. Treaties typically contain a broad definition of "investment" as well as a non-exhaustive list illustrating the types of investment. This is an example from the China-Germany BIT of 2003:

*The term "investment" means every kind of asset invested directly or indirectly by investors of one Contracting Party in the territory of the other Contracting Party, and in particular, though not exclusively, includes:*

- (a) *movable and immovable property and other property rights such as mortgages and pledges;*
- (b) *shares, debentures, stock and any other kind of interest in companies;*
- (c) *claims to money or to any other performance having an economic value associated with an investment;*
- (d) *intellectual property rights, in particular copyrights, patents and industrial designs, trade-marks, trade-names, technical processes, trade and business secrets, know-how and goodwill;*
- (e) *business concessions conferred by law or under contract permitted by law, including concessions to search for, cultivate, extract or exploit natural resources; and any change in the form in which assets are invested does not affect their character as investments.*

In addition to such principal definitions, a BIT may impose further requirements. For example, the same Chinese-German BIT cited above contains in a protocol to the treaty two additional significant requirements or qualifications:

(a) *For the avoidance of doubt, the Contracting Parties agree that investments as defined in Article 1 are those made for the purpose of establishing lasting economic relations in connection with an enterprise, especially those which allow it to exercise effective influence in its management.*

(b) *"invested indirectly" means invested by an investor of one Contracting Party through a company which is fully or partially owned by the investor and having its seat in the territory of the other Contracting Party.*

Additionally, many treaties require that an investment be made in accordance with the laws and regulations of the host state. Sometimes they also stipulate that investments also be "approved" by the host government. This latter restriction is quite typical in the BITs of ASEAN (Association of South East Asian Nations) states.

#### ★ Who Is An Investor?

Only "investors" within the meaning of the applicable investment treaty can rely on its protection. Generally all natural and legal persons that possess the nationality of another contracting state can be considered an "investor". Determining nationality is usually straightforward in relation to natural persons. In relation to legal persons it is stipulated differently in different treaties: some treaties use the criterion of registration, others define the criterion by reference to establishment. Some go further and define specific thresholds of control. Chinese BITs usually define an investor either as:

(a) *a natural person who has the nationality of the People's Republic of China in accordance with its laws; or*

(b) *an economic entity, including companies, corporations, associations, partnerships and other organizations, incorporated and constituted under the laws and regulations of and with their seats in the People's Republic of China, irrespective of whether or not for profit and whether*



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their liabilities are limited or not.

#### ★ Substantive Guarantees of Appropriate Treatment

Standards of Treatment of investments are the substantive guarantees of investment protection promised by the contracting states. These include National Treatment, Most Favoured Nation Treatment and Fair and Equitable Treatment. By submitting to Most Favoured Nation Treatment, the host state assumes an obligation to treat investments of investors no less favourably than it treats investors of third states. National Treatment means the host state will treat the investments of foreign investors no less favourably than it treats those of its own nationals.

The promise of fair and equitable treatment of investments is one of the central guarantees of investment treaties and is present in most treaties. It has developed through arbitral jurisprudence into a set of fairly well defined and widely accepted standards of good governance. These standards include the obligations to act consistently, transparently, without arbitrariness or discrimination, in accordance with good faith and proportionately to the policy aims involved. A particularly important aspect of fair and equitable treatment is the observance of the investor's "legitimate expectations" by reason of which a host state may be held liable to account for its non-observance of any assurances it gave to the investor at the time of the making of the investment.

By way of example, the author of this article represented an engineering company from State D that was the principal promoter of a BIT Tollway concession in State M. Other partners in the venture included a construction company from State F and a local company from State M. The partners established a local project company in which our client held a 10 per cent stake. In the context of detailed feasibility studies, the terms of the concession (e.g. toll rates, the length of the concession period, a toll adjustment clause) were negotiated on the basis of certain assumptions with the common intention between the investors and State M of enabling the initial investors to generate an internal rate of return on equity of about 16 per cent, subject to a contractual allocation of certain commercial risks. The construction and operation of the Tollway were negatively affected by acts of the government of State M including an imposed reduction of the Toll rates, a continuous programme of improvements to untolled roads competing with the

Tollway, and the closure of the airport which the Tollway had been built to serve. These acts led to a dramatic reduction in revenue and over time, in turn, to a significant accumulated deficit and a vastly reduced expectation of return on equity at the end of the Concession period in about a further 15 years' time.

The foreign investors were unable to persuade the majority local private and state shareholders to pursue the concession company's legitimate contractual claims against State M.

Our client claimed its loss against State M in an arbitration that it brought to an international tribunal appointed under the applicable BIT. State M argued that it had never provided any guarantee for the investment return and therefore should not be responsible. We were able to demonstrate that our client's expected return on investment had been based upon identifiable objective criteria in the feasibility studies and negotiations, that these amounted to legitimate expectations at the time the investment was made, and that these expectations had been negatively affected by State M acts after the investment had been made. On this basis, our client requested the tribunal to compensate it for the effect of these acts upon the value of its investment. The tribunal accepted this argument and our client obtained a favourable award and damages. By way of contrast, the other foreign investor (whose State, F, had not entered into a BIT with State M) could not rely on a treaty claim and as a result received no equivalent compensation for its losses from the same factors.

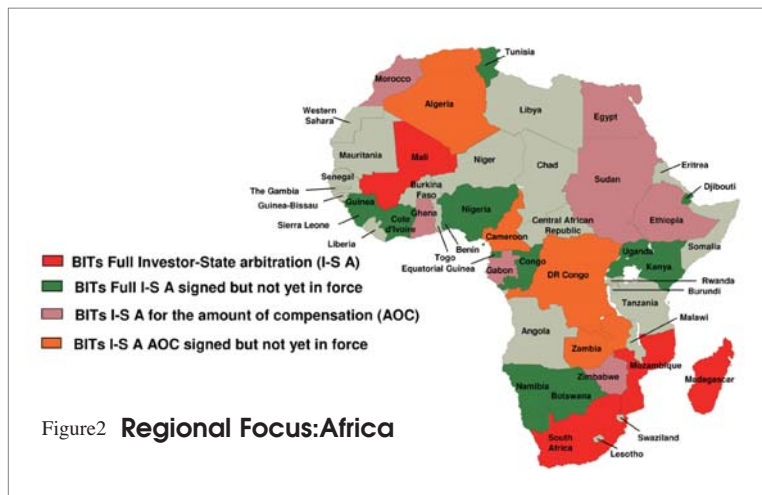
#### *Resolution of Investment Disputes through The Use of BITs*

There are a number of alternative ways to resolve disputes between a contracting state and an investor. These may include negotiation, mediation, administrative proceedings and proceedings before the host state's courts. Nonetheless, international arbitration under a BIT is a very important and powerful right for investors since it means that if a host state breaches its obligations the investor can himself bring a claim before an international arbitral tribunal in its own name, under international law and in a neutral seat. This provides a forum for binding resolution outside the procedural control of the host state and without the need for the investor to have to rely on either diplomatic protection from its own government or local procedures in the host state.

#### ★ Typical Aspects of Investment Arbitration Procedure

In contrast to a commercial arbitration agreement, an investor will typically submit a dispute arising between it and another state directly to an international arbitral tribunal even where no arbitration agreement has been signed directly between it and the government, relying instead on the fact that the host state has included a consent to such arbitration in the applicable BIT with the investor's own state. In this case, the arbitration agreement will consist of the state's offer to arbitrate such disputes in the BIT itself and the acceptance of this offer by an investor who qualifies for protection of his investment under the terms of that BIT.

Investment arbitration proceedings are in many ways similar to international commercial



arbitrations; there are ad hoc arbitrations, often incorporating the UNCITRAL Rules, or institutional arbitrations, e.g. under the rules of the ICC, LCIA or Stockholm Chamber of Commerce. Many investment treaties also offer submission to arbitration under the so-called "ICSID" rules. Such arbitrations are administered by the International Centre for the Settlement of Investment Disputes ("ICSID"), a member of the World Bank Group created specifically for the administration of such investment disputes by the Convention on the Settlement of Investment Disputes between States and Members of Other States ("ICSID Convention"). (You can find information about ICSID on its website at <http://icsid.worldbank.org/ICSID>.)

BIT awards, including ICSID awards, are commonly honoured without the need for enforcement. The high level of compliance with such awards can be attributed to the facts that they constitute international law obligations in themselves and that their non-observance may prejudice the host state's creditworthiness in the international financial and insurance markets. ICSID's affiliation with the World Bank is said to lend particular effectiveness to ICSID awards as there is a perception that non-performance may lead to the withholding of World Bank loans from the non-fulfilling state.

#### ★ Types of Arbitration Consents in China's BITs

China has signed and ratified 100 BITs as of 31 October 2010; 97 of these include a consent to investor-state arbitration. These consents can be sorted in two categories:

The first category consents to Investor-State Arbitration regarding the Amount of Compensation. Such consents stipulate that only disputes concerning the amount of compensation for expropriation can be submitted to an international arbitration tribunal. An example of such a consent is Article 8 of the China-Peru BIT:

*(a) Any dispute between an investor of one Contracting Party and the other Contracting Party in connection with an investment in the territory of the other Contracting Party shall, as far as possible, be settled amicably through negotiations between the parties to the dispute.*

*(b) If the dispute cannot be settled through negotiations within six months, either party to the dispute shall be entitled to submit the dispute to the competent court of the Contracting Party accepting the investment.*

*(c) If a dispute involving the amount of compensation for expropriation cannot be settled within six months after resort to negotiations as specified in Paragraph 1 of this Article, it may be submitted at the request of either party to the international arbitration of the International Center for Settlement of Investment Disputes (ICSID), established by the Convention on the Settlement of Investment Disputes between States and Nationals of Other States, signed in Washington D.C., on March 18, 1965. Any disputes concerning other matters between an investor of either Contracting Party and the other Contracting Party may be submitted to the Center if the parties to the disputes so agree. The provisions of this Paragraph shall not apply if the investor concerned has resorted to the procedure specified in Paragraph 2 of this Article.*

Although BITs typically contain a definition of what constitutes "expropriation", disputes may still arise not only about the amount of

compensation but also about whether there has been an expropriation in the first place.

*Tza Yap Shum v. Republic of Peru*, ICSID Case No ARB/07/6 (based on the China-Peru BIT) is the first case brought by a Chinese investor before ICSID based on a BIT. The case is still pending, following a jurisdictional award that was made on 19 June 2009 that had to determine the scope of such an "amount of compensation" consent to arbitration.

Mr Tza Yap Shum, a Hong Kong resident, issued proceedings against Peru under the China-Peru BIT, claiming compensation for the alleged expropriation of his Peruvian fish flour company. The two parties disagreed over the scope of Peru's consent to investor-state arbitration.

Peru objected to the tribunal's jurisdiction, arguing that according to the Article 8 Para 3 of the relevant BIT the tribunal enjoyed jurisdiction only over the "amount of compensation" but did not have the right to determine whether there had been an "expropriation" within the meaning of the treaty. Peru argued that the determination of whether or not there had been an expropriation should be submitted to the local court. However Article 8 Para 3 last sentence of the treaty stipulated that if the investor had first brought a dispute to the local court, he would be precluded from taking the dispute to an international arbitration tribunal under the BIT. After careful consideration, the tribunal determined that it did have jurisdiction to determine not only the amount of compensation but also whether the act of the Peruvian Government fell within the meaning of "expropriation" in the BIT.

The second type of clause, which can be described as "full" Investor-State Arbitration, provides that all disputes arising from the investment are included in the scope of international arbitration. The China-South Africa treaty signed on 1997 is the first BIT entered into and ratified by China that stipulates consent to full I-S A:

Article 9:

*(a) Any dispute between an investor of one contracting Party and the other Contracting Party in connection with an investment in the territory of the other Contracting Party shall, as far as possible, be settled amicably through negotiations between the parties to the dispute.*

*(b) If the dispute cannot be settled through negotiations within six months, either Party to the dispute shall be entitled to submit the dispute to an international arbitral tribunal provided that the Contracting Party involved in the dispute may require the investor to initiate administrative review procedures in accordance with its laws and regulations, and provided that the investor has not submitted the dispute to a domestic court of that Contracting Party.*

Most of the BITs China that has signed since this time include a consent to 'full' I-SA. The map at Figure 1 shows the states with which China currently has BITs in force, distinguishing between those with "full" investor-state arbitration (shown on the legend as "I-SA"), investor-state arbitration limited to the Amount of Compensation only (shown as "AOC") and those that contain no consent to I-SA at all. Figure 2 is a map concentrating on the Africa region. This map shows in addition those states with which China has signed BITs that have not yet come into force, again distinguishing between those BITs with full I-SA and those with



AoC I-SA. As can be seen, almost all of these BITs awaiting ratification contain the more modern type of full arbitration clause.

### *BITs Should Be Integrated into Investors Strategic Planning*

The protection a BIT can offer is a very useful investment tool indeed, both in strategic planning before an investment has been made or after a dispute has arisen. Given the level of protection they afford they should form part of the strategic planning of any company investing substantially overseas.

#### ★ Purchase Investment Insurance to enhance financing ability

In addition to relying on the rights of protection under the BIT itself, the investor can purchase investment insurance from the only export credit insurance institution in China, China Export and Credit Insurance Corporation. It covers the risk of expropriation, exchange limitation, war and violation and Government breach (<http://www.sinosure.com.cn/sinosure/cpyfw/tzbx/gytzbx/gytzbx.html>). Government Breach refers to situations where:

"the host state breached or did not fulfil relevant agreement signed with the insured or project company, and refuse to compensate the insured or project company according to the arbitration award."

The existence of investment guarantees provided by BITs may be important not only in providing assurance to the investor but also by reducing the cost of investment insurance and the cost of financing, especially in so-called "non-recourse" financing, since the lenders' perception of risk may be influenced as well. In some cases this may even prove decisive as to the availability of financing. Under some circumstances, the existence of a BIT may itself be a prerequisite to the granting of an investment guarantee or export finance under a state-sponsored scheme.

#### ★ Use BITs to evaluate political risk

When evaluating an investment's risk and profitability, investors need to consider the essential supplementary legal protection and remedies that BITs provide, especially in the case of perceived inadequacy, unfairness or ineffectiveness in the host state's domestic legal framework.

This can be illustrated by the following example, known to the author. A company from state A is interested in investing in a long-term, capital-intensive project in state B. Its analysis indicates that state B offers an insufficiently stable and predictable political and administrative framework and that its courts offer insufficient assurance of the enforcement of its contractual rights. There is a BIT between A's state and state B but this does not contain a consent to investor-state arbitration and State B declines to offer such a clause in the investment agreement. On the basis of its risk analysis and the lack of opportunity to enforce its rights in investor-state arbitration, company A decides not to proceed with the project.

#### ★ Establish reasonable or alternative international investment structures

Where an investor's own home state has no or an inadequate BIT with the host state of the investment, the investor may consider whether it

can protect its investment by structuring its investment through a holding in an acceptable third state.

In the case between company X and state Y, X's partner company Z could not bring an international arbitration claim as there was no BIT between state Y and Z's home state. Had it been aware of this when making its investment, it might have been able to protect its investment by structuring it indirectly through a third state that had entered in to a BIT with M state, e.g. by establishing a joint venture with D with the same nationality as D. When considering such a structure, it is vital to check the precise wording of the BIT between the state of the holding company and the host state with regard to whether it protects investments held in such a structure.

#### ★ Maintain status of "Investor" and "Investment"

After obtaining comprehensive international protection, the investor should be careful to maintain its status as "investor". Assignments, reorganisations, mergers and changes of status may each give rise to the risk of losing such status, particularly whether it involves a change of nationality. For example, where a company that is a national of state A invests in a project company in state B but then transfers the shares of the project company to a company in state C, the company in state C will not be protected by a BIT between state A and state B but will have to rely on such BIT as may exist between state B and state C.

In addition, the domestic legislation of many states contain special regulations as regards the definition of "investment", such as requirements that foreign investors' shares in a project company may not exceed 49% of its share capital and that foreign investors may not otherwise control the project company. A failure to observe such requirements risks losing protection of the investment under the applicable BIT, particularly where the BIT includes a requirement that an investment conform to local law.

#### ★ Choose Beneficial Disputes Settlement

As soon as a potential dispute looks likely, the investor should strategically analyse the optimal tactics and potential avenues of dispute resolution. Choices of procedure made early on in a dispute can substantially affect the outcome. This is particularly the case where the BIT or investment agreement stipulates that the investor may choose either the jurisdiction of court and international arbitration but not both (see, e.g., the extracts from the China-Peru and the China-South Africa treaties quoted above). Where the investor has investment insurance, it should contact the insurance institution immediately when the dispute occurs. This may not only be a condition of the insurance, but it might also have the benefit that the investor may obtain support from its government to solve the dispute before having to go to arbitration.

### *Conclusion*

Investment protection offers an effective means to manage and limit exposure to political risk. Chinese investors are fortunate that China offers the second most comprehensive investment treaty programme in the world. To use this advantage effectively, investors should consider the availability of protection and the optimisation of its use in a strategic manner both at the time of making its investment and as soon as any dispute looks likely to arise.

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