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Building a Mirage: The Effectiveness of Tax Carve-out Provisions in International Investment Agreements

By Daniel Uribe and Manuel F. Montes*

I. Introduction

The power to control taxes is a cornerstone in the exercise of full sovereignty of States.[1] Taxation is the principal means to finance the public provision of goods.[2] For many societies, taxation seeks to distribute the burden of achieving public objectives fairly. For societies that choose to do so, it is also a tool to redistribute wealth, and a key feature in the economic system of a State.

The globalization of the economy has diluted the full exercise of sovereignty in tax-related issues. The proliferation of low tax jurisdictions could facilitate tax evasion and tax avoidance and is a source of pressure for States. Studies prepared by Tax Justice Network and the United Nations University World Institute for Development Economics Research (UNU-Wider) have shown the global distribution of revenue loss from tax avoidance[3]. Tax Justice Network has calculated, based on a methodology developed by researchers at the International Monetary Fund, that global losses of tax revenue amounts to around $500 billion a year. By 2017, countries which are non-members of the Organisation for Economic Co-operation and Development (OECD) were affected twice as much as OECD countries in terms of gross domestic product (GDP) loss due to profit shifting[4].

The existence of multiple jurisdictions with simultaneous legitimate claims over the same source of taxable revenue[5] is another source of pressure. States have sought to implement mechanisms to relieve double taxation. These are supposed to promote the recognition of State's sovereignty over tax-related issues and also to guarantee the rights of taxpayers and improve the coordination among States on the collection of tax revenues.

These aims have generally been incorporated in the provisions of double taxation treaties (DTTs), some of which include mutual agreement procedures granting the taxpayer the right to bring claims before the competent authority of either of the contracting parties.[6] The fact that such dispute settlement mechanisms have been incorporated in the majority of DTTs is the reason why States have generally been careful in excluding tax-related claims from bilateral investment treaties (BITs) and other free trade agreements (FTAs). They have done so by incorporating 'carve-out' clauses on tax measures.

Despite the clear and unequivocal provisions for excluding tax measures in investment treaties, the rise of arbitral disputes of tax-related measures is a reality.[7] States' tax measures have come under increasing scrutiny by international arbitral tribunals. Private investors have challenged them through the investor-state dispute settlement system (ISDS) based on the rights granted to them by international investment agreements (IIAs). Claims arising from tax-related issues are effectively being adjudicated by international arbitral tribunals as a matter of state obligations toward foreign investors, even in cases where IIAs contain unambiguous tax carve-out provisions (see Annex).

This brief will analyse the language included in taxation carve-out provisions in IIAs, and its effectiveness in restricting the dispute settlement provisions of IIAs only to non-tax-related claims. It will illustrate that even in cases where such carve-out provisions have been included into such agreements, the broad language and lack of clarity in the drafting of such provisions have effectively allowed ISDS tribunals to scrutinize tax measures adopted by States, and even determine that such measures resulted in a breach of State's obligations under the BIT. The brief in-

Abstract

The present policy brief analyses the language of taxation carve-out provisions incorporated in International Investment Agreements (IIAs), and its effectiveness with regards to restricting the protection and dispute settlement provisions of IIAs only to non-tax-related claims. It illustrates that even in cases where such carve-out provisions have been incorporated into IIAs, the broad language and lack of clarity in the drafting of such provisions have effectively allowed Investor-State Dispute Settlement (ISDS) tribunals to scrutinize tax measures adopted by States, and even determine that such measures resulted in a breach of State's obligations under the agreement. It makes recommendations on how States could effectively implement such carve-outs when negotiating, reforming or drafting new international investment agreements.

* Daniel Uribe is Researcher of the Global Governance for Development Program (GGDP) of the South Centre in Geneva. Prof. Manuel F. Montes is Senior Adviser in Finance and Development and Permanent Observer to the United Nations in New York of the South Centre. Special gratitude to Danish from the South Centre for his useful comments and suggestions.

cludes a number of recommendations that States could consider when negotiating, reforming or drafting IIAs.

II. Provisions in Taxation Carve-out Clauses in BITs

An analytical overview of tax-related claims brought to ISDS tribunals provides the possibility of identifying different "drafting" model approaches for taxation carve-outs. There are at least three approaches to the relation between tax matters and BITs and FTAs. First, these treaties may not contain any provision excluding tax matters from the purview of the investment treaty. This will carry the implication that all tax matters will be covered under the provisions of the BIT, including the dispute settlement clause allowing ISDS tribunals to have competence to review any tax measure adopted by a State.

A second option is the presence of clauses excluding any tax matter from the application of the BIT, particularly when related to the Most Favoured Nation (MFN) and National Treatment (NT) provisions[8]. This approach reaffirms the power of States to control their tax regimes as a showcase of full exercise of their sovereignty. Nevertheless, in some cases, such provisions have been examined by ISDS tribunals on the basis of the Fair and Equitable Treatment (FET) provision and expropriation[9]. Finally, a third approach considers the inclusion of provisions on tax measure carve-outs from the purview of the treaty, while at the same time identifying certain circumstances in which tax measures could fall under the jurisdiction of the treaty in question.

Although the carve-out provision models differ on the extent of benefits recognised in BITs and their exclusion of tax-related measures, the language used in such provisions can often be contradictory and vague. In general terms, the carve-out clauses included in BITs and FTAs have been characterized as *matryoshka* clauses, meaning that you will find "rules within the rules", or even clearer, "exceptions to the exceptions" (see Box 1).

1) European IIAs

Not all IIAs include taxation carve-outs, but those that do provide them have used different drafting styles. In the case of most European BITs, such carve-out provisions have been drafted in a manner that avoids possible contradictions between double taxation treaties (DTTs) and IIAs. In this respect, tax-related provisions recognise the application of NT and MFN standards to tax matters, excluding only "special fiscal advantages" from the purview of the IIA if such special advantage is incorporated in DTTs, economic unions or based on reciprocity with a third State.

For example, Article 4 of The Netherlands - Laos BIT provides:

> Article 4
>
> **With respect to taxes, fees, charges and to fiscal deductions and exemptions**, each Contracting Party shall accord to nationals of the other Contracting Party who are engaged in any economic activity in its territory, treatment not less favourable than that accorded to its own nationals or to those of any third State who are in the same circumstances, whichever is more favourable to the nationals concerned. **For this purpose, however, any special fiscal advantages accorded by that Party, shall not be taken into account:**
>
> **a) under an agreement for the avoidance of double taxation; or**
>
> **b) by virtue of its participation in a customs union, economic union or similar institution; or**
>
> **c) on the basis of reciprocity with a third State**

Although the same wording appears in The Netherlands – Venezuela BIT, other European practices only exclude tax measures from the protection of certain standards in the IIA[10]. The United Kingdom model BIT is the case in question. Article 7 recognises that the provisions of the BIT

> […] relative to the grant of treatment not less favourable than that accorded to the nationals or companies of either Contracting Party or of any third State shall not

Box 1 The *Matryoshka* type Clause[11]

The *Matryoshka* is a typical Russian wooden doll which contains a set of smaller dolls placed one inside another. It has been suggested that, similar to a *matryoshka*, "treaty based investor protection schemes contain fiscal provisions that unfold with exceptions to the exceptions"[12]. This is meant to argue that some BITs contain certain carve-out clauses on fiscal matters, but at the same time, such carve-outs contain exceptions to their implementation.

For example, the Energy Charter Treaty (ECT) contains a general rule on tax measures. After excluding taxation measures from the benefits and obligations drawn from the ECT, Article 21 enumerates the provisions that apply with respect to tax measures, including prohibitions against discrimination, uncompensated expropriation, and measures that "arbitrarily restrict benefits accorded under the Investment provisions of this Treaty"[13].

The ECT thus expressly provides for a general exclusion of taxation matters from the application of the treaty, but it provides for exceptions to those exceptions. As noted by some commentators, "[t]his carve-out provision is, nevertheless, not absolute, as Article 21(5) excludes expropriatory measures from the general carve-out rule under Article 21(1) for direct taxes, i.e. tax on capital and income. Further, Article 21(3) subjects indirect taxes to the national treatment regime".[14]

Therefore, the drafting of such carve-outs in BITs and other IIAs generally include scenarios in which their implementation proves impracticable.

be construed so as to preclude the adoption or enforcement by a Contracting Party of measures which are necessary to protect national security, public security or public order, nor shall these provisions be construed to oblige one Contracting Party to extend to the nationals or companies of the other the benefit of any treatment, preference or privilege resulting from […]

(b) **any international agreement or arrangement relating wholly or mainly to taxation or any domestic legislation relating wholly or mainly to taxation**

Similarly, following the trend of negotiating and ratifying plurilateral trade agreements, the European Union has adopted a two layered method to exclude tax measures from the scope of IIAs: one stressing the State's right to regulate; the second one provides for an exception excluding tax measures from the purview of IIAs. An example of this approach could be found in the Comprehensive and Economic Trade Agreement between the European Union and Canada[15] (CETA). On the first layer, Chapter VIII of CETA addresses investment and recognises and reaffirms the right of States to regulate "within their territories to achieve legitimate policy objectives" (Art. 8.9 paragraph 1). CETA, includes a non-exhaustive list of policy objectives that fall under such "right to regulate"[16], and it emphasizes the mere fact that a regulation, including the modification of laws, which negatively affects an investment, does not amount to a breach of an obligation under the investment section of CETA (Art. 8.9 paragraph 2). The provision also clarifies that such negative effects include an impact on the investor's expectations of profits.

The second level of protection incorporated in CETA is drafted as an exception. Chapter 28 of the agreement excludes certain areas, either from specific chapters of CETA, or from the whole agreement. The objectives of such provision are the protection of public safety or the realization of public policy objectives, among others[17]. Interestingly, Article 28.7 of CETA incorporates a specific exception for taxation. In particular, it ensures that nothing in the Agreement "shall be construed to prevent a Party from adopting or maintaining any taxation measure that distinguishes between persons who are not in the same situation, in particular with regard to their place of residence or with regard to the place where their capital is invested". In addition, it excludes from the purview of the Agreement all measures aimed at preventing the avoidance or evasion of taxes. Article 28.7 (2) establishes that nothing in the Agreement "shall be construed to prevent a Party from adopting or maintaining any taxation measure aimed at preventing the avoidance or evasion of taxes pursuant to its tax laws or tax conventions".

2) North American IIAs

In the case of the North American BITs (Canada and United States), the wording of the carve-outs does not exclude the application of the protection from the BITs when dealing with tax-related issues. The carve-outs follow the *matryoshka* kind of clause that sets out what seems to be a general exception for the application of the BIT to taxation measures, but immediately lists the exceptions in the implementation of the carve-outs.

For example, Article XII of the Ecuador-Canada BIT[18] provides the taxation carve-out clause. While excluding tax measures from the application of the treaty, it introduces what is known as the joint veto system in tax-related claims. The joint veto system refers to an obligation of the investor to notify the intent to bring a claim to the tax authorities of the Parties to the Treaty. No later than six months after being notified, the tax authorities have to jointly determine whether the tax measure contravenes or not the Agreement. The same is applicable with respect to expropriation (Article VIII), wherein the tax authorities have to jointly determine whether the tax measure in question is not an expropriation. The core elements of Article XII of the Ecuador-Canada BIT are also included in the Canada Model for Promotion and Protection of Investments (2004).

Concerning the United States, most IIAs apply the same type of carve-out as the one included, for instance, in the United States-Argentina BIT. Article XII of the aforementioned BIT does not make reference to a general exception of taxation measures; on the contrary it lists the provisions of the treaty which are applicable to matters of taxation: expropriation, transfers, and ISDS. It is worth noting that the first paragraph of this provision recognises the obligation of each Party to "**strive to accord fairness and equity** in the treatment of investment of nationals and companies of the other Party" with respect to tax measures; this has been interpreted by ISDS tribunals as referring to the application of the fair and equal treatment clause. Even though this provision recognises the existence of dispute settlement provisions in DTTs, it does not provide for procedures similar to the ones found in Canadian BITs.

Nevertheless, the US Model BIT of 2012 provides for more explicit carve-outs, limiting the application of the treaty provisions with respect to taxation measures only to expropriation (Article 6) and certain performance requirements for the receipt or continuing receipt of an advantage (Article 8.2, 8.3 and 8.4), while keeping the recognition of dispute settlement provisions in DTTs. What is worth noticing is that, while expropriation claims require a joint decision of the tax authorities recognising that such measures are an expropriation, the same procedure is not applicable when referring to performance requirement claims, which means that the investor may refer the matter directly to ISDS.

3) North American Free Trade Agreement (NAFTA)

The NAFTA includes a typical *matryoshka* clause in Article 2103[19] by recognizing a general taxation carve-out from the provisions of the Treaty while excluding the application of such carve-outs in certain cases. Similarly, it includes language clearly specifying the primacy of tax con-

ventions over the NAFTA in case of inconsistency and excludes application of the most-favoured nation clause (MFN) from any advantage accorded under a tax agreement. It also recognises that "any new taxation measure aimed at ensuring the equitable and effective imposition or collection of taxes and that does **not arbitrarily discriminate** between persons, goods or services of the Parties or **arbitrarily nullify or impair benefits** accorded under those Articles"[20] is exempted from the protections granted by the NAFTA.

The inclusion of such carve-outs in the NAFTA agreement has not prevented investors to bring claims against State tax decisions. Particularly, the wording of Article 2103.4(g) shifts the burden to the State to demonstrate that such decisions, if challenged by an investor, are not arbitrarily discriminatory or nullifying or impairing the benefits accorded in the NAFTA. Therefore, such provisions opens a wide window for investors to bring claims against the State on the basis of fair and equal treatment and non-discrimination (Article 1105).

In addition, the NAFTA agreement establishes that in case investors submit claims challenging a tax measure as an expropriation under the basis of Article 1110, such claim must be referred to the competent authorities of the States concerned in order to determine whether the measure is not an expropriation[21]. If the competent authorities fail to agree that the measure is not an expropriation within a period of six months of such referral, the investor may submit its claim to arbitration.

4) United States, Mexico and Canada Trade Agreement (USMCA)

Under President Trump's administration, the United States decided to negotiate a new FTA with its natural partners, Mexico and Canada. This new agreement replaces NAFTA, which was declared by President Trump as the worst trade deal the United States has ever signed[22]. Commentators have argued that USMCA has not included any dramatic shift from its predecessor and that most of the changes are purely cosmetic[23]. While this may be true in certain aspects, USMCA brings significant changes on the issue of investor-state dispute settlement (ISDS) mechanisms, incorporated in its Investment Chapter (Chapter 14), and with regards to particular industrial and economic sectors (see Box 2).

Box 2 Industrial and economic sectors' treatment modified by USMCA[24]

- North American Content Requirements for Vehicles
- Section 232, U.S. Import Tariffs on Canadian Manufactured Automobiles
- Canadian Dairy and Agricultural Quotas
- Chapter 19 - Dispute Resolution
- Sunset Clause
- Intellectual Property
- Online Shopping
- Steel and Aluminium Industries

On the issue of ISDS, USMCA has developed an unusual approach (see Diagram 1). First, it has eliminated ISDS in the case of Canada, which means that no claim can be brought by a US or Mexican investor against Canada, nor a Canadian investor can bring a claim against the US or Mexico. Secondly, it incorporated Chapter 14 – Annex-D allowing ISDS only in the in the case of Mexico and the United States, but incorporating the principle of exhaustion of local remedies. The application of this principle implies that claims can be brought by an investor or enterprise only after the claimant has initiated a proceeding before a competent court or administrative tribunal of the respondent with respect to the measures alleged to constitute a breach of the respondent obligation under NT, MFN and expropriation. In such cases, it is required that the claim obtain a final decision from a court of last resort of the respondent; or, that 30 months have elapsed from the date the proceeding was initiated, and before 4 years have elapsed from the date on which the claimant first acquired, or should have first acquired, knowledge of the breach alleged. Thirdly, although this formulation may be seen as an important way forward, it is limited on the basis that Chapter 14 also includes Annex-E, which creates a special regime for investors having a contract with the State in certain sectors, in particular:

- oil and natural gas (exploration, extraction, refining, transportation, distribution, or sale);
- supply of power generation services;
- supply of telecommunications services;
- supply of transportation services; and
- ownership or management of roads, railways, bridges, or canals.

Annex 14-E reforms Annex 14-D in cases involving an investment in the sectors described above. These reforms exclude the obligation of exhaustion of local remedies and allow to bring claims on behalf of a juridical person owned or controlled by an investor, independently of the nationality of the investor in the enterprise, if it is "engaged in activities in the same covered sector in the territory of the respondent as another enterprise of the respondent that the claimant owns or controls directly or indirectly and that is a party to a covered government contract" (provision 2(b)(i)(A)(3) Annex 14-E). It also allows the application of another international trade or investment agreement that permits investors to initiate dispute settlement procedures to resolve an investment dispute with a government (provision 2(a)(i)(B) and 2(b)(i)(B) Annex 14-E).

Finally, Chapter 14 of USMCA also incorporates Annex -C, which deals with "legacy investments and pending claims". On the one hand, pending claims will continue their normal course until their conclusion under former NAFTA's Chapter 11-B. On the other hand, the provision on 'legacy investments' allows investors to bring claims on the basis of NAFTA Chapter 11-B in cases in which the investment object of the claim was "established or acquired between January 1, 1994, and the date of termina-

tion of NAFTA 1994, and in existence on the date of e*ntry of force of this Agreement [USMCA]"* (Art. 6(a), Annex 14-C). Nonetheless, it provides a statute of limitation of 3 years after the adoption of the USMCA for investors to bring claims on the basis of legacy investments.

Although USMCA does not include language on tax-carve outs, there are at least two issues to be concerned with when dealing with possible claims under USMCA. First is the fact that a special regime for investors with State contracts includes the majority of public services (power generation services, telecommunications, transportation services, road maintenance and exploration, extraction, refining, transportation, distribution, or sale of oil and natural gas). Considering that such sectors are the most prompt to result in disputes between investors and States, in particular on the basis of windfall taxes and subsidies, the inclusion of this regime in USMCA creates a real risk of increasing the liability of Mexico when adopting, reforming and implementing legislation or policies in these sectors. The fact that exhaustion of local remedies is excluded from such regime, and that the application of the MFN provision on the possible application of BITs signed with other partner countries by investors to bring claims against the State (provision 2(a)(i)(B) and 2(b)(i)(B) Annex 14-E), increase the risk to be brought against international arbitration tribunals, and therefore, reducing the policy space of the State in strategic sectors for development. Secondly, as mentioned above, the inclusion of ISDS provisions on legacy investments expands the risk of challenging a tax measure as an expropriation under the basis of NAFTA Article 1110.

5) Energy Charter Treaty (ECT)

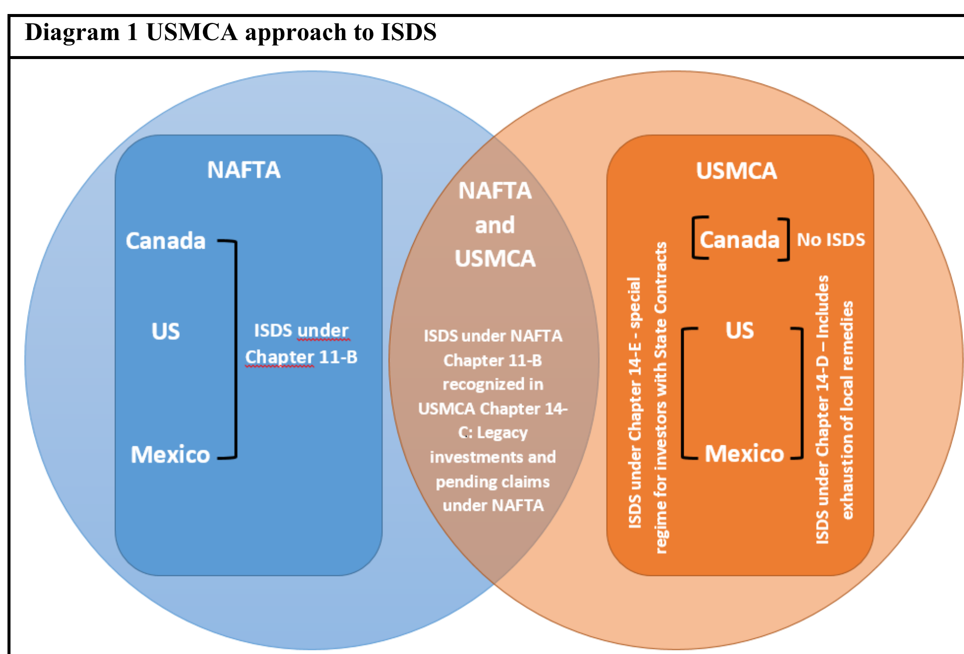
The Energy Charter Treaty is a plurilateral agreement developed with the aim of offering protection to foreign investors in the energy sector and promoting the progressive liberalization of trade in energy. In the area of protection of investment, the ECT establishes State obligations to extend national treatment and most favoured nation treatment to national and legal entities of other signatory States. This protection is based on the principle of non-discrimination and the creation of an "appropriate investment climate" in the energy sector[25]. This has led to the recognition of the ECT as a treaty that "carries the equivalent legal force of a unified network of bilateral investment protection treaties"[26] or "one treaty to rule them all"[27].

Concerning the relationship of the ECT and tax matters, Article 21 includes similar language to the one found in the NAFTA. It establishes that nothing in the ECT shall "create rights or impose obligations with respect to Taxation Measures of the Contracting Parties" and recognises that in case of inconsistency between Article 21 and any other provision in the ECT, the former will prevail. Nonetheless the inclusion of explicit exceptions to the tax carve-out resembles the language included in the NAFTA and other BITs as it includes the possibility of bringing a claim against a State for adopting or implementing a tax measure which could be understood as violating the national treatment clause or most favourable nation clause (Article 10.2 and 10.3 ECT), which extends to related activities in the sector, including management, maintenance, use, enjoyment or disposal of the investment (Article 10.7 ECT).

The ECT also recognises under Article 21.5 that protection from expropriation is also excluded from the tax carve-out, thereby allowing an investor to bring a claim to international arbitration even if the competent tax authority deems such measure not to be an expropriation, as the ECT only requires that the arbitral tribunal[28] takes into account any conclusions arrived at by the competent tax authority within the six-month period prescribed in the ECT.

Finally, it is important to note that the roadmap for modernization of the ECT prompted the adoption of the

Diagram 1 USMCA approach to ISDS



International Energy Charter (IEC) in The Hague at the Ministerial Conference on the International Energy Charter on 20 May 2015. Although the IEC is only a political declaration, it forms part of the broader legal framework of the ECT. Further, the IEC includes vague language on taxation; particularly it declares that:

> With a view to facilitating the development and diversification of resources, the signatories **decide to avoid imposing discriminatory rules on** operators, notably rules governing the ownership of resources, internal operation of companies and **taxation**.

This language, read in conjunction with the exceptions included in Article 21 of the ECT, could allow for a broader interpretation of cases limiting the application of tax carve-out clauses by arbitral tribunals, which in turn could facilitate bringing ISDS claims against the State for supposedly discriminatory practices in tax matters examined below.

III. Effectiveness of Taxation Carve-out Clauses in BITs

A recent study prepared by the Transnational Institute and Global Justice Now[29] lists forty two ISDS tax-related procedures brought against States by private investors. Among those cases, twenty eight were based on BITs, and among these BITs, all contain taxation carve-out clauses. This means that a hundred percent of the time, the taxation carve-outs clauses, as traditionally drafted, are not effective to prevent tax-related measures to be challenged using ISDS procedures.

The most practical mechanism included in traditional taxation carve-out clauses to exclude tax-related claims from BITs, is the incorporation of a "joint tax consultation" procedure between the tax authorities of the Parties to the BITs. Nevertheless, such procedures are time restricted (six months), after which the investor can pursue procedures before international arbitration; therefore they work as a time bar for ISDS claims, rather than preventing the challenge of a tax measure. The fact that the "joint tax consultation" is recognised as a pre-procedural requisite[30] rather than a ban to bring tax-related claims in ISDS procedures is one of the reasons why arbitral tribunals have recognised that such referral mechanism is not compulsory when the measure under review is openly discriminatory or intended to impose liabilities or fines amounting to expropriation[31].

Further, the language incorporated into these carve-outs, which sometimes is vague and broad, has allowed ISDS tribunals to consider claims in which their jurisdiction was contested precisely on the basis that the measure challenged was a tax measure excluded from the application of the BIT through a carve out provision[32]. In such cases, a broad definition of the term "tax measures" and a broad interpretation of certain BIT provisions allowed those tribunals to explicitly exclude a tax measure from the application of a carve-out provision[33].

Similarly, the lack of consistency among ISDS awards and the opportunity of arbitral tribunals to broadly interpret the terms, principles and scope of the language used in the BITs, limit the expected effect of carve-out provisions in BITs. The difference in outcomes arising from claims dealing with the same tax measures but decided by different arbitral tribunals demonstrates how taxation carve-out clauses might be interpreted differently by ISDS Tribunals, even if such cases relate to the same time period, the same country and apply to companies operating in the same economic sector (see Box 3).

1) Effects on the right of State to regulate

According to a report published by the United Nations Economic Commission for Africa (UNECA), States' ability to mobilize resources to support the growth and diversification of their economy is fundamental for achieving inclusive and sustainable development[34]. In order to achieve such objective, there is an outstanding need to include provisions guaranteeing the right of the State to regulate as an expression of countries' sovereignty[35] and recognise that this right also includes the State's possibility to implement economic or financial policies[36], including the design and implementation of tax measures towards the achievement of their development objectives. Investment lawyers appear to be quite aware of the chilling effect the dispute mechanism can have on public policy. For example, a study prepared by Wiśniewski and Górska suggests that the threat of sparking a dispute is a legitimate company tactic to prevent any changes in the regulatory regime in which they operate and argue that ISDS can also be seen as a "preventive" investment protection[37].

Considering that the adoption or modification of tax measures is generally done through legislation with the objective of procuring public financing for the national budget, including the provision of public and social services, and development strategies[38], the inclusion of language safeguarding the right of the State to regulate, covering tax measures, was supposed to grant States the necessary flexibilities to adopt measures necessary to achieve their development interests.

Nonetheless, as noted, such language has not effectively covered decisions taken by tax authorities in full exercise of their powers, for example in determining tax liability of foreign investors or the decision to terminate or discontinue tax subsidies. Similarly, in other instances, arbitral tribunals have examined the legislative process of adoption of tax measures in order to determine its nature, and even examined its compliance with constitutional provisions[39].

Consequently, the lack of effectiveness of tax carve-outs has been detrimental for the full exercise of the right of the State to regulate and it might require the addition of certain provisions clarifying or controlling the scope of interpretation of BIT provisions by arbitral tribunals[40], particularly when dealing with such tax measures.

2) Legitimate expectations and the fair and equitable treatment provisions in BITs

The fair and equitable treatment (FET) standard is one of the most popular provisions used by foreign investors to challenge a State's conduct[41]. The FET standard has served as a basis to bring claims against tax measures in a number of cases, including the withdrawal of tax exceptions, suspension of tariff adjustments for public utilities or refusal to reimburse taxes, among others[42]. The relationship between FET and foreign investors' legitimate expectations is of upmost importance in the case of tax related matters, as a number of cases have recently been brought against developing and developed States[43], even where no specific commitments were made in relation to foreign investors.[44]

Article 10.1 of the ECT requires States to encourage and create stable, equitable, favourable and transparent conditions for foreign investors in the energy sector. It continues by affirming that such conditions shall include a commitment to accord fair and equitable treatment. Such provision has been interpreted differently by a number of tribunals[45], recognising for example that the provision contains two different obligations, one creating a 'favourable environment' for investments in the energy sector, and another responding to the FET standard[46]. ECT tribunals have recognised that the investor's 'legitimate expectations' are protected under Article 10.1 from any unfair, unreasonable or inequitable exercise of the State's legislative power[47] or from any disproportionate change that "suddenly and unpredictably eliminate the essential characteristics of the existing regulatory framework"[48]. Either interpretation will require the State to prove that the adoption of a tax measure is not arbitrary, irrational or disproportional with regards to the interest of foreign investors. In practical terms, this implies that the decisions taken by States in the exercise of their regulatory power pursuing public interest objectives could be challenged by foreign investor even if such decisions comply with the principles of the rule of law and its domestic legal framework.

Different tribunals have recognised that the FET provisions required a minimum standard of treatment for foreign investors, and a violation of such standard would involve "a gross denial of justice, manifest arbitrariness, blatant unfairness, a complete lack of due process, evident discrimination, or a manifest lack of reasons"[49]. Although, it might be argued that such standard has evolved, according to the United Nations Conference on Trade and Development (UNCTAD), the content of FET, as applied and interpreted by ISDS tribunals, includes foreign investors' legitimate expectations, denial of justice and due process, arbitrariness in decision making, discrimination and abusive treatment and therefore no longer circumscribes only to the concept of minimum standard of treatment[50].

The leap from a minimum standard of treatment under

Box 3 *Occidental v. Ecuador* and *EnCana v. Ecuador*[59]

Both cases refer to the implementation of the same taxation measure, which led to the refusal by the tax authorities to refund valued-added tax (VAT) for purchases made in Ecuador. Both companies operated in the oil market, and had a "participation contract" agreed upon with the State. Although both cases were similar, the decisions by the ISDS tribunal differed.

- In the ***Occidental* case**, the claim was brought under the United States – Ecuador BIT. The respondents argued that the claim concerned the non-refund of the VAT, and it was under the scope of the taxation carve-out included in the treaty. Moreover, the State also considered that the rules invoked by the claimants (no less favourable treatment, national treatment and fair and equal treatment) were also within the scope of the carve-out.

  Nevertheless, the tribunal considered that the first paragraph of the carve-out clause providing that "With respect to its tax policies, each Party **should strive to accord fairness and equity** in the treatment of investment of nationals and companies of the other Party", implied the same obligation as FET and, therefore, the fair and equal treatment was outside the scope of the taxation carve-out.

  In addition, the tribunal concluded that the exclusion of a tax measure relating to "the observance and enforcement of terms of an investment agreement" from the scope of the carve-out clause was meant to clarify that every "tax matter associated with an investment agreement" was within their jurisdiction.

- In the ***EnCana* case**, the carve-out provision included in the Canada-Ecuador BIT was somewhat different from the one contemplated in the United States – Ecuador BIT, particularly as the former introduced a general rule of exception of tax-related matters from the application of the BIT, with certain exceptions.

  On this matter, the Tribunal first addressed the definition of the term "tax measure", since the BIT did not include one. The Tribunal considered that a "tax measure" should be analysed from "its legal operation, not its economic effect"[60], therefore "a taxation law is one which imposes a liability on classes of persons to pay money to the State for public purposes"[61]. Following this definition, the Tribunal concluded that its jurisdiction is limited under the BIT with respect to taxation measures (Article XII), subject to the exception for expropriation[62].

  Then, the Tribunal turned to the question of expropriation, as the only exception within the carve-out provision. First it recognised that a foreign investor "has neither the right nor any legitimate expectation that the tax regime will not change, perhaps to its disadvantage, during the period of the investment"[63]. Further, it reasoned that a tax measure itself should not be considered a taking of property; the opposite would deny a universal State prerogative by a guarantee against expropriation[64], particularly in the absence of a specific commitment from the host State.

  The Tribunal concluded that the tax measure adopted by the State did not amount to expropriation, and therefore it was not within the exception included in the carve-out clause as provided by the BIT.

international law to a broader concept of 'legitimate expectations' has direct implications on the rights of States to regulate. Even if it has been generally argued that, in the absence of specific commitments and stabilization clauses in investment contracts, States have the power to lawfully manoeuvre, modify or issue regulations pursuing public objectives[51], such argument could be wrongly interpreted as limiting the power of States to regulate in the face of such specific commitments or even make permissible a broader interpretation of 'legitimate expectations' of investors to allow claims on the basis of FET for the change on the tax regime in the country.

3) Stabilization clauses and tax carve-outs

As mentioned above, the inclusion of tax carve-out provisions in most BITS and other IIAs aimed in principle to avoid possible contradictions among the protections granted to foreign investors on DTTs and BITs and to safeguarding the regulatory space of the State in a quite sensitive issue as tax. Nonetheless, a number of legal advisors continue promoting international arbitration as an appropriate forum to challenge State tax measures which they consider not favourable to foreign investors' interests.

Even when if certain tax matters are excluded from the application of a BIT or IIAs, States should carefully consider the inclusion of stabilization clauses in investment contracts. Such clauses, according to the view of practitioners, could "fill the gap and protect investors from ´adverse changes´ in tax regimes"[52], therefore making tax carve-out clauses in BITs and IIAs useless.

The principal objective of stabilization clauses is to restrain the right of the State to modify its legislation in order to "increase the predictability of the regulatory environment in which the investor will be operating"[53]. In fiscal matters, stabilization clauses pursue the objective of protecting royalty rates and their repatriation, and limiting reforms in the tax regime in general[54]. In addition, the detrimental effects of the stabilization clauses in environmental and social legislation have been identified by several reports[55].

A number of practitioners[56] intend to endorse the idea that modern stabilization clauses do not limit the right of the State to regulate, but rather triggers compensation even if such regulations do not unreasonably affect the economic interest of foreign investors[57]. The reality is that such stabilization clauses have served as a basis for challenging regulatory reforms intended to achieve developing country objectives. Additionally, arbitral tribunals have recognised that under international law the commitments made in favour of foreign investors are binding notwithstanding the power of the Parliament and other State organs under the domestic jurisdiction to override or nullify them[58].

IV. Conclusions

The State's right to regulate is an expression of its sovereignty. The capacity of the State to adopt measures to achieve public interest objectives, and particularly, the welfare of society, should only be limited by the principles of the rule of law.

The right of the State to regulate assumes particular importance when it is related to the financing of the public provision of goods and fair distribution of wealth. State capacity to design its tax regime according to its own needs and development objectives is an integral part of its sovereignty, particularly when it aims at strengthening the tax base to increase domestic resource mobilization to achieve the Sustainable Development Goals.

Nevertheless, the right of the State to tax foreign investors and their operations often faces limitations resulting from the broad and somewhat overstretched interpretations of provisions contained in IIAs by arbitral tribunals in cases brought against States. A number of States have incorporated carve-outs in their IIAs to exclude tax measures from their purview. Nevertheless, such provisions have been proven ineffective in a number of cases, namely because the majority of IIAs do not include a definition of "tax measures", which allows a broad interpretation by ISDS tribunals when facing claims against the State. In addition, the language used by tax carve-out provisions in IIAs spell out general rules on exclusion of taxation matters from the application of the treaty provisions, but includes exceptions within the carve-out.

In other cases, although not expressly mentioned, such exceptions include a fair and equal treatment standard which requires the State to "strive to accord fairness and equity" and "a stable, equitable, favorable and transparent" environment to foreign investors. Similarly, even though most of taxation carve-out clauses in IIAs require the application of double taxation treaties, in particular their dispute settlement procedures, the application of such procedures has been interpreted by ISDS tribunals only as procedural requirements which do not restrict the right of the investor to submit a claim under an IIA, and establishes a 'cooling' period after the notification of intent to arbitrate to the State in question. Under these conditions, States should be careful when drafting IIAs and include clear and unequivocal carve-outs for tax measure -without following the '*matryoshka*' model clauses- as well as provisions recognizing the need to exhaust local remedies before allowing the case to be brought to ISDS tribunals. Clarifying the language on what constitutes a tax matter, and differentiating it from other legislative measures, could also limit the possibility of arbitral tribunals to apply the concept of "legitimate expectations" to the establishment or reform of obligations and rights under a particular tax regime.

Similarly, even if States allow their tax regimes to be reviewed by such tribunals, it would be indispensable to include the "due diligence" obligation by the investor regarding the knowledge of the legal framework of the country before, during and after certain investment is established in a particular jurisdiction. This would entail a comprehensive understanding of how legislative measures can be drafted, adopted, amended or abolished

in such jurisdiction. Only then could the standard of 'legitimate expectations' be applied.

That understanding would entail that a presumed violation of 'legitimate expectations' required the existence of a quasi-contractual relationship between the State and the investor[65] or special or specific commitments[66] granted to the investor . In case such relation or commitments did not exist, any reform or amendment of a particular legislative regime, for example taxation, would require an analysis of the relation between the aim pursued by the legislative measures and their effects on the investment. Such analysis should be built on the criteria normally applied by administrative, constitutional and human rights courts[67].

V. Annex

The Annex is available at: https://www.southcentre.int/wp-content/uploads/2019/03/Annex-IPB14.pdf

Endnotes:

[1] See: Claire Provost, *Taxes on Trial: How Trade Deals Threaten Tax Justice* (Transnational Institute and Global Justice Now, 2016) Annex. Available from https://www.tni.org/en/publication/taxes-on-trial.

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[3] George Turner, "*New estimates reveal the extent of tax avoidance by multinationals,*" Tax Justice Network, 22 March 2017. Available from https://www.taxjustice.net/2017/03/22/new-estimates-tax-avoidance-multinationals/; Alex Cobham and Petr Janský, "Global Distribution of Revenue Loss from Tax Avoidance," Wider Working Paper 2017/55 (UNU-WIDER, March 2017). Available from https://www.wider.unu.edu/sites/default/files/wp2017-55.pdf.

[4] Cobham and Janský, "Global Distribution of Revenue Loss from Tax Avoidance."

[5] Christians, "Sovereignty, Taxation, and Social Contract," p. 109.

[6] Article 25 of the Model Convention with Respect to Taxes on Income and on Capital. Available from https://www.oecd.org/ctp/treaties/2014-model-tax-convention-articles.pdf.

[7] William W Park, "Arbitrability and Tax", in *Arbitrability: International and Comparative Perspectives,* Loukas A. Mistelis and Stavros L. Brekoulakis, eds. (The Netherlands, Kluwer Law International, 2009).

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[9] It has been recognised by a number of tribunals that tax measures could "unilaterally modify" the contractual and legal framework that existed at the time an investment was established in a certain jurisdiction, therefore breaching the FET provision. See: Julie Bédard, David Herlihy, Lea Haber Kuck, Timothy G. Nelson, *The 'Law 42' Arbitrations Against Ecuador and the Importance of BIT Language* (Skadden's Insights, 2015). Available from https://www.lexology.com/library/detail.aspx?g=cfade941-dd9a-46a0-b937-6b88f7733721.

[10] Svitlana Buriak, "Tax Measures Under International Investment Treaties: Current Regulation, Arbitral Practice and Perspectives" (Central European University, 2017), p. 15.

[11] Park , "Arbitrability and Tax,", p. 188.

[12] Ibid., p. 189.

[13] The Energy Charter Treaty (1994), Article 21.3 (b).

[14] Uğur Erman Özgür, *Taxation of Foreign Investments under International Law: Article 21 of the Energy Charter Treaty in Context* (Brussels, Energy Charter Secretariat, 2015), p. 13.

[15] Available from http://ec.europa.eu/trade/policy/in-focus/ceta/ceta-chapter-by-chapter/.

[16] Article 8.9 paragraph 1 of CETA incorporates a non-exhaustive list of public policy objectives, which includes protection of public health, safety, the environment or public morals, social or consumer protection or the promotion and protection of cultural diversity.

[17] Article 28.3 of CETA includes general exceptions to the application of the Agreement. Paragraph 2 of the cited article includes a list of such public policy objectives.

[18] Agreement between the Government of Canada and the Government of the Republic of Ecuador for the promotion and reciprocal protection of investments, unilaterally terminated on 19 May 2018.

[19] Article 2103 of the NAFTA establishes: "Except as set out in this Article, nothing in this Agreement shall apply to taxation measures".

[20] Article 2103.4(g) of the NAFTA

[21] Article 2103.6 refers to Annex 2103.6 which determines as competent authorities of the parties of NAFTA the following: a) in the case of Canada, the Assistant Deputy Minister for Tax Policy, Department of Finance; (b) in the case of Mexico, the Deputy Minister of Revenue of the Ministry of Finance and Public Credit ("Secretaría de Hacienda y Crédito Público"); and (c) in the case of the United States, the Assistant Secretary of the Treasury (Tax Policy), Department of the Treasury.

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October 2018. Available from https://www.bilaterals.org/?nafta-2-0-and-investor-state.

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[25] Energy Charter Secretariat, *The Energy Charter Treaty and Related Documents: A Legal Framework for International Energy Cooperation* (2004). Available from http://www.ena.lt/pdfai/Treaty.pdf.

[26] Ibid., p. 14.

[27] See: Pia Eberhardt, Cecilia Olivet and Lavinia Steinfort, *One treaty to rule them all* (Corporate Europe Observatory and Transnational Institute, 2018), at: https://www.tni.org/files/publication-downloads/one_treaty_to_ruled_them_all.pdf.

[28] In accordance with Article 26.2 (c), the arbitral tribunal could be: International Centre for Settlement of Investment Disputes (ICSID), a sole arbitrator or ad hoc arbitration tribunal established under the Arbitration Rules of the United Nations Commission on International Trade Law (UNCITRAL), or an arbitral proceeding under the Arbitration Institute of the Stockholm Chamber of Commerce.

[29] Provost, *Taxes on Trial: How Trade Deals Threaten Tax Justice.*

[30] See: *Marvin Roy Feldman Karpa v. United Mexican States*, ICSID Case No. ARB(AF)/99/1 (2002).

[31] See: *Yukos Universal Limited (Isle of Man) v. The Russian Federation*, UNCITRAL, PCA Case No. AA 227 (2014).

[32] See: *Occidental Petroleum Corporation and Occidental Exploration and Production Company v. Republic of Ecuador*, ICSID Case no. ARB/06/11 (2012).

[33] Ibid.

[34] United Nations Economic Commission for Africa, *Strategies for mobilizing domestic resources and investments for structural transformation* (2017). Available from https://repository.uneca.org/bitstream/handle/10855/23647/b11832575.pdf?sequence=5.

[35] United Nations Conference on Trade and Development (UNCTAD), *Investment Policy Framework for Sustainable Development* (2015).

[36] UNCTAD, *World Investment Report 2011: Non-Equity Modes of International Production and Development.*

[37] C. Wiśniewski, C. and O. Górska. "A Need for Preventive Investment Protection?" Kluwer Arbitration Blog, 30 September 2015. Available from http://kluwerarbitrationblog.com/blog/2015/09/30/a-need-for-preventive-investment-protection/?utm_source=feedburner&utm_medium=email&utm_campaign=Feed%3A+KluwerArbitrationBlogFull+%28Kluwer+Arbitration+Blog+-+Latest+Entries%29.

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[39] *Occidental Petroleum Corporation and Occidental Exploration and Production Company v. Republic of Ecuador*, ICSID Case no. ARB/06/11 (2012) Award

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[45] See: *Isolux Netherlands, BV v. Kingdom of Spain* (SCC Case V2013/153), *Charanne B.V. and Construction Investments S.a.r.l. v. Spain* (SCC Case No. 062/2012) and *Blusun S.A., Jean-Pierre Lecorcier and Michael Stein v Italian Republic* (ICSID Case No. ARB/14/3).

[46] *Eiser Infrastructure Limited and Energía Solar Luxembourg S.à r.l. v. Kingdom of Spain* (ICSID Case No. ARB/13/36), in Eberhardt, Olivet and Steinfort, *One treaty to rule them all.*

[47] *Eiser Infrastructure Limited and Energía Solar Luxembourg S.à r.l. v. Kingdom of Spain* (ICSID Case No. ARB/13/36) Award, 4 May 2017, para. 387.

[48] *Charanne B.V. and Construction Investments S.a.r.l. v. Spain* (SCC Case No. 062/2012) Award, 21 January 2016, para. 517 (Mena Chambers unofficial translation).

[49] *Glamis Gold, Ltd. v. United States of America* (UNCITRAL) Award, 8 June 2009, paras. 627 and 762.

[50] UNCTAD, "Fair and Equitable Treatment," p. 62.

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[57] Katja Gehne and Romulo Brillo, "Stabilization Clauses in International Investment Law: Beyond Balancing and Fair and Equitable Treatment".

[58] *Revere Copper & Brass, Inc. v. OPIC, 17 ILM 1978.*

[59] *EnCana Corporation v. Republic of Ecuador*, LCIA Case No. UN3481, UNCITRAL, Award (3 February 2006).

[60] Ibid., para. 142(4).

[61] Ibid.

[62] Ibid., para. 147 and para. 149.

[63] Ibid., para. 173.

[64] Ibid., para. 177.

[65] *Glamis Gold, Ltd. v. United States of America* (UNCITRAL) Award, 8 June 2009, para. 766.

[66] *Blusun S.A., Jean-Pierre Lecorcier and Michael Stein v Italian Republic* (ICSID Case No. ARB/14/3) Award, 27 December 2016, para. 319.

[67] Ibid., para. 138.

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While the reform process of international investment protection treaties is evolving, it is still at a nascent stage. Systemic reforms that would safeguard the sovereign right to regulate and balance the rights and responsibilities of investors would require more concerted efforts on behalf of home and host states of investment in terms of reforming treaties and rethinking the system of dispute settlement.

Experiences of developing countries reveal that without such systemic reforms, developing countries' ability to use foreign direct investment for industrialization and development will be impaired.

The policy brief series is intended as a tool to assist in further dialogue on needed reforms.

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The South Centre
Chemin du Champ d'Anier 17
PO Box 228, 1211 Geneva 19
Switzerland
Telephone: (4122) 791 8050
Fax: (4122) 798 8531
E-mail: south@southcentre.int
https://www.southcentre.int

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